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2010



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1 Taxation of Securities Transactions Cite As

Cite As

Cite this publication as:

[Vol. no.] Martin L. Fried, Taxation of Securities Transactions § [sec no.] (Matthew Bender)

Example:

1. Martin L. Fried, Taxation of Securities Transactions § 1.01 (Matthew Bender)

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ISBN **978-0-8205-1729-2**

Library of Congress Card Number: 64-1242

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1 Taxation of Securities Transactions Dedications

Dedications

Dedications

Martin L. Fried Dedication

To

Sue

Linda

Margie

Rusty

and

"L.B."

for they persevered



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1 Taxation of Securities Transactions Preface

Preface

What should be the scope of a book concerned with the taxation of securities transactions? This was the question I asked myself when I began the preparation of this manuscript. The conclusion I reached was that the work must be many things. It must be a book concerned, among other things, with the basic rules of taxing gains and losses from dispositions of property; with the relationship of shareholder and corporation, and of debt holder and obligor; with the provisions governing employee stock options; with the tax consequences that attend a distribution of securities to a beneficiary or partner; and with the treatment of transactions in foreign securities by United States citizens and in domestic securities by foreign persons. On the other hand, since its thrust is the taxation of securities transactions, it cannot be a treatise on, say, capital gains and losses, the taxation of shareholders and corporations, or employee compensation. It is hoped, however, that it does reach the intended goal—a comprehensive treatment of the income taxation of securities.

This book would not have been possible without the assistance of Alan L. Aronson, Thomas M. Dailey, and Edward S. Wactlar, students at the Syracuse University College of Law; David S. Good, James A. Robbins, and Ray L. Steele, students at the University of Iowa College of Law; and Patricia Hamblin, my secretary during my visiting year at the University of Iowa.

Special thanks must go to Claudine Harris. She assumed the difficult task of preparing the index.

Finally, words cannot fully acknowledge the role that my wife, Suzanne, played in this entire endeavor. She typed the manuscript, commented on its content, prepared the table of cases and statutory references, and put up with me from the first word until the last.

M.L.F.



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What's New

1 Taxation of Securities Transactions Scope

Scope

HIGHLIGHTS

Release 63 August 2010

Taxation of Securities Transactions is an essential publication covering all the vital issues and creative planning opportunities in this field.

This publication has been fully updated to keep you abreast of recent federal court decisions and IRS rulings and releases affecting the taxation of securities transactions.

Andrew W. Singer continues the coverage of new developments in the field of taxation of securities transactions with this Release Number 63. Topics covered include:

The Economic Substance Doctrine. Congress codified and clarified the economic substance doctrine by adding *IRC Section 7701(o)* to the IRC in 2010. (See updated § 1.02A for a detailed discussion.)

Specific Exceptions to Capital Gain or Loss Treatment. Although it is generally true that a transaction meeting the requisites for capital gain or loss, i.e., a sale or exchange of a capital asset, will qualify for such treatment, there are a number of situations wherein this does not obtain. For the most part, the exceptions are decreed by specific provision in the Code, but on occasion the result has come about solely through judicial determination. (See newly revised material in § 2.07 for a detailed discussion.)

Direct Pay Tax Credit Bonds--*IRC Section 6431*. In 2010, Congress amended *IRC Section 6431* to give issuers of most qualified tax credit bonds the option, previously available only to issuers of Build America and certain recovery zone bonds, of having their interest costs paid directly by the federal government in lieu of allowing federal tax credits to bondholders. (See new § 17.02[12][g] for a complete discussion.)

Bonds With Original Issue Discount. The tax treatment of original issue discount or "OID," which arises when

the issuer of a debt instrument accepts less than the instrument's face value at maturity as the issue price. It is thus distinguishable from market discount, which arises when a debt instrument is issued at par but thereafter sells on the open market at less than par due to independent market forces. Newly revised Section 17.03 briefly reviews the meaning of terms used in the Code's OID provisions (*IRC Sections 1271-1275*), and examines the tax treatment of OID. (See newly revised § 17.02.)

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CHAPTER 1 Gains and Losses From the Disposition of Property

1-1 Taxation of Securities Transactions 1.syn

§ 1.syn Synopsis to Chapter 1: Gains and Losses From the Disposition of Property

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[c] Transfers of Appreciated Property to Charity.

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CHAPTER 1 Gains and Losses From the Disposition of Property

1-1 Taxation of Securities Transactions § 1.01

§ 1.01 Introduction

Gross income includes "gains derived from dealings in property,"ⁿ¹ and securities are property. Any consideration of the tax aspects of transactions involving securities must therefore start with an understanding of the manner in which gains (and losses, as well) from the disposition of property are measured. As this book is concerned with the taxation of securities transactions, any discussion of rules, problems, and issues having relevance only to property other than securities has been eliminated.ⁿ²

FOOTNOTES:

(n1)Footnote 1. *IRC § 61(a)(3)*.

(n2)Footnote 2. A comprehensive discussion of sales and other dispositions of property can be found in Rabkin & Johnson, *Federal Income, Gift and Estate Taxation*.



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CHAPTER 1 Gains and Losses From the Disposition of Property

1-1 Taxation of Securities Transactions § 1.02

§ 1.02 The Elements of Gain or Loss--The Taxable Event

[1] The Realization Requirement--A Brief Overview.

Neither appreciation nor depreciation in the value of an investment has income tax significance until it is "realized" in a sale or other disposition. There must be a realization of the gain, a "severance of the gain from capital," before appreciation becomes taxable gain.ⁿ¹ Although the Supreme Court has retreated from the view expressed in *Eisner v Macomber* that realization is a Constitutional requirement,ⁿ² as a general rule the income tax statute still requires realization via a taxable event as a prerequisite to gain recognition.ⁿ³ Congress can of course depart in specific instances from a realization requirement that is statutory rather than constitutional, but it has done so only infrequently and in limited circumstances.ⁿ⁴

Gain is normally includible as income in the year realized,ⁿ⁵ unless it is realized in a transaction that qualifies for deferral of gain or loss under one of the Internal Revenue Code's nonrecognition provisions.ⁿ⁶ A loss is correspondingly deductible in the year it is realized in a sale or other disposition; in addition, a loss may be deducted without a sale if, as the result of some identifiable event, the investment becomes worthless.ⁿ⁷ Gain is measured by the excess of the amount realized (usually, the sales price) over the adjusted basis of the investment (typically, cost); conversely, a loss is incurred to the extent the taxpayer's adjusted basis exceeds the amount realized.ⁿ⁸

Investment gains are typically taxed at a maximum capital gains tax rate, currently 15 percent if the investment has been held for more than one year.ⁿ⁹ Capital losses are generally deductible only from capital gains, although a limited amount of up to \$3,000 per year may be deducted from other income.ⁿ¹⁰ Unused capital losses may be carried forward indefinitely, subject to the same limitations.ⁿ¹¹

The Code does not define a taxable event, but *IRC Section 1001(a)*, which contains instructions for calculating realized gains and losses, clearly infers that such gains and losses must arise out of a "sale or other disposition of property." Sales are of course the most common type of taxable event. Other dispositions of property may also be taxable events, as *IRC Section 1001(a)* clearly indicates, but many common dispositions of property have been excluded from the category of taxable events by longstanding administrative practice. These include gratuitous transfers of property, such as gifts and bequests,ⁿ¹² and transfers of less than full ownership in the property, such as a mortgage or pledge of property for the limited purpose of allowing the property to serve as security for a loan,ⁿ¹³ or a lease or license carved out of the ownership interest and conveyed to a third party.ⁿ¹⁴

A loss can be realized as the result of a sale or other disposition of property, but if property becomes worthless a loss may also be realized by any event that establishes the fact and fixes the amount of the loss with respect to the property.ⁿ¹⁵ For example, the holder of stock or securities in a foreign company whose assets are seized or expropriated by its home country is entitled as a result of that expropriation to claim a worthless stock or bad debt deduction without having to go through the formality of a selling the stock or securities for a nominal price.ⁿ¹⁶

[2] Sales as Taxable Events.

"A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent ... "n1 Since "sale" is not defined in the Internal Revenue Code, courts will use its ordinary meaning in determining whether a given transaction is a taxable event for purposes of *IRC Section 1001* unless doing so "would lead to absurd results ... or ... thwart the obvious purpose of the statute."ⁿ²

A sale can take place for tax purposes without the passage of legal title as long as beneficial ownership passes to the purchaser.ⁿ³ In *Miami Nat'l Bank*, the Tax Court recognized a sale of stock for tax purposes even though title did not pass and the stock sold remained in a "subordinated securities account" held by the seller's broker.ⁿ⁴ The subordination agreement gave the seller's broker legal title to the stock, possession of the physical stock certificates, and the right to hypothecate the stock under certain circumstances. On the other hand, the broker continued to recognize the seller as the true owner of the stock in the monthly statements it sent him, and the seller had the right to receive dividends on the stock, to vote the stock, to reacquire the stock by substituting cash or readily marketable securities of equivalent value, and to file a claim against the broker for the proceeds of any shares sold out of the subordination account.ⁿ⁵ The Tax Court found that the seller's retained rights amounted to beneficial ownership of the stock, and that the seller's transfer of those rights to the purchaser (*i.e.*, beneficial ownership) resulted in a sale of the stock for tax purposes.ⁿ⁶

Moreover, passage of legal title does not necessarily guarantee that a "sale" has taken place for federal income tax purposes. For example, the transfer of title to real property from mortgagor to mortgagee as security for a loan is not a "sale, in the ordinary sense of the word" nor is it treated as such for federal income tax purposes.ⁿ⁷ The Supreme Court has observed that:

"[T]axation is not so much concerned with the refinements of title as it is with actual command over the property taxed--the actual benefit for which the tax is paid." *Corliss v Bowers*, 281 U.S. 378 (1930) . In a number of cases, the Court has refused to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of property where the transferor continues to retain significant control over the property transferred. [Citations omitted]. In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed."ⁿ⁸

Following the substance over form principle, the Internal Revenue Service and the courts disregard formal sales as "shams," regardless of whether legal title passes to the purchaser, when excessively high and unrealistic purchase prices, paid largely if not exclusively with nonrecourse indebtedness, make it unlikely that the purchaser will ever acquire an economically significant interest in the property.ⁿ⁹ Conversely, a lease may be reclassified as a sale for tax purposes, despite the lack of a title transfer, when indicia such as the lessee's option to renew the lease at the end of its term for a nominal rent for the remainder of the property's useful life show that the lessee, as a matter of economic substance, is the purchaser of the property.ⁿ¹⁰

There is, however, a limit to how far the Government may go in disregarding or reclassifying a transaction cast in the form of a sale. In many cases there will be more than one path leading to substantially the same economic objective, and the paths may have different tax consequences. Substance over form does not give the Government a license to put the

taxpayer on a path different from the one he chose simply because another path leads to the same economic result but produces more tax.ⁿ¹¹

The Supreme Court has limited substance over form's role to requiring that there be some economic significance to the taxpayer's choice of form beyond the tax benefits derived from using it.ⁿ¹² The Court found that the economic substance requirement was met in *Frank Lyon Co v US*,ⁿ¹³ where a bank, after initially planning to obtain long-term financing for its headquarters building, decided instead to sell the building to the taxpayer and lease it back for a 25-year primary lease term. The taxpayer/purchaser made a \$500,000 down payment and obtained a \$7,140,000 mortgage loan to fund the purchase price. The initial 25 year lease term was the same as the term of the taxpayer's mortgage loan. Rents under the primary lease equaled exactly the amounts taxpayer needed to make principal and interest payments on its mortgage. After expiration of the primary lease, the bank held options to renew the lease for an additional 40 years at rentals calculated to provide the taxpayer with a return of its \$500,000 down payment with interest compounded at 6 percent per annum. Alternatively, the bank held options to repurchase the building at various times at option prices similarly calculated to return taxpayer's \$500,000 down payment with 6 percent interest. In the event the building was destroyed or condemned, the taxpayer's share of any award was limited to a return of its \$500,000 down payment with 6 percent interest; any excess belonged to the bank.

The Supreme Court refused to disregard the sale and leaseback and reclassify the transaction as a secured loan of \$500,000 from taxpayer to the bank at 6 percent interest as the Government urged because the parties' choice of the sale-and-leaseback route had economic consequences the Court could not ignore. As a result of casting the transaction as a sale-and-leaseback rather than a secured loan, the taxpayer was required to incur the substantial mortgage indebtedness necessary to acquire the building, which impacted the taxpayer's balance sheet and limited its ability to obtain financing for other business needs.ⁿ¹⁴ Moreover, the Government's proposal to treat the bank's sale to the taxpayer as though it never happened ignored the real world risk that the taxpayer could lose its \$500,000 down payment if, as the building's actual owner, it was unable to find new tenants or a purchaser for the building once the bank's 25-year primary lease expired. To be sure, its investment would be recovered with interest if the bank exercised its options to renew the lease and/or reacquire the building, but though the taxpayer may have contemplated this outcome it had not reserved a legal right to require the bank to exercise those options. Noting the "many contingencies" affecting the probability that the options would be exercised, "including variations in the value of real estate, in the cost of money, and in the capital structure of [the bank],"ⁿ¹⁵ and stressing the trial court's findings that the option prices were "negotiated at arm's length," and "represented fair estimates of market value," the Supreme Court refused to assume that the bank was bound to exercise its options after the primary lease expired.ⁿ¹⁶

In *Commr v Brown*,ⁿ¹⁷ another landmark Supreme Court case, the taxpayers, owners of a closely held corporation that operated a lumber mill, sold their stock in the corporation to a tax-exempt charitable organization for a \$1.3 million nonrecourse note. The note was payable solely out of the earnings of the corporation's lumber business and secured by its assets. Pursuant to the agreement of sale, the charity immediately liquidated the corporation and leased its lumber mill assets for five years to a newly formed corporation owned by the sellers' attorneys, which continued to operate the business with the same assets and the same personnel as before the sale. The new corporation paid rent to the charity equal to 80 percent of its operating profit, and the charity in turn paid 90 percent of the rent to the former shareholders to amortize the \$1.3 million purchase price of their stock.

The Internal Revenue Service argued that the shareholders' sale lacked economic substance because the sellers did not transfer the economic risks of ownership to the charity, which made no cash investment and assumed no personal liability to pay the purchase price of the stock. The Supreme Court, however, ruled that risk-shifting was not an essential element of a sale.

"To require a sale for tax purposes to be to a financially responsible buyer who undertakes to pay the purchase price from sources other than the earnings of the assets sold or to make a substantial down payment seems to us at odds with commercial practice and common understanding of what constitutes a

sale. The term 'sale' is used a great many times in the Internal Revenue Code and a wide variety of tax results hinge on the occurrence of a 'sale.' To accept the Commissioner's definition of sale would have wide ramifications which we are not prepared to visit upon taxpayers, absent congressional guidance in this direction."¹⁸

Although *Lyon* and *Brown* give tax planners a fairly wide berth, the Internal Revenue Service will continue to challenge sales that more closely resemble a loan, a lease, or other type of transaction. Each case must be resolved on the basis of its particular facts and circumstances.¹⁹ Factors bearing on whether a transaction is a "sale" for tax purposes include: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property.²⁰ However, the relevant factors and the weight to be attached to each can vary with the circumstances involved.²¹

[a] Rescissions, Reformations, and Repurchases.

An option to rescind a sale and restore the *status quo ante* will not, of itself, prevent realization of gain or loss by the seller unless the option is actually exercised before the end of the taxable year.²² The seller's obligation to report a gain even though it may be rescinded and he may ultimately be required to return the sale price is rooted in the claim of right doctrine: as long as the seller has an unrestricted right to the sale proceeds he is required to report the gain as income, notwithstanding the possibility that he may later be called upon to return it.²³

If a right of rescission is actually exercised, and the exercise occurs before the end of the taxable year in which the sale was made, the original sale will be disregarded for federal income tax purposes.²⁴ There must be an actual return of the property and a refund of the purchase price or an unconditional commitment to do so before the end of the taxable year. Where a seller of stock brought suit against the purchaser before the end of the taxable year of sale seeking rescission of the sale on grounds, *inter alia*, of fraud, but the seller continued to hold the purchaser's funds, and the purchaser denied the fraud allegations and contested the lawsuit, the seller's obligation to report gain realized on the sale of the stock was unaffected by his filing of the lawsuit in the taxable year of sale.²⁵ If the sale is rescinded in a year subsequent to the year of sale, the seller remains obligated to report gain or loss in the year of sale, and has no right to re-open or amend the earlier year's return.²⁶ This result is compelled by the annual accounting principle: the rule that "each taxable year is a separate unit for tax accounting purposes" and the income for each year must be determined using the facts as they exist at the end of that year.²⁷ If the seller reacquires property sold earlier in the same taxable year, his basis in the reacquired property is the same as it was immediately before the sale; this follows from the fact that the sale itself is disregarded for tax purposes. If, however, the rescission occurs in a subsequent taxable year, the seller's basis in the reacquired property will be the property's sale price, the amount the seller received for the property and subsequently refunded to the purchaser.²⁸

The same rules apply to a sale declared void by judicial decree, where a state court determines that a mistake was made and retroactively reforms the instrument of sale to conform it to the parties' true intent. In *Davis v US*,²⁹ the taxpayers intended to make gifts of stock to their sons, although the sons were to pay any gift taxes. They asked an executive with their company to draft the necessary documents and he, misunderstanding their intent, drafted the documents as sales contracts rather than gifts. The mistake was discovered and a state court decree reforming the sale documents to effect gifts rather than sales was obtained prior to the end of the taxable year. The Court, finding that the taxpayers had intended to make gifts of the stock, gave effect to the state court's decree, because "the reformation was made in the same taxable year as the original transaction to correct a mistake contrary to the taxpayer's intent."³⁰

If the seller has an option to reacquire the property sold at a price other than the original sales price, but not a right to

rescind, neither the existence of the option nor its later exercise should affect the original sale.ⁿ³¹ Of course, if the seller is legally or economically compelled to exercise the option, then it is not an option at all and the sale will be reclassified or disregarded.ⁿ³² Absent evidence of legal or economic compulsion, courts treat the option as an independent transaction even if it appears likely (though not certain) to be exercised.ⁿ³³

[3] Other Dispositions.

The term "other dispositions" in *IRC Section 1001(a)* signifies Congress' intent to take account of gain or loss derived in any type of transaction in property, unless specifically excluded, whether or not the transaction is considered a sale.ⁿ¹ For example, dispositions involving the retirement of debt instruments through payment by the issuer are common realization events but are not "sales" as that term is usually understood,ⁿ² although for reasons related to the special treatment of capital gains and losses Congress has legislatively declared that such dispositions are to be treated as sales or exchanges for federal income tax purposes.ⁿ³

Any transfer of property subject to indebtedness, whether the indebtedness is recourse or nonrecourse, is a taxable "disposition" of the property if the transfer is not otherwise taxable as a sale, as when encumbered property is surrendered in payment of a debt, or transferred to a third party as a gift. The "amount realized" by the transferor in such a disposition is the amount of the debt.ⁿ⁴

The remainder of this section considers the unique tax issues raised by transactions in property, frequently involving securities, that are not sales but are taxable "dispositions" within the meaning of *IRC Section 1001* in which gain or loss may be realized. These include exchanges in which the property received is "materially different" from the property given up; so-called "bargain sales" in which the transferor receives less than fair market value for transferred property, dispositions of appreciated property to charity, where Congress has effectively required gain recognition in certain instances by disallowing a charitable contribution deduction rather than including the gain in income, and the disposition of property to a spouse, or to a former spouse in a property settlement incident to a divorce, which the courts originally viewed as a taxable event but Congress has legislatively treated, for most purposes, as a nontaxable gift.

[a] Exchanges.

[i] In General.

An exchange has been distinguished from a sale on the ground that the consideration for the latter is expressed in terms of money, "while in an exchange property is transferred in return for other property without the intervention of money."ⁿ⁵ The distinction may have relevance in determining whether a specific nonrecognition provision of the Code will be applicable in a given case,ⁿ⁶ but not for purposes of realization of gain or loss. Since the receipt of new and different property constitutes the requisite severance of gain from capital, most exchanges, like sales, result in a realization of gain or loss.ⁿ⁷

The regulations under *IRC Section 1001* provide that an exchange will not be treated as a taxable event if the property received does not differ "materially either in kind or in extent" from the property given up.ⁿ⁸ The Supreme Court gave a surprisingly technical interpretation of "material difference" in *Cottage Savings Ass'n v Commr*,ⁿ⁹ holding that the regulations are satisfied by any exchange of properties representing "legally distinct entitlements" even though the properties are economic substitutes. The Court ruled that an exchange between two savings banks of participating interests in different but economically equivalent mortgage portfolios were "materially different" within the meaning of the regulations because the obligors and the homes that secured the mortgage loans were different in each of the portfolios. In view of the distinct legal entitlements embodied in each portfolio, the fact that the regulatory agency having jurisdiction over the banks considered the portfolios "substantially identical" from an economic standpoint and on that ground permitted the banks to disregard losses sustained in such portfolio exchanges for financial reporting purposes was not controlling. The bank's financially unrecognized losses were therefore allowed as realized and

deductible losses for tax purposes.ⁿ¹⁰

[ii] Modifications of Debt Instruments.

Not long after the Supreme Court decided *Cottage Savings*, the Treasury Department proposed and subsequently finalized regulations,ⁿ¹¹ dealing with the materiality issue in the context of a modification of a debt instrument; whether a change in the bond's terms, such as its maturity date or interest rate, results in a materially different security justifying treatment of the modification as a taxable exchange.ⁿ¹² Although intended to address taxpayer uncertainty regarding the materiality standard after *Cottage Savings*, they do not apply to exchanges of debt instruments between holders,ⁿ¹³ the type of transaction before the Supreme Court in *Cottage Savings*. Neither do the regulations address the tax consequences of modifications in financial instruments other than debt instruments, or modifications in contracts generally.ⁿ¹⁴

The regulations are notable in two respects. First, they make any "significant modification" in the terms of a debt instrument a realization event--a "deemed exchange"--which triggers recognition of gain or loss (unless protected by one of the Code's nonrecognition provisions), whether or not there has been a physical exchange of debt instruments between the issuer and the holder.ⁿ¹⁵ Second, the regulations mostly distinguish taxable material from nontaxable immaterial modifications by weighing the economic significance of the modifications, rather than rigidly adhering to the "distinct legal entitlement" standard followed in *Cottage Savings*.ⁿ¹⁶

A change in a debt instrument cannot trigger a realization event unless it first meets the definition of a "modification": "any alteration ... of a legal right or obligation of the issuer or a holder of a debt instrument whether ... expressed in a written or oral agreement or inferred from the conduct of the parties or otherwise."ⁿ¹⁷ The purpose of the modification gateway is to insure that (with a few exceptions) there is truly a new agreement between the parties before testing to determine the "significance" of the difference between the old and new agreements and whether it potentially triggers realization of gain or loss. Thus, the unilateral action of one party, such as an issuer's failure to perform an obligation required under the terms of the debt instrument, does not qualify as a "modification" unless the other party expressly or impliedly acquiesces in the changed performance.ⁿ¹⁸ Nor, by definition, is there a *new* agreement if a change in terms occurs automatically by operation of the terms of the original debt instrument.ⁿ¹⁹

However, certain types of alterations are considered so fundamental that they are classified as "modifications" which must be tested for "significance" even though the alterations result from the operation of the original terms of the debt instrument. The exceptions to the general rule are: (1) alterations that result in a substitution of a new obligor or the addition or deletion of a co-obligor;ⁿ²⁰ (2) alterations that change the nature of the instrument from a recourse to a nonrecourse obligation, or vice-versa;ⁿ²¹ and (3) alterations that result in the debt instrument becoming something other than debt for federal income tax purposes.ⁿ²²

Further, if an alteration results from the exercise of an option in the original terms of the debt instrument that effectively requires both parties to agree to the alteration before it becomes effective, the alteration is essentially a new agreement between the parties. Accordingly, the regulations provide that an alteration resulting from the exercise of an option contained in the original terms of the debt instrument will nevertheless be treated as a "modification" unless the option qualifies as a "unilateral option".ⁿ²³ To so qualify it must meet three tests: (1) its exercise must not require the consent or approval of (i) the other party, (including a party related to the other party within the meaning of *IRC Sections 267(b)* or *707(b)(1)*), (ii) a court or (iii) an arbitrator;ⁿ²⁴ (2) at the time the option is exercised or as a result of its exercise, the other party must not have a right to alter or terminate the instrument or to put the instrument to a person related to the issuer;ⁿ²⁵ and (3) if exercise of the option requires payment of consideration, it must be (as of the debt instrument's issue date) either a de minimis amount, a specified amount, or an amount based on a formula that uses objective financial information (as defined in *Treasury Regulation Section 1.446-3(c)(4)(ii)*).ⁿ²⁶ Moreover, even if the option qualifies as a "unilateral option," if its exercise by a holder of a debt instrument results in a deferral of or reduction in any scheduled payment of principal or interest, that alteration will be considered a "modification" which must be tested

for "significance."ⁿ²⁷

An alteration that falls within the definition of a "modification" does not trigger a "deemed exchange" unless it is considered a "significant modification." The next operative part of the regulations, *Treasury Regulation Section 1.1001-3(e)*, contains several bright-line tests for distinguishing significant from insignificant modifications in various situations.

(1) Significant change in yield. A modification to a debt instrument other than a contingent payment instrument is regarded as significant if it has the effect of changing the yield of the instrument by more than the greater of (a) 1/4 of one percent (25 basis points) or (b) 5 percent of the annual yield of the unmodified instrument.ⁿ²⁸

(2) Changes in Timing of Payments. A modification that changes the timing of payments is "significant" if it results in a "material deferral" of the payments. "Materiality" depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amounts deferred, and the time period between modification and actual deferral.ⁿ²⁹ However, the regulations do provide an objective safe harbor: if all deferred payments are unconditionally payable no later than the end of a defined safe harbor period, the deferral will not be considered "material." The safe harbor period begins on the due date of the first deferred payment and ends either five years later, or after the expiration of 50 percent of the original term of the instrument, whichever period is shorter.ⁿ³⁰ Deferrals longer than the safe harbor period may still be shown not to be "material" under the facts and circumstances test.

(3) Substitution of New Obligor on a Recourse Debt Instrument. The substitution of a new obligor on a recourse debt instrument is, ordinarily, an automatic "significant modification."ⁿ³¹ However, in the following three circumstances, contrary to the general rule, the substitution of a new obligor on a recourse debt instrument will not be deemed a "significant" modification.

(i) **Section 381(a) transactions.** The substitution of a new obligor is not a "significant" modification if, in a transaction to which *IRC Section 381(a)* applies, (a) the acquiring corporation (within the meaning of *IRC Section 381*) becomes the new obligor; (b) the transaction does not result in a "change in payment expectations"; as defined below, and (c) the transaction does not result in any "significant alteration" to the terms of the debt instrument.ⁿ³²

A "change in payment expectations" occurs if, as a result of a modification, there is either a "substantial enhancement" or a "substantial impairment" of the obligor's "capacity" to meet the payment obligations under the debt instrument. There is a "substantial enhancement" if the obligor's capacity was "primarily speculative" prior to the modification and is "adequate" thereafter; a "substantial impairment" is the reverse.ⁿ³³ An obligor's "capacity" includes any source for payment, including collateral, guarantees, or other credit enhancement.ⁿ³⁴

There is a "significant alteration" if the transaction causes the terms of the debt instrument to trigger a modification that would have been considered "significant" under the regulations had it resulted from a new agreement of the parties rather by operation of the terms of the instrument.ⁿ³⁵ Suppose, for example, that under the terms of a debt instrument the interest rate is reset annually keyed to an objective index. If the rate is reset pursuant to this provision after an acquiring corporation in a Section 381(a) transaction is substituted as a new obligor, and the debt instrument's yield changes beyond the limits

allowed in *Treasury Regulation Section 1.1001-3(e)(2)*, the yield change is not a "significant alteration" because the alteration was not caused by the acquisition transaction.ⁿ³⁶ On the other hand, a "significant alteration" could occur if a significant change in yield results from a provision in the debt instrument (eg, one requiring a change from a fixed to a variable interest rate) that becomes operative only in the event of an assumption of the debt by a new obligor.ⁿ³⁷

(ii) **Acquisitions of Substantially All the Assets of the Original Obligor.** The substitution of a new obligor is not a "significant" modification if the new obligor (a) acquires substantially all of the assets of the original obligor, (b) the transaction does not result in a change in payment expectations, as defined above, and (c) the transaction does not result in any "significant alteration" to the terms of the debt instrument as defined above.ⁿ³⁸

(iii) **Tax-Exempt Bonds.** The substitution of a new obligor on a tax-exempt bond will not be treated as a "significant" modification if the new obligor is a related entity to the original obligor (as defined in *IRC Section 168(h)(4)(A)*) and the collateral securing the instrument continues to include the original collateral.ⁿ³⁹

(4) Substitution of a New Obligor on Nonrecourse Debt Instrument. Since the holder of a nonrecourse debt obligation agrees to look solely to the collateral for payment, the regulations do not regard the substitution of a new obligor as "significant."ⁿ⁴⁰

(5) Addition or Deletion of Co-Obligor. The addition or deletion of a co-obligor on any debt instrument is a "significant" modification only if it results in a "change in payment expectations," as defined above.ⁿ⁴¹

(6) Change in Security or Credit Enhancement. A modification that releases, substitutes, adds or otherwise substantially alters the collateral for, a guarantee on, or other form of credit enhancement for a **nonrecourse** debt instrument is always "significant" unless (1) it involves a substitution of collateral and the collateral is either fungible or of a type where the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type or rating); or (2) it involves a substitution of one commercially available credit enhancement contract for a similar one; or (3) property securing the nonrecourse debt instrument is improved.ⁿ⁴² However, a modification releasing, substituting, adding or otherwise substantially altering collateral or a guarantee or other form of credit enhancement for a **recourse** debt instrument is only considered "significant" if it results in a "change in payment expectations."ⁿ⁴³ For example, if an issuer of a recourse obligation agrees with a holder to substitute for an existing letter of credit a letter of credit from a second bank with a higher credit rating, the modification is not "significant" if the issuer's capacity to meet payment obligations is not dependent on the letter of credit. The substitution of the new letter of credit would be "significant" if the obligor's capacity is dependent on the letter of credit and the substitution substantially enhances that capacity from primarily speculative to adequate.ⁿ⁴⁴

(7) Change in the Priority of Debt. A modification that changes the priority of a debt instrument relative to other debt of the issuer will not be deemed "significant" unless there is a "change in payment expectations."ⁿ⁴⁵

(8) Changes in the Nature of a Debt Instrument. A modification of a debt instrument is "significant" if it changes a debt instrument into an instrument or property right that is not debt for federal income tax purposes,ⁿ⁴⁶ or changes the nature of a debt instrument from recourse to nonrecourse or vice-versa.ⁿ⁴⁷

There are two exceptions to this rule. First, a defeasance of a tax-exempt bond is not a "significant" modification even though the issuer is released from any liability to make payments if (1) the defeasance occurs by operation of the terms of the original bond and (2) the issuer places in trust government securities or tax-exempt government bonds that are reasonably expected to provide interest and principal payments sufficient to satisfy the payment obligations under the bond.ⁿ⁴⁸ Second, a change from recourse to nonrecourse is not a "significant" modification if (1) the debt instrument continues to be secured only by the original collateral and (2) the modification does not result in a "change in payment expectations" as defined above.ⁿ⁴⁹

(9) Accounting or Financial Covenants. A modification that adds, deletes, or alters customary accounting or financial covenants is not considered "significant."ⁿ⁵⁰

If the significance of a modification cannot be judged under one of the specific rules described above, it must be tested under the general "economic significance" rule: "A modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant."ⁿ⁵¹ For purposes of applying this general rule, all modifications, other than those found "not significant" under one of the specific tests described above, are considered collectively, so that a series of such modifications may be economically significant when considered together although each modification, if considered alone, would not be economically significant.ⁿ⁵²

The following rules of application are to be used in determining whether a modification is "significant" under all the tests (including the economic significance test) prescribed in *Treasury Regulation Section 1.1001-3(e)*:

(1) If a modification is potentially "significant" under more than one rule, it must be tested under each such rule before it can finally be determined to be "not significant."ⁿ⁵³ For example, a modification of a fixed rate debt instrument which defers annual interest payments until maturity must be tested for significance under both the change in yield test and the deferral of scheduled payments test.ⁿ⁵⁴

(2) If a modification otherwise covered by a specific rule becomes effective only upon the occurrence of a substantial contingency, the modification is tested under the general "economic significance" rule rather than the specific rule normally applicable to modifications of that type.ⁿ⁵⁵ Moreover, if any modification that would ordinarily be tested for significance under rules governing changes in obligors, changes in security or debt priority, or changes in the nature of a debt instrument, becomes effective on a substantially deferred basis (whether or not subject to a contingency), the significance of the modification must be determined under the general "economic significance" test rather than any of those specific rules.ⁿ⁵⁶

(3) When the rules applicable to modifications causing changes in yield, changes in timing of payments, changes in obligors or changes in security (including debt priority) prescribe a degree of change that constitutes a significant modification under that rule, a change of the same type but to a lesser degree is not a significant modification.ⁿ⁵⁷ Likewise, if a rule provides that a modification that results in a change in payment expectations is a "significant modification," any modification that does not result in a change of payment expectations is not a "significant modification."ⁿ⁵⁸

(4) Modifications have a cumulative effect. Earlier modifications are combined with later ones if their combined effect creates a "significant modification."ⁿ⁵⁹ However, in testing for the significance of a change in yield, any prior modification occurring more than 5 years before the date of the modification being tested is disregarded.ⁿ⁶⁰

(5) Modifications of different terms of a debt instrument, none of which separately would be a significant modification under the specific rules, cannot be combined to create a significant modification.ⁿ⁶¹ For example, a change in yield that is not a significant modification under *Treasury Regulation Section 1.1001-3(e)(2)* and a substitution of collateral that is not a significant modification under *Treasury Regulation Section 1.1001-3(e)(4)(iv)*, cannot together result in a significant modification. However, although the significance of each modification is tested independently, in testing a particular modification it is assumed that all other simultaneous modifications have already occurred.ⁿ⁶²

Under *Rev Proc 2001-21*,ⁿ⁶³ the issuer of a debt instrument and one or more holders may make an election under certain circumstances to treat a substitution of new for old debt instruments as a realization event even though there is no "significant modification" of terms in the new and old debt instruments within the meaning of *Treasury Regulation Section 1.1001-3*. The holder realizes gain or loss by reason of the election, but such gain or loss is not recognized on the holder's return in the year of the debt substitution. Instead, the holder takes as its basis in the new debt its adjusted basis in the old debt and the holding period for the new debt includes the holding period for the old debt.ⁿ⁶⁴

[b] Gifts and Bargain Sales.

Suppose a taxpayer owns 1,000 shares of publicly traded stock for which he paid \$1 per share but which have since doubled in value to \$2 per share. Desiring to make a gift of the appreciation to his daughter, he considers selling half of his shares on the market to recover his initial \$1,000 investment (500 shares x \$2 per share), and giving the remaining shares to his daughter. In that case, however, he will owe tax on a \$500 gain (\$1,000 realized on the sale less his \$500 cost basis in 500 shares), and fail to accomplish his goal of recovering his original \$1,000 investment.

This was the problem facing the taxpayer in *Fincke v Commr*.ⁿ⁶⁵ The solution: merge the sale and gift transactions into a single "bargain sale" transaction in which all 1,000 shares are transferred to the daughter at a bargain price of \$1 per share (taxpayer's cost). The taxpayer recovers his \$1,000 investment, free of tax, and his daughter receives a gift of the \$1,000 appreciation in value.ⁿ⁶⁶ Approving this technique, the Board of Tax Appeals (predecessor of today's United States Tax Court) held that "where property has been transferred for a substantial consideration which is less than its market value... such transfers constitute bona fide sales coupled with a gift to the extent of the excess of the market value of the property over the selling price."ⁿ⁶⁷

The key to the happy tax result was the Board's decision to calculate gain on the bargain sale using the taxpayer's artificially low "sales price" as the "amount realized," representing only a fraction of its actual value, but deducting therefrom the taxpayer's full basis in the property, allocating no portion of basis to the gift.ⁿ⁶⁸ An alternative approach would have been to apportion the taxpayer's basis between the sale and gift components of the transaction and allow only a proportionate amount of basis to be deducted from the bargain sale proceeds. *IRC Section 1011(b)* requires such apportionment when a taxpayer makes a bargain sale to charity,ⁿ⁶⁹ but in the case of non-charitable donees the recovery of basis rule applied in *Fincke* has been adopted by regulation.ⁿ⁷⁰

Unlike *Fincke*, it is not always obvious that a donor is entering a bargain sale transaction; realization principles can make this a trap for the unwary. A donor may owe tax as a result of a transaction in which he receives no cash or other tangible property but makes a gift of property subject to a mortgage or other secured indebtedness. There is a part sale in these circumstances because the mortgage indebtedness is an "amount realized" as a consequence of the transfer of the property. The donor pays tax on the amount, if any, by which the secured debt exceeds his basis in the property, regardless of whether he is personally liable to repay the debt or whether the donee assumes the indebtedness.ⁿ⁷¹

For a time, it appeared that a transfer of property subject to an obligation to pay the federal gift taxes owed by the donor as a result of making the gift might prove an exception to the rule. The Tax Court and two courts of appeal held that the donor realizes no economic benefit from the donee's payment of gift taxes, and that the donor's intent is simply to make a "net gift" of the property less the taxes imposed on the transfer.ⁿ⁷² The issue reached the Supreme Court in *Diedrich*

v Commr,ⁿ⁷³ which rejected the "net gift" theory. The Court concluded that the donee's assumption of the donor's personal obligation to pay gift tax was similar to the employer's assumption of an employee's income tax liability in *Old Colony Tr Co v Commr*.ⁿ⁷⁴ In both cases, an economic benefit is conferred on the debtor equal to the amount of taxes paid by a third party on his behalf, and that benefit is properly taxable to him. The donor's intent that gift taxes be offset against the value of the gift changes neither the economic benefit bestowed by the donee's payment of those gift taxes nor the donor's obligation to pay income taxes on the value of the benefit.ⁿ⁷⁵

[c] Transfers of Appreciated Property to Charity.

As a general rule, a taxpayer is entitled to deduct from income the fair market value of property contributed to charity, including its value in excess of the taxpayer's basis.ⁿ⁷⁶ The taxpayer does not realize gain as a result of the disposition, even if the transfer is made in satisfaction of a fixed dollar pledge to the charity.ⁿ⁷⁷ The combination of a deduction for the full value of appreciated property and escape from tax on the gain has made charitable contributions of appreciated securities and other property a popular method of charitable giving, but Congress, the Internal Revenue Service and the courts have created several exceptions that limit the use and abuse of this technique.

IRC Section 170(b)(1)(C) imposes a special limitation on the amount that may be deducted currently with respect to donations of "capital gain property"; i.e., capital assets which, if sold at fair market value at the time of the contribution, would generate long-term capital gain.ⁿ⁷⁸ The deduction for the value of capital gain property contributed during the year is limited to 30 percent of the taxpayer's adjusted gross income ("AGI") for the year.ⁿ⁷⁹ If the fair market value of capital gain property contributed by the taxpayer during the year exceeds the capital gain property limitation for that year, the excess can be carried forward to the following five taxable years, but remains subject to the capital gains property limitation in each subsequent year.ⁿ⁸⁰ Alternatively, the taxpayer may elect to forego permanently any deduction for the unrealized capital gain component of the value of capital gain property and thereby avoid application of the capital gain property limitation to the remaining value of such property.ⁿ⁸¹

If appreciated property is not capital gain property, i.e., if sold at its fair market value, gain on its sale would not be long-term capital gain, *IRC Section 170(e)(1)(A)* simply disallows a charitable contribution deduction for the entire value of the property in excess of basis. Thus, a donation of appreciated stock held for 12 months or less is deductible, after applying *IRC Section 170(e)(1)(A)*, only to the extent of the taxpayer's basis in the stock.

IRC Section 170(e)(1)(A) may actually reduce the taxpayer's charitable contribution deduction to zero when "section 306 stock" is donated to charity because, under *IRC Section 306(a)*, the entire proceeds from the sale of such stock may be taxed as "ordinary income."ⁿ⁸² In general, Section 306 stock is preferred stock received as a nontaxable stock dividendⁿ⁸³ (sometimes referred to as a "preferred stock bailout") and the proceeds from its sale or other disposition are taxable as "ordinary income" to the extent the recipient shareholder would have had taxable dividend income had the issuing corporation distributed cash equal to the fair market value of the preferred instead of the stock. Unless the Section 306 stock has appreciated beyond its "dividend" value, therefore, *IRC Section 170(e)(1)(A)* will reduce the deduction allowable for a gift of such stock to zero.ⁿ⁸⁴

Does *IRC Section 170(e)(1)(A)* disallow a charitable contribution deduction for the dividend component of section 306 stock under the temporary tax regime established by Title III of the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA")? JGTRRA generally taxes qualified dividend income ("QDI") and long-term capital gains at the same favorable tax rates.ⁿ⁸⁵ Moreover, JGTRRA treats the "dividend" portion of the proceeds from the sale or other disposition of Section 306 stock as a dividend includible in QDI and taxable at long-term capital gain rates.ⁿ⁸⁶ Technically, a gift of Section 306 stock remains subject to *IRC Section 170(e)(1)(A)* since, if sold, its proceeds are classified as a dividend and "not long-term capital gain."ⁿ⁸⁷ On the other hand, the Congressional purpose for permanently disallowing a charitable contribution deduction under *IRC Section 170(e)(1)(A)* disappears as long as dividends (including income from the disposition of Section 306 stock which is treated as dividends) are taxable at the same rates as long-term capital gains. The question has not yet arisen and may become moot if, in accordance with their

"sunset" provisions, JGTRRA rules and rates are repealed as scheduled for taxable years beginning after December 31, 2010.ⁿ⁸⁸

Another statutory limitation on the charitable contribution deduction for appreciated property applies when such property is donated to or for the use of certain private foundations. With such a private foundation donee, the charitable contribution deduction for appreciated property is limited to the donor's basis even though the unrealized appreciation would have been taxable as long-term capital gain had the property been sold.ⁿ⁸⁹ However, this provision will not apply if the appreciated property is "qualified appreciated stock;" *i.e.*, publicly traded stock for which "market quotations are readily available on an established securities market."ⁿ⁹⁰

A final statutory rule that limits the tax benefit of contributing appreciated property to charity is the special apportionment of basis rule applicable in bargain sales to charity, which increases the amount of gain subject to tax in such sales.ⁿ⁹¹

When a taxpayer makes a bargain sale of appreciated property to charity, he must of course deduct the value of the money or other property received from the charity from the value of the property transferred to the charity in determining the amount of the charitable contribution deduction. A line of cases related to "bargain sales" holds that a charitable contribution deduction may be denied entirely if instead of receiving cash or tangible property the donor receives "substantial benefits" from the charity beyond those available to the general public.ⁿ⁹² Indeed, when the donor receives a substantial benefit from the charity in exchange for transferred property, the contribution of property is not considered a "gift" at all unless the donor can prove that the fair market value of the transferred property exceeds the value of the substantial benefit received.

"Where in return for a transfer a taxpayer receives something patently of more than nominal value from the transferee (whether economic or other), a benefit which other members of the public do not receive, a presumption arises that the transfer from taxpayer to the government or charity was not a gift or at least not a gift in its entirety. An identifiable benefit presumptively provides a *quid pro quo* for the transfer. Where a transaction has an "inherently reciprocal nature" when looked at in its entirety, there is no debate that the entire value of the donor's property which was transferred may not be deducted ... [citations omitted]"ⁿ⁹³

Individual shareholders in a closely held corporation may be reluctant to donate their corporation's appreciated shares to a charity, despite the favorable tax consequences of such gifts, because of concerns about interference with their control over the corporation or the assertion of minority shareholder rights. These concerns can be overcome if the donated shares are immediately redeemed by their closely held corporation from the charity for cash or other corporate property, in which case the shareholder may obtain a charitable contribution deduction for the appreciated value of his donated shares without giving up (except for a brief period) ownership or control of the corporation's stock.ⁿ⁹⁴ The Internal Revenue Service tried to collapse such donation/redemption transactions under the step transaction doctrine,ⁿ⁹⁵ treating the shareholder as if his stock had first been redeemed by the corporation (with the proceeds taxed to the shareholder as a dividend) and the proceeds then contributed by him to the charity. However, the courts refused to integrate the gift and redemption transactions when the charity was under no legal obligation to redeem the donated shares.ⁿ⁹⁶ The Service finally gave up in *Rev Rul 78-197*,ⁿ⁹⁷ where it acquiesced in *Palmer v Commr*, agreed to follow *Grove*, *Behrend*, and *Carrington*, and announced that henceforth it would only treat the proceeds of a redemption of stock donated to charity as income to the donor "if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption."

Nevertheless, the Court of Appeals for the Second Circuit resurrected the Service's step transaction argument in *Blake v Commr*.ⁿ⁹⁸ The taxpayer in that case, in a variation on the donation/redemption theme, donated publicly traded stock to a charitable organization, which immediately sold the stock and used the proceeds to purchase the taxpayer's yacht. The Court of Appeals, affirming the Tax Court's decision,ⁿ⁹⁹ accepted the Commissioner's invitation to apply the step

transaction doctrine.ⁿ¹⁰⁰ The Court found that an "understanding" between the charity and the taxpayer that the charity would sell the stock donated to it by the taxpayer and use the proceeds to purchase taxpayer's yacht created, under principles of promissory estoppel, a legal obligation on the part of the charity to do so.ⁿ¹⁰¹ Disagreeing with *Palmer* and Rev Rul 78-197, the Court also said that the parties' "expectation" that the yacht purchase would follow the stock donation was sufficient to satisfy the requirements of the step transaction doctrine even if the charity had no legal obligation to purchase the yacht.ⁿ¹⁰² Notwithstanding *Blake*, however, the Tax Court views the Government as estopped by *Rev Rul 78-197* from applying the step transaction doctrine in charitable donation/redemption or donation/sale cases if the donee is not *legally* bound to redeem or sell the gifted stock.ⁿ¹⁰³

Gifts of appreciated stock or securities in anticipation of an impending corporate distribution may be attacked under the assignment of income doctrine if not propitiously timed. In *Ferguson v Commr*,ⁿ¹⁰⁴ the taxpayers' rights as shareholders to receive a fixed dollar price per share under a merger agreement were deemed to have "matured" by the time they gave their shares to charity. As a result the merger price paid to the charities in exchange for the donated shares was included in the income of the donor shareholders as taxable gain to the extent the proceeds exceeded their basis in the donated shares.ⁿ¹⁰⁵ In *Kinsey v Commr*,ⁿ¹⁰⁶ *Jones v US*,ⁿ¹⁰⁷ and *Allen v Commr*,ⁿ¹⁰⁸ the assignment of income doctrine was similarly applied when stock was donated to charity after a plan of liquidation had been adopted by the corporation; in each case the donor was held taxable on the liquidation proceeds.

[d] Transfers to a Spouse or Former Spouse.

While most transfers of property between spouses during marriage are probably nontaxable gifts, donative intent is clearly lacking in property settlements incident to the dissolution of a marriage.ⁿ¹⁰⁹ In *US v Davis*, the Supreme Court held that a transferor spouse realized taxable gain in a transfer of appreciated stock to his former spouse, measured by the difference between the stock's fair market value and his basis in the stock.ⁿ¹¹⁰

Although the Supreme Court's decision in *Davis* accorded with recognized tax principles, Congress found the result unsatisfactory for several reasons.ⁿ¹¹¹ A principal concern was that it treated similarly situated taxpayers differently depending on the laws of the state in which they happened to reside. A transfer of property in a marriage settlement could be taxable if state law gave the transferee spouse only inchoate marital rights in the property transferred (as in *Davis*), but nontaxable if state law made the spouses co-owners of property acquired during marriage, as in community property and certain common law jurisdictions.ⁿ¹¹² Congress also questioned the appropriateness of imposing federal income taxes on a transfer of property between spouses when tax law generally treats spouses as an economic unit (eg, transfers of property between spouses are exempt from gift taxes). *Davis* represented a trap for the unwary, since most taxpayers did not expect an intrafamily transfer to have income tax consequences. Perhaps worse, *Davis* allowed tax considerations to intrude upon private decisions "with respect to relations between spouses."ⁿ¹¹³

To achieve uniformity of application of the tax laws in this area and to make federal income taxes less intrusive in a divorce, Congress enacted *IRC Section 1041*, treating transfers of property between spouses (or, if made incident to a divorce, between former spouses) as gifts in most respects. In general, no gain or loss is recognized by the transferor on an intermarital transfer, *IRC Section 1041(a)*, but there are a few statutory exceptions and qualifications to the nonrecognition rule.

First, if the transferee is a "former spouse," the transfer must be "incident to a divorce." This requires either that (1) the transfer be made within one year after the marriage ceases, or (2) the transfer be related to the cessation of the marriage.ⁿ¹¹⁴ The regulations include a safe harbor under which any transfer made pursuant to a divorce or separation instrument not more than 6 years after cessation of the marriage is deemed "related to the cessation of the marriage."ⁿ¹¹⁵ A later transfer, or one not made pursuant to a divorce or separation instrument, is presumed not related to the cessation of the marriage, but the presumption is rebuttable.ⁿ¹¹⁶

Second, *IRC Section 1041* does not apply if the transferee spouse is a nonresident alien.ⁿ¹¹⁷

Third, if property is transferred to a trust for the benefit of a spouse (but not if it is transferred directly to the spouse), the transferor is required to recognize gain to the extent that liabilities assumed by the transferee plus any other liabilities to which the property is subject exceed the transferor's basis in the property.ⁿ¹¹⁸

The transferee spouse takes a basis equal to the basis of the property in the hands of the transferor, as though it were received by gift.ⁿ¹¹⁹ Unlike a gift, however, a transferee spouse is not required to use the fair market value of the property at the time of the transfer as its basis for purposes of determining loss on a subsequent sale when the transferor's adjusted basis is greater than such fair market value (i.e., the transferee can deduct the transferor's built-in loss).ⁿ¹²⁰ Furthermore, again unlike a gift, the transferee spouse may not increase the carryover basis prescribed in *IRC Section 1041(b)(2)* by the amount of cash or other consideration the transferee is required to give up in the marital exchange.ⁿ¹²¹

The Internal Revenue Service and the courts have generally given *IRC § 1041* a liberal reading in accord with its remedial purposes. The Internal Revenue Service has ruled that section 1041 trumps the assignment of income doctrine; thus, a transferor spouse is not taxable on a transfer of her interest in nonqualified stock options and deferred compensation plans to a transferee spouse, either at the time of the transfer or when the stock options are exercised and deferred compensation is actually paid.ⁿ¹²² The tax burden is shifted to the transferee spouse, who must pay tax on the exercise of the stock option under *IRC Section 83*, and tax on receipt of deferred compensation under *IRC Section 61*, as though the transferee rather than the transferor had performed the services. The Service analogizes the position of the transferee spouse in these circumstances to that of a non-earning spouse in a community property state, whose entitlement to a share of the earning spouse's compensation has long been held to require attribution of that share of the compensation to the non-earning spouse for federal income tax purposes notwithstanding the assignment of income doctrine.ⁿ¹²³

There are, however, a few specific Code provisions that the Service believes are not trumped by *IRC Section 1041*. In Rev Rul 87-112,ⁿ¹²⁴ the Service ruled that a cash basis taxpayer was required to recognize income under *IRC Section 454* and *Treasury Regulation Section 1.454-1(a)* upon the transfer of US savings bonds to a spouse, in an amount equal to the accrued but unreported interest on the bonds from the date of issuance to the date of the transfer.ⁿ¹²⁵ In Private Letter Rule 8820086 the Service, relying on the principle of statutory construction that a specific provision prevails over a general one, held that *IRC Section 1041* does not apply to the transfer of an interest in an IRA because the taxation of transfers of such interests is governed specifically by *IRC Section 408(d)(6)*. Since that provision limits nonrecognition treatment when an interest in an IRA is transferred to a spouse or former spouse to transfers "under a divorce or separation instrument..." it would be inconsistent with Congressional intent to allow transfers of IRAs not made under divorce or separation instruments to enjoy nonrecognition under Section 1041. Finally, *IRC Section 453B(g)* also overrides *IRC Section 1041* to a limited extent. Although that paragraph excepts transfers "described in subsection (a) of section 1041" from the general rule taxing dispositions of installment obligations, there is an exception to the exception if the Section 1041(a) transfer is a "transfer in trust." Accordingly, gain realized on a transfer of an installment obligation to a spouse is taxable under *IRC Section 453B(g)* if the transfer is made in trust.

Temporary regulations under *IRC Section 1041* provide that a transfer of property to a third party "on behalf of" a spouse or former spouse may also qualify for nonrecognition treatment if: (1) the transfer to a third party is required by a divorce or separation instrument, or (2) the transfer to a third party is requested in writing by the other spouse (or former spouse), or (3) the transferor receives a written consent or ratification of the transfer to a third party from the other spouse or former spouse.ⁿ¹²⁶ If a third party transfer does qualify, the regulations deem that the property is transferred first to the transferor's spouse or former spouse in a tax-free transaction under section 1041, and then by that spouse to the third party in a transaction to which section 1041 does not apply.ⁿ¹²⁷ For example, if pursuant to a divorce decree or separation agreement H transfers appreciated stock to his spouse W's creditor to discharge W's debt to the creditor, the regulations treat the transaction as though H actually transferred the property to W in a tax-free transaction to which Section 1041 applies (and in which W inherits H's adjusted basis in the stock), and W then

transfers the stock to the creditor in a transaction to which Section 1041 does not apply, triggering gain or loss to W equal to the difference between the amount realized (debt discharged) and H's basis in the stock.ⁿ¹²⁸

The third party rule was soon invoked by taxpayers seeking to bring divorce-related stock redemptions within the ambit of *IRC Section 1041*.ⁿ¹²⁹ If the redeeming spouse was successful in demonstrating that she transferred her stock to the family corporation "on behalf of" the spouse who was the remaining shareholder, she would pay no tax on any gain realized in the transaction under *IRC Section 1041* and the remaining shareholder/spouse, treated as the deemed transferor of the stock to the family corporation by *Temporary Treasury Regulation Section 1.1041-1T*, Q&A 9, would be taxed on the entire redemption proceeds as a constructive dividend to the extent of the corporation's earnings and profits.ⁿ¹³⁰

The courts, however, had a difficult time reconciling *Temporary Treasury Regulation Section 1.1041-1T*, Q&A 9 with existing corporate tax doctrine that prohibited charging a remaining shareholder with receipt of a constructive dividend as a result of a complete redemption of another shareholder's stock unless the remaining shareholder had a pre-existing "primary and unconditional obligation" to purchase the redeemed shares from the redeeming shareholder which was satisfied by the corporation's redemption.ⁿ¹³¹ If the court construed the "on behalf of" language in *Temporary Treasury Regulation Section 1.1041-1T*, Q&A 9 consistently with this doctrine, the transferor spouse would be denied the benefits of *IRC Section 1041* unless she could show that the remaining shareholder/spouse had a primary and unconditional obligation to purchase her stock which was satisfied by the family corporation's redemption of that stock. On the other hand, if the court construed the "on behalf of" language more expansively to give effect to the remedial purposes of *IRC Section 1041*, allowing it to apply whenever the corporate redemption was made pursuant to a judicial decree or spousal agreement even though the remaining shareholder never had a "primary and unconditional obligation" personally to purchase the redeemed stock, the remaining stockholder would either have to suffer a constructive dividend where similarly situated shareholders (outside the divorce context) would not, or the court would have to ignore the constructive transfer provision of *Temporary Treasury Regulation Section 1.1041-1T*, Q&A 9 and allow gain on the redeemed shares to escape tax forever.ⁿ¹³²

A few years after *Arnes* was decided, a majority of the Tax Court in *Read v Commr*,ⁿ¹³³ in one of six opinions filed in the case, held that the words "on behalf of" in *Temporary Treasury Regulation Section 1.1041-1T*, Q&A 9 should be given their "common, ordinary meaning;" that the "primary and unconditional obligation" standard was too restrictive to fit that meaning; and, using the Webster's Dictionary definition, that the standard to be applied is whether the transferor spouse, in redeeming his or her shares, acted "in the interest of" or "as a representative of" the remaining shareholder/spouse.ⁿ¹³⁴ The majority opinion found that this standard was met where all of the wife's shares in the family corporation were redeemed pursuant to a divorce decree that gave the husband the option of either acquiring the shares personally or having the corporation (or its ESOP plan) redeem them, and pursuant to the decree the husband elected to have the corporation redeem the shares. In these circumstances, the directed transfer of his spouse's shares to their corporation was "in his interest" or made "as his representative," and the transferor spouse was entitled to nonrecognition of gain realized in the redemption under *IRC Section 1041*. The Tax Court majority indicated that it did not find the "primary and unconditional obligation" standard to be an appropriate one to apply to "any case involving a corporate redemption in a divorce setting," but since the husband had stipulated that he would accept constructive dividend treatment if the Tax Court found that his wife had transferred her shares on his behalf, that issue was not controverted.ⁿ¹³⁵

Not long after the decision in *Read*, Treasury and the Internal Revenue Service adopted new regulations that removed corporate redemptions from the purview of *Temporary Regulation Section 1.1041-1T*, Q&A 9, and prescribed new rules for determining the tax consequences of a divorce-related redemption.ⁿ¹³⁶ The most striking change made by the regulations allows the spouses (or former spouses), if they can agree, to determine with certainty whether the transferor or the nontransferor spouse pays tax on the redemption transfer, without regard to whether the transfer of stock to the family corporation is made "on behalf of" the nontransferor spouse or satisfies a "primary and unconditional" obligation of the nontransferor spouse to purchase the transferor's stock.ⁿ¹³⁷ The spouses' agreement must be contained in a

divorce or separation instrument or other valid written agreement between the spouses which expressly provides (1) the manner in which the spouses elect that the transaction be taxed (either as a taxable redemption by the transferor spouse with no tax consequences to the nontransferor spouse, or a nontaxable redemption but a constructive distribution of the redemption proceeds to the nontransferor spouse); and (2) that the instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption or other disposition of the stock that is the subject of the redemption. The divorce or separation instrument must be effective, or the valid written agreement must be executed by the parties, before the date on which a return for the year in which the redemption occurred, (but not later than the due date (including extensions) of the return) is filed by the transferor spouse (if the parties elect to make the transferor spouse taxable) or the nontransferor spouse (if the parties elect to make the nontransferor spouse taxable.) There is no requirement that the instrument or agreement, or any form of election, be filed with the return.ⁿ¹³⁸

If the spouses cannot agree, the regulations provide that the transferor spouse is taxable on gain realized in the redemption (*i.e.*, *IRC Section 1041* does not apply) unless, "under applicable tax law," the nontransferor spouse is deemed to have received a constructive distribution from the corporation as a result of the transfer. The preamble to the regulations makes clear that the Treasury considers the "primary and unconditional obligation" standard to be the "applicable tax law" for this purpose.ⁿ¹³⁹ If the remaining stockholder had a primary and unconditional obligation to purchase the redeemed stock, the same constructive transfer rule as that found in *Temporary Treasury Regulation Section 1.1041-1T*, Q&A 9 will apply: the transferor spouse is deemed to have transferred her stock to the nontransferor spouse in a transaction protected by *IRC Section 1041*, and the nontransferor spouse is deemed to re-transfer the stock to the corporation in exchange for the redemption proceeds, which will normally be treated as a constructive dividend to the extent of the corporation's earnings and profits.

FOOTNOTES:

(n1)Footnote 1. *Eisner v Macomber*, 252 US 189 (1920) .

(n2)Footnote 2. *Helvering v Bruun*, 309 US 461 at 469 (1940) ; *Helvering v Horst*, 311 US 112 at 115-116 (1940) (the rule that income is not taxable until realized is "founded on administrative convenience").

(n3)Footnote 3. See *IRC § 61(a)* (income includes gains "derived from *dealings* in property" (emphasis added)).

(n4)Footnote 4. One example is the mark-to-market provisions of *IRC §§ 1256 and 475*. See § 18.05.

(n5)Footnote 5. Interpreting a pre-16th Amendment income tax act, the Supreme Court once took the position that a statute that taxed "income" on an annual basis could not reach any part of a gain realized in the current year that accrued in prior years. *Grey v Darlington*, 82 US (15 Wall) 63 (1872) . Although the current income tax is not subject to that limitation, see *Merchants Loan & Trust Company v Smietanka*, 255 US 509 (1921) , the fact that tax rates on capital gains are lower than rates applicable to other income is sometimes justified as compensating for the "bunching of income" effect of taxing the entire gain when realized. See Blum, "A Handy Summary of the Capital Gains Arguments," 35 Taxes 247 (1957).

(n6)Footnote 6. For investors in stocks and securities, the most important nonrecognition provisions are those dealing with exchanges pursuant to corporate reorganizations. See Ch 8. The installment method of accounting, under which gain is recognized ratably as installment payments are received, is another important exception to the "year realized" rule. See *IRC § 453*, discussed at § 1.05[2].

(n7)Footnote 7. See *IRC § 165(g)* (If any security (including corporate stock) becomes worthless during the taxable year, the security is treated as disposed of in a sale or exchange of a capital asset on the last day of the taxable year.) See discussion at § 1.05[1].

(n8)Footnote 8. *IRC § 1001(a)*.

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(n9)Footnote 9. *IRC § 1(h)(1)(c)*. A limited amount of such capital gains may be taxable at a 0 percent tax rate, *i.e.*, they are tax-exempt, depending on the taxpayer's filing status and amount of other income. *IRC § 1(h)(1)(B)*. By contrast, the top rate bracket for ordinary income is currently 35 percent. *IRC § 1(a)*. The 15 percent maximum capital gains rate applicable to most long-term capital gains does not apply to gains from the sale of "collectibles," "qualified small business stock," or "unrecaptured section 1250 gain," which are subject to maximum capital gains tax rates of 28 percent, 28 percent, and 25 percent, respectively. *IRC § 1(h)(1)(D) and (E)*. The taxation of capital gains, including rates of tax, is discussed in detail in Ch 2.

(n10)Footnote 10. *IRC § 1211*.

(n11)Footnote 11. *IRC § 1212*.

(n12)Footnote 12. See Rev Rul 55-410, 1955-1 CB 297. While a bequest by a testator of specific property is not taxable to the testator or his estate, if the testator leaves a fixed dollar legacy or other form of pecuniary bequest and his estate satisfies the fixed dollar legacy with property distributed from the estate, any gain or loss that accrued with respect to the property between the date of death and date of distribution must be recognized on the estate's return. *Treas Reg § 1.661(a)-2(f)*; *Kenan v Commr*, 114 F2d 217 (2nd Cir 1940) ; *Suisman v Eaton*, 15 F Supp 113 (D Conn 1935) , *aff'd* 83 F2d 1019 (2nd Cir) , *cert denied* 299 US 573 ; *Rev Rul 60-87*, 1960-1 CB 286 .

(n13)Footnote 13. *Woodsam Assoc, Inc v Commr*, 198 F2d 357 (2nd Cir 1952) .

(n14)Footnote 14. *Bell Intercontinental Corp v US*, 381 F2d 1004 (Ct Cl 1967) .

(n15)Footnote 15. *SS White Dental Mfg Co v US*, 274 US 398 (1928) ; *IRC § 165(g)*.

(n16)Footnote 16. *Id.*

(n17)Footnote 1. *Commr v Brown*, 380 US 563, 571 (1965) . The Supreme Court was quoting from *Iowa v McFarland*, 110 US 471 (1883) , a case which held that the transfer of public land to soldiers as an enlistment bonus was not a "sale" of the land for purposes of a statute that granted to certain states, when they were admitted to the Union, 5 percent of the proceeds from federal "sales" of public lands within their borders. The conclusion that a transfer of property for services is not ordinarily regarded as a "sale" is probably still valid today, although such transfers are nevertheless taxable events under the "other disposition" language of *IRC § 1001(a)*. See *United States v General Shoe Corp*, 282 F2d 9 (6th Cir 1960) ; *International Freighting Corp v Commr*, 135 F2d 310 (2nd Cir 1943) ("delivery of shares ... [as compensation for services] constituted a disposition in exchange for a valid consideration ... "(emphasis added)). However, the quoted definition is on shakier ground in limiting the common understanding of "sales" to transfers for a *fixed* price. At least today, a transfer of property for a partially or wholly contingent sales price is commonly understood to be a "sale," for tax and other purposes. See *Allen v Commr*, *TC Memo 1975-39* and cases cited therein (Supreme Court in *Brown* did not mean to imply, even in dictum, that a contingent price sales price was not within the commonly understood meaning of a sale).

(n18)Footnote 2. *Id.*

(n19)Footnote 3. *Miami Nat'l Bank v Commr*, 67 TC 793 (1977) . See also *Boykin v Commr*, 344 F2d 889 (5th Cir 1965) ; *Rev Rul 54-607*, 1954-2 CB 177 .

(n20)Footnote 4. The seller intended to make a present transfer of the stock at the closing, but the stock actually remained in the dealer's subordinated securities account for almost 2 1/2 years after the sale before the shares were physically transferred to the purchaser.

(n21)Footnote 5. Since the seller's claim would be for the stock's value on the date sold rather than the date the stock was placed in the subordinated securities account, the seller would enjoy the benefit of any subsequent

appreciation or bear the burden of any decrease in the stock's value. *Miami Nat'l Bank v Commr*, 67 TC at 801 .

(n22)Footnote 6. The taxpayer in *Miami Nat'l Bank* was neither the seller nor the purchaser but the issuer of the stock in dispute. The ultimate question for decision was whether the taxpayer/issuer was entitled to file consolidated tax returns with its parent company, the purchaser of the stock in the above transaction. In order to file consolidated returns with the taxpayer the parent had to "own directly" at least 80 percent of its voting stock, see *IRC § 1502(a)(2)*, and to meet the 80 percent requirement the parent needed to include in its stock ownership the stock acquired from the seller which physically remained with the seller's broker in the subordinated securities account during the taxable years in issue. The Tax Court's holding that seller had transferred beneficial ownership in the stock to the taxpayer's parent, and therefore "sold" the stock to the taxpayer's parent, allowed the taxpayer and its parent to file consolidated returns in those years.

(n23)Footnote 7. See, eg, *United National Corp v Commr*, 33 BTA 790, 794 (1935) , *nonacq* 1936-1 CB 47 : "It is an established doctrine that a court of equity will treat a deed, absolute in form, as a mortgage, when it is executed as security for a loan of money. That court looks beyond the terms of the instrument to the real transaction; and when that is shown to be one of security, and not of sale, it will give effect to the actual contract of the parties." (Quoting from the Supreme Court's decision in *Peugh v Davis*, 96 US 332).

(n24)Footnote 8. *Frank Lyon Co v US*, 435 US 561, 572-73 (1978) .

(n25)Footnote 9. See, eg, *Coleman v Commr*, 16 F3d 821 (7th Cir 1994) ; *Grodts & McKay Realty, Inc v Commr*, 77 TC 1221 (1981) . In such cases, the purchaser is attempting to acquire not property but tax benefits.

(n26)Footnote 10. *Starr v Commr*, 274 F2d 294 (9th Cir 1959) . The property leased in *Starr*, a sprinkler system installed in a building owned by the lessee, "was tailor-made for...[that] specific piece of property," and would have a "negligible" value to the lessor in the unlikely event it were ever removed from the building, which lent further support to the conclusion that the purported lease of the sprinkler system was, in substance, a sale. 274 F2d at 295 .

(n27)Footnote 11. See *Commr v First Security Bank of Utah*, 405 US 394, 398 (n 4) (1972), quoting Learned Hand's famous dictum in *Commr v Newman*, 159 F2d 848, 850-851 (2nd Cir 1947) (dissenting opinion): "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant."

(n28)Footnote 12. For a fuller discussion of the economic substance doctrine, see § 1.02A below.

(n29)Footnote 13. 435 US 561 (1978) .

(n30)Footnote 14. The Court thought it significant that state and federal bank regulators rejected the bank's original plan to self-finance the headquarters building because the regulators feared that such indebtedness on the bank's books would impair its capital. The fact that the bank regulators approved the sale-and-leaseback scheme was indicative of a real economic difference between a direct loan and a sale-and-leaseback financing arrangement in these circumstances. 435 US at 564 .

(n31)Footnote 15. 435 US at 579-80 .

(n32)Footnote 16. In general, an unexercised option to reacquire property sold will not defeat a completed sale for tax purposes unless the option holder is legally bound or economically compelled to exercise the option. See discussion at § 1.02[1][b] below.

Frank Lyon Co was distinguished, and a purported sale was reclassified as a loan, in *Schering-Plough Corp v US*, 2009 US Dist LEXIS 77467 at *104-109 (DNJ August 28, 2009) .

(n33)Footnote 17. *380 US 563 (1965)* .

(n34)Footnote 18. *380 US at 575* . The Commissioner originally argued before the Tax Court that there was no "sale" at all for tax purposes (including *IRC § 1001(a)*), but later conceded that position and in the Supreme Court argued that even if a bootstrap sale could be considered a sale giving rise to gain or loss under *IRC § 1001*, it was not a "sale or exchange" within the meaning of the capital gains provisions (*IRC § 1222(3)*); therefore, although the sellers may have realized gain it was taxable as ordinary income and not at preferential long-term capital gains rates. As the quotation in the text above indicates, the Supreme Court drew no distinction between the meaning of "sale" in *IRC §§ 1001 and 1222*, at least with regard to the role of risk-shifting.

(n35)Footnote 19. *Frank Lyon v US 435 US at 581, n 16* . The trial court makes the determination of what the facts and circumstances are subject to a "clearly erroneous" standard of appellate review, but whether those facts do or do not support classification of the transaction as a "sale" for tax purposes is a question of law subject to *de novo* appellate review.

(n36)Footnote 20. *Grodt & McKay Realty, Inc v Commr, 77 TC 1221, 1237* .

(n37)Footnote 21. In *Torres v Commr, 88 TC 702 (1987)* , the Tax Court found that half the factors listed in *Grodt & McKay*, which involved a purported sale of cattle, had "little relevance" to a sale-and-leaseback of office equipment. *88 TC at 721* . Of greater importance in *Torres* were: (1) whether the office equipment had a useful life significantly in excess of the leaseback term; (2) whether there was a purchase option exercisable by the lessee at less than fair market value; (3) whether any renewal rental at the end of the leaseback term was set at fair market rent; and (4) whether there was a reasonable possibility that the owner of the property could recoup his investment in the property from the income producing potential and residual value of the property at the expiration of the lease. *Id. In Miami Nat'l Bank v Commr, 67 TC 793 (1977)* , involving a sale of corporate stock, the relevant factors taken into account in deciding whether the stock had been sold for federal income tax purposes included legal title, possession, right to vote, right to receive dividends, the right of a third party bailee to sell the stock and the right to redeem the stock from the bailee by substituting cash or other collateral.

(n38)Footnote 22. See *Hope v Commr, 55 TC 1020 (1971)* , *affd 471 F2d 738 (3rd Cir 1973)* ; *Schultz v Commr, 59 TC 559 (1973)* ; *Hutcheson v Commr, TC Memo 1996-127* ; *Robinson v Commr, TC Memo 1973-242* ; *Rev Rul 80-58, 1980-1 CB 181* . A right of rescission may arise as a matter of law, eg, the right of an innocent party to rescind the sale upon discovery of fraud or misrepresentation, see *Hope v Commr, 55 TC 1020 (1971)* , *affd 471 F2d 738 (3rd Cir 1973)* , or be acquired under the terms of the contract. See *Rev Rul 80-58, 1980-1 CB 181* (sale of land made conditional on buyer being able to obtain rezoning of property); *Robinson v Commr, TC Memo 1973-242* (buyer given unconditional option or "put" for approximately 18 months after the sale to tender stock back to seller for original sales price plus interest).

(n39)Footnote 23. See *James v US, 366 US 213, 219-20 (1961)* ; *Schultz v Commr, 59 TC at 564* .

(n40)Footnote 24. See *Rev Rul 80-58, 1980-1 CB 181* .

(n41)Footnote 25. *Hope v Commr, 55 TC 1020 (1971)* , *affd 471 F2d 738 (3rd Cir 1973)* .

(n42)Footnote 26. *Rev Rul 80-58, 1980-1 CB 181* . See also *Hope v Commr, 55 TC 1020 (1971)* , *affd 471 F2d 738 (3rd Cir 1973)* ; *Schultz v Commr, 59 TC 559 (1973)* ; *Hutcheson v Commr, TC Memo 1996-127* .

(n43)Footnote 27. *Security Flour Mills Co v Commr, 321 US 281 (1944)* .

(n44)Footnote 28. *Rev Rul 80-58, 1980-1 CB 181* .

(n45)Footnote 29. *378 F Supp 579 (ND Tex 1974)* .

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(n46)Footnote 30. *378 F Supp at 582* . On the other hand, as in rescission cases, federal courts have refused to give reformation decrees retroactive effect to prior taxable years. *Van Den Wymelenberg v US*, 397 F2d 443, 445 (7th Cir 1968) ("not even judicial reformation can operate to change the federal tax consequences of a completed transaction"); *American Nurseryman Pub Co v Commr*, 75 TC 271 (1980) .

(n47)Footnote 31. See *Fisher v Commr*, 30 BTA 433 (1934) . Note, however, that where, as in *Fisher*, the seller sells stock at a loss but acquires an option to reacquire the same or "substantially identical" stock, the statutory "wash sale" provisions, *IRC § 1091*, may result in the disallowance of a deduction for any realized loss.

(n48)Footnote 32. See *United National Corp v Commr*, 33 BTA 790 (1935) , *nonacq 1936-1 CB 47* , where the Board of Tax Appeals, applying the substance over form doctrine for the benefit of the taxpayer, reclassified the seller's "sale" of stock as a loan because the seller not only had an option to repurchase the stock sold but could be (and was) legally compelled by the purchaser to repurchase it. Despite casting the transaction in the form of a sale and initially reporting the transaction in that manner on their books and tax returns, the parties intended the transaction to be a secured loan. The loan was repaid and the stocks returned within 2 months of the original transaction, in the same taxable year. The Board distinguished true option cases like *Fisher v Commr*, 30 BTA 433 (1934) , on the ground that the seller in *United National* had not merely the right but the *obligation* to reacquire the subject matter of the sale.

(n49)Footnote 33. See *Thompson v Commr*, 66 TC 1024, 1048 (1976) , *affd on other grounds 631 F2d 642 (9th Cir 1980)* , *cert denied 452 US 961* , where the Tax Court refused to hold that a seller's extremely favorable option to repurchase negated a sale even though the Court found it "difficult to believe that anyone in the position of a true beneficial owner [i.e., the purchaser], seeking to maximize potential gain, would enter into an agreement such as [the purchaser's option agreement with seller]."

(n50)Footnote 1. See *Herbert's Estate v Commr*, 139 F2d 756 (3d Cir 1943) , *cert denied 322 US 752 (1944)* .

(n51)Footnote 2. *Herbert's Estate v Commr*, 139 F2d 756 (3d Cir 1943) (retirement of a note through payment is a taxable disposition even though not a "sale"); *Long v Commr*, 96 F2d 270 (9th Cir 1938) , *cert denied 305 US 616 (1938)* (charging off debt as "worthless" is a disposition for purposes of federal tax law).

(n52)Footnote 3. *IRC §§ 1271(a)* (amounts received on retirement of a debt instrument considered "received in exchange therefor") and 165(g) ("sale or exchange" treatment upon worthlessness of a security that is a capital asset).

(n53)Footnote 4. See *Rev Rul 90-16, 1990-1 CB 12* (transfer to lender); *Ebben v Commr*, 783 F2d 906 (9th Cir 1986) (transfer to charitable donee). See also *Gehl v Commr*, 102 TC 784 (1994) , *affd without published opinion 50 F3d 12 (8th Cir 1995)* (an insolvent taxpayer's surrender of property with a recourse mortgage to the mortgagee is taxable to the extent the fair market value of the property exceeds the taxpayer's adjusted basis; the exclusion for discharge of indebtedness income under *IRC § 108* applies only to the difference between the amount of the mortgage debt and the fair market value of the property).

(n54)Footnote 5. *Spalding v Commr*, 7 BTA 588, 590 (1927) .

(n55)Footnote 6. See, eg, *IRC § 1031*.

(n56)Footnote 7. See, eg, *Rev Rul 73-558, 1973-2 CB 298* ; *Rev Rul 69-263, 1969-1 CB 197* ; *Rev Rul 55-757, 1955-2 CB 557* .

(n57)Footnote 8. *Treas Reg § 1.1001-1*.

(n58)Footnote 9. *499 US 554, 560-561 (1991)* .

(n59)Footnote 10. The Court relied on its early "realization" decisions in *US v Phellis, 257 US 156 (1921)* , *Marr v*

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US, 268 US 536 (1925) , and *Weiss v Stearn*, 265 US 242 (1924) , the progenitors of the Treasury regulation in question. In *Phellis* and *Marr* the Court found no material difference between stock received and stock given up pursuant to a reorganization involving the reincorporation of the same business in the same state, and therefore found nontaxable a shareholder's exchange of shares in the old corporation for shares in the new reincorporated entity. In *Weiss v Stern*, on the other hand, the reincorporation occurred in a different state, giving the reincorporated entity legal rights and powers different in some respects from those of the old corporation. This legal distinction, though without economic significance in terms of the value of the shares of the old and new corporations, was deemed sufficient in *Weiss v Stearn* to make the shares of the old and reincorporated entities "materially different" which justified treating the exchange as a taxable event in which gain or loss had to be recognized.

(n60)Footnote 11. *Treas Reg § 1.1001-3*.

(n61)Footnote 12. The *Cottage Savings* regulations were proposed on December 2, 1992, 57 FR 57034 , and adopted by TD 8675 , 61 FR 32926 , on June 26, 1996.

(n62)Footnote 13. See *Treas Reg § 1.1001-3(a)(1)*.

(n63)Footnote 14. See TD 8675 , 61 FR at 39927; Peaslee, "Modifications of Nondebt Financial Instruments as Deemed Exchanges," 95 *Tax Notes* 737 (Apr 29, 2002).

(n64)Footnote 15. *Treas Reg § 1.1001-3(b)*. The Internal Revenue Service and the courts applied the "material difference" test in *Treas Reg § 1001-1* many times prior to the issuance of the *Cottage Savings* regulations, but usually in the context of a physical exchange by a holder of the debt instrument for another instrument issued by the same obligor. See, eg, *Motor Products Corp v Commr*, 47 BTA 983 (1942) , *affd* 143 F2d 449 (6th Cir 1944) (extended maturity date on debenture received did not make it "materially different" from debenture given up); *Girard Trust Co v US*, 69 F Supp 874 (ED Pa 1946) , *affd* 166 F2d 773 (3rd Cir 1948) (change in both maturity date and interest rate in debentures received represented a "material difference" from debentures of the same obligor that were given up); *Mutual Savings & Loan Co v Commr*, 184 F2d 161 (5th Cir 1950) (exchange of defaulted municipal bonds for refunding bonds of same municipality containing changes in interest rate, maturity date and sinking fund was not a taxable event; it did not create a "new indebtedness" because the municipality did not have the legal right to issue new indebtedness under state law without authorization by the electorate). In *Rev Rul 73-160, 1973-1 CB 365* , the Internal Revenue Service held that the "material difference" test could also be applied when a change is made to the terms of an existing debt instrument other than by the issuance of a new instrument. ("The income tax liability resulting from a particular transaction involving a change in the terms of outstanding securities is not controlled entirely by the mechanical means used for the accomplishment of the change.") Although a strong "substance over form" case can be made for the "deemed exchange" approach, it has yet to be tested in court.

(n65)Footnote 16. See *Treas Reg § 1.1001-3(e)*. The regulations' emphasis on the economic significance of the modifications is mostly beneficial to taxpayers, but in some instances can produce a taxable event where none existed under prior law. Compare *Treas Reg §§ 1.1001-3(e)(2)* and (3) (change in yield or deferral of maturity date can be a "significant" modification triggering a "deemed exchange") with *Rev Rul 73-160, 1973-1 CB 365* ("mere extension of the maturity date" is not a "material" difference); *West Mo Power Co v Commr*, 18 TC 105 (1952) , *acq* 1952-2 CB 3 ; *Motor Products Corp v Commr*, 47 BTA 983 (1942) , *affd* 143 F2d 449 (6th Cir 1944) ; *City Bank Farmers Tr Co v Hoey*, 52 F Supp 665 (SDNY 1942) , *affd per curiam*, 138 F2d 1023 (2nd Cir 1943) .

(n66)Footnote 17. *Treas Reg § 1.1001-3(c)(1)(i)*.

(n67)Footnote 18. *Treas Reg § 1.1001-3(c)(4)(i)*. The regulations provide that a holder's temporary forbearance from exercising default rights promptly after the issuer's failure to perform will not be regarded as such an acquiescence provided (1) there is no written or oral agreement to alter other terms of the instrument, and (2) the forbearance does not last beyond (a) two years following the issuer's failure to perform, plus (b) any additional period in which the parties are

conducting good faith negotiations or the issuer is in a title 11 or similar bankruptcy case. *Treas Reg* § 1.1001-3(c)(4)(ii).

(n68)Footnote 19. *Treas Reg* § 1.1001-3(c)(1)(ii). Thus, a change in interest rate is a modification of the instrument if accomplished by agreement between the issuer and the holder after the debt instrument is issued, but not if the rate is changed pursuant to a provision in the debt instrument that automatically resets the interest rate annually based on the value of an index. *Treas Reg* § 1.1001-3(c)(1)(ii).

(n69)Footnote 20. *Treas Reg* § 1.1001-3(c)(2)(i).

(n70)Footnote 21. *Id.*

(n71)Footnote 22. *Treas Reg* § 1.1001-3(c)(2)(ii). The conversion of a debt instrument into equity of the issuer pursuant to an option granted to the holder by the original terms of the instrument is not subject to this rule, however, nor is it subject to the exception discussed below regarding alterations made pursuant to an option granted by the terms of a debt instrument.

(n72)Footnote 23. *Treas Reg* § 1.1001-3(c)(2)(iii)(A).

(n73)Footnote 24. *Treas Reg* § 1.1001-3(c)(3)(ii).

(n74)Footnote 25. *Treas Reg* § 1.1001-3(c)(3)(i).

(n75)Footnote 26. *Treas Reg* § 1.1001-3(c)(2)(iii).

(n76)Footnote 27. *Treas Reg* § 1.1001-3(c)(2)(iii)(B).

(n77)Footnote 28. *Treas Reg* § 1.1001-3(e)(2).

(n78)Footnote 29. *Treas Reg* § 1.1001-3(e)(3)(i).

(n79)Footnote 30. *Treas Reg* § 1.1001-3(e)(3)(ii). If a modification results in a deferral that is shorter than the full "five year or 50 percent of original term" safe harbor period, the unused portion may be used as a safe harbor for any subsequent deferral of payments on the instrument.

(n80)Footnote 31. *Treas Reg* § 1.1001-3(e)(4)(i). The regulations specify that a Section 338 election following a qualified stock purchase of an issuer's stock is not regarded as a "substitution of a new obligor," *Treas Reg* § 1.1001-3(e)(4)(i)(F). Similarly, the filing of a petition in a title 11 or similar case will not be treated as the substitution of a new obligor. *Treas Reg* § 1.1001-3(e)(4)(i)(G).

(n81)Footnote 32. *Treas Reg* § 1.1001-3(e)(4)(i)(B).

(n82)Footnote 33. *Treas Reg* § 1.1001-3(e)(4)(vi)(A).

(n83)Footnote 34. *Treas Reg* § 1.1001-3(e)(4)(vi)(B).

(n84)Footnote 35. *Treas Reg* § 1.1001-3(e)(4)(i)(E).

(n85)Footnote 36. *Treas Reg* § 1.1001-3(g), Ex 7.

(n86)Footnote 37. Cf *Treas Reg* § 1.1001-3(g), Ex 5.

(n87)Footnote 38. *Treas Reg* § 1.1001-3(e)(4)(i)(C).

(n88)Footnote 39. *Treas Reg § 1.1001-3(e)(4)(i)(D)*.

(n89)Footnote 40. *Treas Reg § 1.1001-3(e)(4)(ii)*.

(n90)Footnote 41. *Treas Reg § 1.1001-3(e)(4)(iii)*. The regulations warn that if the addition or deletion is part of a transaction or series of transactions that results in the substitution of a new obligor, the entire transaction must be tested for "significance" under the regulations dealing with a substitution of a new obligor, as discussed in paragraphs (3) and (4) above.

(n91)Footnote 42. *Treas Reg § 1.1001-3(e)(4)(iv)(B)*.

(n92)Footnote 43. *Treas Reg § 1.1001-3(e)(4)(iv)(A)*.

(n93)Footnote 44. *Treas Reg § 1.1001-3(g)*, Ex 8.

(n94)Footnote 45. *Treas Reg § 1.1001-3(e)(4)(v)*.

(n95)Footnote 46. *Treas Reg § 1.1001-3(e)(5)(i)*. In making a determination as to whether a modification changes debt to equity for tax purposes, any deterioration in the financial condition of the obligor between the issue date of the instrument and the date of the modification will not be taken into account unless, in connection with the modification, a new obligor is substituted or added or an existing obligor is removed. *Id.* Proposed regulations clarify that a decrease in the fair market value of a debt instrument is not taken into account for purposes of determining whether modified debt is not debt for federal income tax purposes to the extent that the decrease is attributable to the deterioration in the financial condition of the obligor and not to a modification of the terms of the instrument. *Prop Treas Reg § 1.1001-3(f)(7)*. Thus, if a debt instrument is significantly modified, and the issue price of the modified debt instrument is determined under *Treas Reg § 1.1273-2(b)* or *(c)* (relating to a fair market value issue price for publicly traded debt), any increase in the modified debt instrument's yield that is attributable to the new issue price generally is not taken into account to determine whether the modified instrument is debt or some other property right for federal income tax purposes. However, any portion of the increased yield that is not attributable to a deterioration in the financial condition of the issuer, such as a change in market interest rates, is taken into account. Notice of Proposed Rulemaking, REG-106750-10, 75 FR 31736, 31737 (June 4, 2010) .

(n96)Footnote 47. *Treas Reg § 1.1001-3(e)(5)(ii)*. If an instrument is not either substantially all recourse or substantially all nonrecourse before and after a modification, and there is a modification that affects the classification of the debt as recourse or nonrecourse, the modification must be tested under the catch-all "economic significance" test.

(n97)Footnote 48. *Treas Reg § 1.1001-3(e)(5)(ii)(B)(1)*.

(n98)Footnote 49. *Treas Reg § 1.1001-3(e)(5)(ii)(B)(2)*. The debt instrument will be considered "secured only by the original collateral" even if some of the units of the original collateral are or have been replaced by other units of the same or similar type and value if the original collateral is fungible or otherwise of a type where the particular units pledged are unimportant. *Id.* See also *Treas Reg § 1.1001-3(e)(4)(iv)(B)*.

(n99)Footnote 50. *Treas Reg § 1.1001-3(e)(6)*.

(n100)Footnote 51. *Treas Reg § 1.1001-3(e)(1)*.

(n101)Footnote 52. *Id.*

(n102)Footnote 53. *Treas Reg § 1.1001-3(f)(1)(i)*.

(n103)Footnote 54. See *Treas Reg § 1.1001-3(g)*, Ex 4. *Treas Reg § 1.1001-3(g)*, Ex 1 provides another example. Suppose a holder pays an issuer consideration to waive a right in the debt instrument to call the bond. Since the holder's

payment changes the bond's yield, the modification must be tested for significance under the change of yield test (change of more than 25 basis points or 5 percent of original yield). This, however, only tests the significance of the modification's impact on bond yield, not the significance of the modification itself (relinquishment of the call right). If the modification passes the change of yield test, the deletion of the call right still needs to be tested before it can be concluded that the modification is "not significant." Since no specific rule tests the significance of the deletion of a call right, the general "economic significance" test must also be applied.

(n104)Footnote 55. *Treas Reg § 1.1001-3(f)(1)(ii)*. Modifications in accounting and financial covenants are never considered "significant," however, whether or not they are subject to a contingency. *Id.*

(n105)Footnote 56. *Treas Reg § 1.1001-3(f)(1)(iii)*.

(n106)Footnote 57. *Treas Reg § 1.1001-3(f)(2)*. Thus, if a change in interest rates causes a change in yield rates of less than 25 basis points, it is not a "significant modification" under the changes in yield rule.

(n107)Footnote 58. *Id.*

(n108)Footnote 59. *Treas Reg § 1.1001-3(f)(3)*.

(n109)Footnote 60. *Id.*

(n110)Footnote 61. *Treas Reg § 1.1001-3(f)(4)*.

(n111)Footnote 62. *Id.*

(n112)Footnote 63. 2001-1 CB 742 , modifying *Rev Proc 99-18*, 1999-1 CB 736 .

(n113)Footnote 64. The purpose of the election is to facilitate the consolidation of debt instruments from two or more outstanding debt issues into a single new issue by allowing for uniform original issue discount (OID) among the new debt instruments issued in the consolidation. In the absence of such an election, the exchange of new debt for more than one outstanding issue of old debt could cause different debt instruments in the new issue to have different amounts of OID under *Treas Reg § 1.1275-2(j)*, depending on the terms of each old debt issue for which the new debt is substituted. As a result, the new debt might not be fungible. See *Rev Proc 99-18*, 1999-1 CB 736 , §§ 1 and 2.06.

(n114)Footnote 65. 39 BTA 510 (1939) , *nonacq* 1939-1 CB 47 , *nonacq withdrawn and acq substituted* 1939-2 CB 12 .

(n115)Footnote 66. The donees in *Fincke* (which actually included the taxpayer's wife and several daughters) sold their "bargain sale" stock a few days after the purchase, thus shifting the taxable gain to their (presumably) lower tax brackets. The Board of Tax Appeals was aware that the taxpayer "deliberately refrained from selling this stock on the market [himself,] which would have resulted in [his] realizing a large profit... and subjecting himself to income tax on that profit" but said the taxpayer was not obligated to accomplish his goals by following the route that produced the highest tax. "The income tax consequences of [the taxpayer's] acts depend upon what was actually done, not upon what might have been done." 37 BTA at 514 .

(n116)Footnote 67. 37 BTA at 514 .

(n117)Footnote 68. See generally Cohen, "Apportioning Basis: Partial Sales, Bargain Sales and the Realization Principle," 34 *San Diego L Rev* 1693 (1997).

(n118)Footnote 69. See text at § 1.04[7].

(n119)Footnote 70. See *Treas Reg § 1.1001-1(e)*: "Where a transfer of property is in part a sale and in part a gift,

the transferor has a gain *to the extent that the amount realized by him exceeds his adjusted basis in the property*" (emphasis added). The section 1001 regulations further provide that the transferor cannot realize a loss in a part sale, part gift transaction, i.e., if the bargain sale price is less than both the value and the basis of the property, the donor reports neither gain nor loss. *Treas Reg § 1.1001-1(e)*; see also *Treas Reg § 1015-4* (for purposes of determining loss, basis of property acquired by the transferee in a bargain sale may not exceed the fair market value of the property at the time of the transaction).

(n120)Footnote 71. *Treas Reg § 1.1011-2(a)(3)*; *Ebben v Commr*, 783 F2d 906 (9th Cir 1986) ; *Johnson v Commr*, 59 TC 791 (1973) , *affd* 495 F2d 1079 (6th Cir 1974) , *cert denied* 419 US 1040 .

(n121)Footnote 72. See *Turner v Commr*, 49 TC 356 (1968) , *affd per curiam*, 410 F2d 752 (6th Cir 1969) ; *Hirst v Commr*, 572 F2d 427 (4th Cir 1978) , *aff'g* 63 TC 307 .

(n122)Footnote 73. 457 US 191 (1982) .

(n123)Footnote 74. 279 US 716 (1929) .

(n124)Footnote 75. The Supreme Court also invoked the substance over form principle: " ... [H]ad the donors sold a portion of the stock immediately before the gift transfer in order to raise funds to pay the expected gift tax, a taxable gain would have been realized. 26 USC § 1001. The fact that the gift tax obligation was discharged by way of a conditional gift rather than from funds derived from a pregift sale does not alter the underlying benefit to the donors." 457 US at 198 . Significantly, however, the Supreme Court did not tax the donors as though they had taken the pregift sale route. Instead, the Supreme Court calculated the donor's taxable gain using the same return of basis method applied in *Fincke* and *Treas Reg § 1.1001-1(e)*: "gain thus derived ... [when the donee assumes the donor's liability for gift tax]" is "the gift tax liability less the donor's adjusted basis in the [gifted] property." 457 US at 198-199 .

(n125)Footnote 76. See *IRC § 170(a)*; *Treas Reg § 170-1(c)*.

(n126)Footnote 77. *Rev Rul 55-410*, 1955-1 CB 297 ; *accord: Wekesser v Commr*, *TC Memo 1976-214* ; *Rev Rul 64-240*, 1964-2 CB 172 . Although a charitable pledge can often be enforced against the donor as a personal debt under state law, see *Taft v Commr*, 304 US 351 (1938) , the Internal Revenue Service in *Rev Rul 55-410* held that it would be "inconsistent" to treat a transfer of property to charity in satisfaction of a pledge as a "contribution or gift," as it is required to do by statute, "and at the same time treat the transfer as a satisfaction of a debt with the tax consequences that would ordinarily follow from the use of appreciated property ... to pay a debt." Accordingly, a charitable pledge is not considered a debt for federal income tax purposes. See *Rev Rul 64-240*, 1964-2 CB 172 .

(n127)Footnote 78. *IRC § 170(b)(1)(C)(iv)*. For example, appreciated stocks and securities held for more than one year would generally be "capital gain property."

(n128)Footnote 79. For purposes of *IRC § 170*, AGI is calculated without taking loss carrybacks into account and is referred to as the taxpayer's "contribution base." *IRC § 170(b)(1)(G)*. A separate special limitation is applied to capital gain property contributed to certain private foundations, the value of which may only be deducted currently to the extent it does not exceed 20 percent of the taxpayer's AGI. See *IRC § 170(b)(1)(D)*.

(n129)Footnote 80. See *IRC § 170(b)(1)(C)(ii)*; *Treas Reg § 1.170A-10(b)(1)(ii)*.

(n130)Footnote 81. *IRC § 170(b)(1)(C)(iii)*. The election applies to all of the taxpayer's contributions of capital gain property made during the taxable year, as well as to carryovers to that year of the unused portion of deductions for capital gain property contributed in prior years (for which no such election was made). In that case the carryovers must be recalculated (and may be reduced to zero) as if an election to forego a deduction for unrealized appreciation had been made in the year the property was originally contributed to charity, although charitable contribution deductions actually claimed in respect of the property in prior years will not be disturbed. *Treas Reg § 1.170A-8(d)(2)*.

(n131)Footnote 82. See *Pescosolido v Commr*, 883 F2d 187 (1st Cir 1989) , *aff'g* 91 TC 52 (1988) ; *Bialo v Commr*, 88 TC 1132 (1987) .

(n132)Footnote 83. See *IRC* § 305.

(n133)Footnote 84. For a detailed analysis of *IRC* § 306, see Ch 7.

(n134)Footnote 85. *IRC* §§ 1(h)(1), 1(h)(3)(B), and 1(h)(11).

(n135)Footnote 86. *IRC* § 306(a)(1)(D).

(n136)Footnote 87. For the same reason, Section 306 stock could not be "capital gain property" the contribution of which is subject to a special limitation on current deductibility but not permanent disallowance. See *IRC* § 170(b)(1)(C).

(n137)Footnote 88. See § 102, Tax Increase Prevention and Reconciliation Act of 2005, Pub L No 109-222, 120 Stat 345, 346 (2006).

(n138)Footnote 89. *IRC* § 170(e)(1)(B)(ii).

(n139)Footnote 90. See *IRC* § 170(e)(5)(A) and (B). If the amount of a corporation's stock donated by a donor and members of his family (within the meaning of *IRC* § 267(c)(4)) exceeds, on a cumulative basis, 10 percent (in value) of all of the corporation's outstanding stock, the excess will not be considered "qualified appreciated stock." *IRC* § 170(e)(5)(C).

(n140)Footnote 91. See *IRC* § 1011(b). See also § 1.04[7].

(n141)Footnote 92. The rule applies to contributions of cash as well as appreciated property. See *Hernandez v Commr*, 490 US 680 (1989) (cash payments to Church of Scientology for "training" and "auditing" in Church principles not deductible because of substantial benefit to donor); *Sklar v Commr*, 549 F3d 1252 (9th Cir 2008) (tuition payments for instruction in beliefs of Orthodox Jewish religion for donor's children nondeductible for same reason). See also *US v American Bar Endowment*, 477 US 105 (1986) .

(n142)Footnote 93. *Transamerica Corp v US*, 902 F2d 1540, 1544 (Fed Cir 1990) (transfer by taxpayer movie studio of its library of old movies on highly flammable and fragile nitrate film stock to the Library of Congress in return for Library's commitment to care for and store the film and make preservation copies, giving the taxpayer access to the originals and the exclusive right to commercially exploit the copies even after its copyrights expired, held not a charitable gift). See also *Ottawa Silica Co v US*, 699 F2d 1124 (Fed Cir 1983) (contribution of land to local government for use as a public school site was not deductible when the government agreed to build access roads to the school site that significantly enhanced the value of adjoining parcels owned by the taxpayer); *Singer Co v US*, 449 F2d 413 (Ct Cl 1971) (difference between usual retail price and discounted price at which taxpayer sold its sewing machines to public and parochial schools was not a charitable contribution because the taxpayer made the discounted sales to enlarge its future potential market for sewing machines). Not surprisingly given the difficulty of valuing the intangible benefits, none of the taxpayers in these cases was able to show that the property contributed had a value in excess of the benefits received. Quere whether the Government might have argued in these cases that the "substantial benefit" derived by the taxpayers constituted an "amount realized" under *IRC* § 1001 and charged the taxpayers with taxable gain equal to the difference between the property's basis and its fair market value, the presumed value of the benefits received. See *US v Davis*, 370 US 65 (1962) ; *US v General Shoe Corp*, 282 F2d 9 (6th Cir 1960) ; *International Freightling Corp v Commr*, 135 F2d 310 (2nd Cir 1943) and text at § 1.02[4][c]. The taxpayers might then argue that the fair market value of the property was deductible as an "ordinary and necessary" expense of the business under *IRC* § 162, *cf. Marquis v Commr*, 49 TC 695 (1968) , but on the facts it is more likely that the outlay would be considered capital in nature, and therefore not currently deductible.

(n143)Footnote 94. See *Palmer v Commr*, 62 TC 684 (1974) , *affd on other grounds* 523 F2d 1308 (8th Cir 1975) ; *Grove v Commr*, 490 F2d 241 (2nd Cir 1973) ; *Behrend v US*, 1972 US App LEXIS 6282 (4th Cir 1972) ; *Carrington v Commr*, 476 F2d 704 (5th Cir 1973) ; *Sheppard v US*, 361 F2d 972 (Ct Cl 1966) .

(n144)Footnote 95. The step transaction doctrine, as the Tax Court explained in *Palmer*, is applied "[W]here a taxpayer has embarked on a series of transactions that are in substance a single, unitary, or indivisible transaction, [in which case] the courts have disregarded the intermediary steps and have given credence only to the completed transaction." 62 TC at 692 . However, "Transactions that are challenged as intermediary steps of an integrated transaction are disregarded only when found to be so interdependent that the legal relations created by one transaction would have been fruitless without the completion of the series. *Id.*

(n145)Footnote 96. See *Palmer v Commr*, 62 TC 684 (1974) , *affd on other grounds* 523 F2d 1308 (8th Cir 1975) ; *Grove v Commr*, 490 F2d 241 (2nd Cir 1973) ; *Behrend v US*, 1972 US App LEXIS 6282 (4th Cir 1972) ; *Carrington v Commr*, 476 F2d 704 (5th Cir 1973) ; *Sheppard v US*, 361 F2d 972 (Ct Cl 1966) .

(n146)Footnote 97. 1978-1 CB 83 .

(n147)Footnote 98. 697 F2d 473 (2nd Cir 1982) .

(n148)Footnote 99. TC Memo 1981-579 .

(n149)Footnote 100. The Court treated the charity as having sold the appreciated stock on the taxpayer's behalf, thus making him taxable on the gain, and the taxpayer as having donated his yacht to the charity, for which he was entitled to a charitable contribution deduction equal to the yacht's actual fair market value.

(n150)Footnote 101. 697 F2d at 477-478.

(n151)Footnote 102. The Court observed that the charity was well aware that it would be jeopardizing further contributions, from this taxpayer and others, if it disregarded taxpayer's "reasonable" expectations. "Where there is, as here, an expectation on the part of the donor that is reasonable, with an advance understanding that the donee charity will purchase the asset with the proceeds of the donated stock, the transaction will be looked at as a unitary one. A wooden view that would require legal enforceability of an understanding or obligation to purchase the asset contemplated to be donated *ab initio* is not what the tax law contemplates. At least, this circuit will not take it to do so." 697 F2d at 480-481.

(n152)Footnote 103. *Rauenhorst v Commr*, 119 TC 157, 173 (2002) .

(n153)Footnote 104. 108 TC 244 (1997) , *affd* 174 F3d 997 (9th Cir 1999) .

(n154)Footnote 105. In *Ferguson*, the Tax Court held that the right to receive merger proceeds matured not only before the merger was actually accomplished but before it was formally approved. The critical event was the tender to the acquiring corporation of a sufficient number of shares (a majority) to insure shareholder approval of the merger. It was at that point that the court found the shareholders' right to the merger's share price had matured, notwithstanding remaining obstacles that the Court termed "remote" and "hypothetical." *Ferguson v Commr*, 108 TC at 257 . See also *Hudspeth v US*, 471 F2d 275 (8th Cir 1972) and *Estate of Applestein v Commr*, 80 TC 331 (1983) (donors taxed on merger proceeds received by charitable donees of their stock).

(n155)Footnote 106. 477 F2d 1058 (2nd Cir 1972) .

(n156)Footnote 107. 531 F2d 1343 (6th Cir 1983) .

(n157)Footnote 108. 66 TC 340 (1976) .

(n158)Footnote 109. See *US v Davis*, 370 US 65, 69 (n 6) (1962) (dismissing the possibility of gift treatment for transfers in marital property settlements as "completely unrealistic.")

(n159)Footnote 110. Virtually every lower court that considered the issue concluded that a transfer of property to a spouse or former spouse in exchange for the relinquishment by the transferee spouse of inchoate marital rights was a taxable event. *US v Davis*, 370 US at 67-68. The issue reached the Supreme Court because of a split of authority as to whether the transaction nevertheless escaped tax because the transferee spouse's inchoate marital rights could not be valued. The Supreme Court resolved the issue by applying the principle that the values of "two properties exchanged in an arm's length transaction are either equal in fact, or are presumed to be equal." *Philadelphia Park Amusement Co v US*, 126 F Supp 184,189 (Ct Cl 1954). Thus, the fair market value of inchoate marital rights received by the transferor was presumed equal to the fair market value of the stock given up; the difference between that fair market value and the stock's basis was a taxable gain to the transferor.

(n160)Footnote 111. See HR Rpt No 98-432, 1491-1492 (1984).

(n161)Footnote 112. A division or partition of community or jointly owned property is not a taxable event. See *Yonadi v Commr*, 21 F3d 1292 (3d Cir 1994); *Carrieres v Commr*, 64 TC 959 (1975), *affd per curiam* 552 F2d 1350 (9th Cir 1977); *Rev Rul 75-551*, 1975-2 CB 292; *Rev Rul 56-437*, 1956-2 CB 507.

(n162)Footnote 113. HR Rpt No 98-432,1491-1492. Congress was also concerned that the Government could be whipsawed under *Davis* if the transferor spouse, out of ignorance of the law or otherwise, failed to report gain on the transfer of property to his spouse and the transferee, probably years later, claimed a stepped-up basis on a subsequent sale of the property (to which she was entitled under *Davis*) when it was too late to go after the transferor.

(n163)Footnote 114. *IRC § 1041(c)*. See *Young v Commr*, 240 F3d 369 (4th Cir 2001) (transfer of land to a former spouse in payment of promissory note given to her several years before as part of a property settlement agreement resolving all "claims arising out of the marital relationship" was "related to the cessation of the marriage" and therefore "incident to a divorce.")

(n164)Footnote 115. *Temp Treas Reg § 1.1041-1T*, Q&A 7.

(n165)Footnote 116. *Id.*

(n166)Footnote 117. *IRC § 1041(d)*.

(n167)Footnote 118. *IRC § 1041(e)*.

(n168)Footnote 119. *IRC § 1041(b)(1)* provides that for purposes of subtitle A (Income Taxes) of the Internal Revenue Code, the property transferred shall be considered as acquired by the transferee by gift. *IRC § 1041(b)(2)* goes on to provide that the basis of the transferee in the acquired property shall be the adjusted basis of the transferor.

(n169)Footnote 120. See *Temp Treas Reg §§ 1.1041-1T*, Q&A 11 and compare *IRC § 1015(a)*.

(n170)Footnote 121. *Temp Treas Reg § 1.1041-1T*, Q&A 11; *Godlewski v Commr*, 90 TC 200 (1988). But see *Rev Rul 87-112*, 1987-2 CB 207, where a transferee of US savings bonds in a section 1041 transfer was permitted to increase her basis in transferred bonds by the amount of accrued interest that the transferor was required to recognize as income under *IRC § 454*. Furthermore, even though a transferee who pays consideration in the form of personal debt for property received in a section 1041 transfer may not use the amount of the debt to increase her basis in the property, *Temp Treas Reg § 1.1041-1T*, Q&A 11, the Internal Revenue Service and the Tax Court permit the transferee to deduct interest on the debt if the property acquired from the transferor spouse was investment property, the transferee's residence, or other property described in *IRC § 163(h)(2)*. *Notice 88-74*, 1988-2 CB 385; *Seymour v Commr*, 109 TC 279 (1997); *Armacost v Commr*, TC Memo 1998-150.

(n171)Footnote 122. *Rev Rul 2002-22, 2002-1 CB 849* .

(n172)Footnote 123. See *Poe v Seaborn, 282 US 101 (1930)* . But cf *Balding v Commr, 98 TC 368 (1992)* (cash payments received by transferee spouse in exchange for relinquishment of rights in earning spouse's military pension were shielded from taxation to the non-earning spouse by *IRC § 1041*).

(n173)Footnote 124. *1987-2 CB 207* .

(n174)Footnote 125. The Service used the assignment of income doctrine to help justify its conclusion in *Rev Rul 87-112* , reasoning which it later repudiated in *Rev Rul 2002-22* , without repudiating the result in *Rev Rul 87-112* .

(n175)Footnote 126. *Temp Treas Reg § 1.1041-1T, Q&A 9*.

(n176)Footnote 127. *Id.*

(n177)Footnote 128. But where a former spouse sold her separate property to a third party to raise funds with which to pay a debt owed to her ex-husband as required by their property settlement agreement, the transfer was not made "on behalf of" the ex-husband and she was not entitled to nonrecognition treatment under *Temp Treas Reg § 1.1041-1T, Q&A 9* and *IRC § 1041*. *Ingham v US, 167 F3d 1240 (9th Cir 1999)* .

(n178)Footnote 129. A threshold issue is whether an arm's length sale of stock for cash or other consideration that does not include inchoate marital rights like those in *US v Davis, 370 US 65 (1962)* , can ever be within the scope of *IRC § 1041*. The temporary regulations, echoing the section's legislative history, answer that question in the affirmative; all transfers of property between spouses (or former spouses if incident to a divorce) are within the scope of *IRC § 1041* and must be treated as gifts, even if the transaction is simply a bona fide sale in which no inchoate marital rights are exchanged. See HR Rept. 98-432 (Part 2), 1491-1492 (1984) ("the nonrecognition rule applies whether the transfer is for the relinquishment of marital rights, for cash or other property * * * or for other consideration"); *Temp Treas Reg § 1.1041-1T, Q&A 11* ("Even if the transfer is a bona fide sale, the transferee does not acquire a basis in the transferred property equal to the transferee's cost (the fair market value)." (Q&A 11)). See also *Godlewski v Commr, 90 TC 200 (1988)* . Accordingly, a spouse's sale of property to a third party corporation "on behalf of" the other spouse, if qualified under *Temp Treas Reg § 1.1041-1T, Q&A 9*, should qualify for nonrecognition under *IRC § 1041*.

(n179)Footnote 130. See *IRC §§ 301 and 302*.

(n180)Footnote 131. The "primary and unconditional obligation" standard is discussed in the text at § 5.02[4].

(n181)Footnote 132. The "no-tax" solution is effectively though unintentionally what occurred in the first of the divorce-related corporate redemption cases to reach the courts. In *Arnes v US, 981 F2d 456 (9th Cir 1992)* , the Court of Appeals for the Ninth Circuit, which had only the transferor spouse (the wife) before it, held that her transfer of stock to the family corporation in exchange for cash was made "on behalf of" her husband, the remaining shareholder and was therefore nontaxable under *IRC § 1041*. For purposes of *Temp Treas Reg § 1.1041-1T, Q&A 9*, the Court said, an "obligation" of the husband had been satisfied by the redemption of the wife's stock because he had entered into an agreement with her, incorporated into the divorce decree, in which he had not only obtained her commitment to sell her stock to the corporation but had agreed to personally guarantee a note to be issued by the corporation in the exchange. When the husband's tax liability came before the Tax Court on the same facts, however, a majority held that the husband could not be charged with a constructive dividend because he never had a personal obligation, and certainly not a "primary and unconditional obligation," to purchase the redeemed stock as required by existing corporate tax doctrine. *Arnes v Commr, 102 TC 522 (1994)* . The two cases were like ships passing in the night: the Ninth Circuit decision applied *Temp Treas Reg § 1.1041-1T, Q&A 9* without considering or distinguishing any of the cases following the "primary and unconditional obligation" standard, and the Tax Court majority relied exclusively on the "primary and unconditional obligation" cases, making no reference to *Temp Treas Reg § 1.1041-1T, Q&A 9* except to note in a footnote that the Court expressed no opinion on the interpretation of its "on behalf of" language in determining the

applicability of *IRC § 1041* to the redeeming shareholder. *Arnes v Commr*, 102 TC at n. 3.

(n182)Footnote 133. *114 TC 14 (2000)* .

(n183)Footnote 134. Accord: *Craven v US*, 215 F3d 1201 (11th Cir 2000) .

(n184)Footnote 135. See *Read v Commr*, 114 TC at 58 .

(n185)Footnote 136. See *Treas Reg § 1.1041-2*, adopted by *TD 9035*, 68 FR 1534 (January 13, 2003). Since the Tax Court's decision in *Read v Commr*, was based on *Temp Treas Reg § 1.1041-1T*, Q&A 9, that decision no longer applies to divorce-related corporate redemptions occurring on or after January 13, 2003 (the effective date of the new regulations), though it presumably continues to apply to spousal transfers to third parties other than those involving corporate redemptions which are still governed by *Temp Treas Reg § 1.1041-1T*, Q&A 9.

(n186)Footnote 137. *Treas Reg § 1.1041-2(c)*.

(n187)Footnote 138. See *TD 9035* , 68 FR at 1535.

(n188)Footnote 139. See *TD 9035* , 68 FR at 1535. The regulations thus adopt the reasoning of the Tax Court in *Arnes v Commr*, 102 TC 522 (1994) , and reject the separate standard for constructive dividends in divorce-related redemptions in *Read v Commr*, 114 TC 14 (2000) .



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Taxation of Securities Transactions

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CHAPTER 1 Gains and Losses From the Disposition of Property

1-1 Taxation of Securities Transactions § 1.02A

§ 1.02A The Elements of Gain or Loss--Non-Events: Sham and Other Tax-Avoidance Transactions

[1] The Economic Substance Doctrine: Statement and Purposes.

Understanding the taxation of securities transactions requires knowledge of the applicable statutory rules of the Internal Revenue Code, certainly, but also of judge-made law, the so-called common law of federal taxation, that has developed over the years as a gloss on the statutory provisions. Application of the various judicial doctrines--substance over form, step transaction, sham transaction, business purpose, and economic substance--can produce results that are very different from what might be predicted from looking at the Internal Revenue Code alone. Securities transactions are not the only targets of these judicial doctrines but, perhaps because of their protean nature, securities transactions have often been at the center of their development.

This section will examine in particular the economic substance doctrine, which polices the often murky line between legitimate tax planning and tax avoidance.ⁿ¹ The previous discussion of the term "sale" in the context of the realization requirement showed that the Internal Revenue Service and the courts may invoke the substance over form doctrine to disregard the "sale" label put on a transaction by the parties (or, conversely, ignore a "lease" or "loan" label on a transaction that is really a sale) and reclassify the transaction in accordance with its true nature.ⁿ² If a transaction falls on the tax avoidance side of the economic substance line, however, it is neither fish nor fowl, and realization is no longer an issue.ⁿ³ A loss claimed by the taxpayer with respect to the transaction will be disallowed as though the transaction had never occurred.ⁿ⁴ A transaction that fails the economic substance test is, at least for realization purposes, a non-event.

Although Congress codified and clarified the economic substance doctrine by adding *IRC Section 7701(o)* to the IRC in 2010, knowledge of the judge-made law leading up to *IRC Section 7701(o)* remains essential to understanding and applying that provision. This section will therefore look first at the three Supreme Court cases that are generally regarded as providing the foundation for the economic substance doctrine. It will then review the various ways in which more recent lower court decisions have refined the economic substance doctrine, including the objective and subjective criteria applied to determine whether a transaction has economic substance. Finally, this section will consider the consequences, before and after codification, of applying the economic substance doctrine to a transaction, including the automatic penalty for engaging in a transaction lacking economic substance that was added as part of the codification package.

[a] Foundations of the Economic Substance Doctrine--The Landmark Supreme Court Decisions.

Clearly the bellwether case in the development of the substance over form and economic substance doctrines, and frequently cited by the courts to the present day, is the Supreme Court's 1935 decision in *Gregory v Helvering*.ⁿ⁵ The taxpayer in that case, an individual, owned all the stock of United Mortgage Corporation, which in turn held valuable shares of stock in the Monitor Securities Corporation. The taxpayer wished to acquire the Monitor shares for the purpose of reselling them individually to a prospective purchaser but to do so directly would have required United Mortgage to pay her a dividend of the Monitor shares taxable as ordinary income. Instead, she acquired the Monitor shares through a more complicated process: first, she caused a new corporation, Averill, to be formed; second, United Mortgage transferred the Monitor shares to Averill in exchange for Averill's issuance of all of its stock to United Mortgage's sole stockholder, the taxpayer; and third, taxpayer liquidated Averill, receiving the desired Monitor shares as a liquidating distribution and immediately reselling the shares to a third party. Following this route, taxpayer paid capital gains tax on the gain realized on the liquidating distribution instead of paying ordinary income tax on a dividend equal to the full value of the Monitor shares (to the extent of United Mortgage's earnings and profits).

The issue in *Gregory* was whether the second of the three steps taken by the taxpayer qualified as a tax-free reorganization. Under the income tax statute in force at that time, a reorganization was defined as any transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred.ⁿ⁶ No one disputed that step two literally complied with that definition; the question was whether the transaction was sufficient to warrant tax-free reorganization treatment.

The taxpayer's argument, repeated countless times over the years (and accepted by the Board of Tax Appeals, the trial court below),ⁿ⁷ was that since every element of the statutory definition had been satisfied, "the motive of the taxpayer ... to escape payment of a tax will not alter the result or make unlawful what the statute allows."ⁿ⁸ The Supreme Court's response, which has likewise become part of the mantra invoked in almost every economic substance case since *Gregory*, was first to acknowledge that "The 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."ⁿ⁹ "But," said the Court, "the question for determination is whether what was done, apart from the tax motive, was the thing the statute intended."ⁿ¹⁰ The purpose of the reorganization statute is to facilitate transactions implementing a legitimate plan of reorganization of a corporate business, while what happened in this case was "the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares" to the taxpayer.ⁿ¹¹ Accordingly, "the rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."ⁿ¹²

A securities transaction was also involved in a second significant Supreme Court case, *Higgins v Smith*.ⁿ¹³ The Court there decided that a sale of securities by a taxpayer to his wholly owned corporation should be disregarded for "realization of loss" purposes because the taxpayer's control over his corporation allowed him to exercise the same dominion and control over the securities after the sale as before.ⁿ¹⁴ Although the treatment of losses in transactions between related parties is now dealt with principally by *section 267 of the Internal Revenue Code*,ⁿ¹⁵ the language of the *Higgins v Smith* opinion continues to resonate in the economic substance doctrine:ⁿ¹⁶

"[*Gregory v Helvering* ... gives support to the natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration.

* * *

The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes

of taxpayers to supersede legislation in the determination of the time and manner of taxation."ⁿ¹⁷

Finally, in the third significant Supreme Court decision, *Frank Lyon Co v US*,ⁿ¹⁸ the Supreme Court placed limits on the ability of the Government and the courts to re-characterize or disregard tax-motivated transactions. The Court reviewed the sale and leaseback of a building in which the seller-lessee, through various contractual provisions and options, retained most of the significant attributes of ownership (including, as a practical matter, the right to future appreciation in value), while the purchaser-lessor was limited to a fixed (though apparently arm's length) return on the relatively small cash investment it made in the transaction, in addition to the significant tax benefits it derived from the transaction.ⁿ¹⁹ The Court decided that the transaction affected the economic positions of both parties in non-trivial ways,ⁿ²⁰ and that this gave the transaction the economic substance necessary to be respected for tax purposes.

"In short, we hold that where, as 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."ⁿ²¹

[b] Statements of the Doctrine in Modern Decisions.

A few years after *Lyon*, the Tax Court derived from that decision "a two-pronged inquiry" for determining when it is permissible to disregard a transaction for tax purposes.ⁿ²² "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."ⁿ²³ This "two-pronged inquiry," adopted by the Court of Appeals for the Fourth Circuit in affirming the Tax Court's decision, has become the point of departure for subsequent expressions of the economic substance doctrine by the courts.

The economic substance doctrine as stated in *Rice's Toyota World* implies that an initial determination that the taxpayer had some business purpose for engaging in a transaction would require that a transaction be respected for tax purposes even if, objectively viewed, it had no non-tax significance. Other courts have interpreted *Lyon* differently and uniformly reject that position.ⁿ²⁴ To the contrary, "[t]he majority view ... is that a lack of [objective] economic substance is sufficient to invalidate the transaction regardless of whether the taxpayer has motives other than tax avoidance."ⁿ²⁵ Even courts that believe the taxpayer's subjective motives, as well as objective indicia of economic significance, should always be examined reject a "rigid two-step analysis" like that prescribed in *Rice's Toyota World*; such courts view objective economic significance and subjective motives not as "discrete prongs" of a two-pronged test "but rather ... [as] 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."ⁿ²⁶

As a practical matter, objective and subjective tests of economic significance normally reinforce each other and come to the same conclusion. A court that is unable to find non-tax significance in a transaction is unlikely to give credence to a taxpayer's claim that the transaction was motivated by a business purpose, just as a court that finds objective evidence of non-tax significance is unlikely to disregard a transaction on the ground that the transaction was tax motivated.ⁿ²⁷ No matter how the test is expressed, "the presence or absence of economic substance for Federal tax purposes is determined by a fact-specific inquiry on a case-by-case basis."ⁿ²⁸ Of greater importance, therefore, are the indicia or factors considered by the courts in the fact-specific inquiry as to whether a transaction either possesses, or lacks, economic substance.

[2] Indicia of Presence or Lack of Economic Significance.

The surest indicator that a transaction has economic significance is its potential to make a profit without taking income taxes into account. If a transaction is under economic substance scrutiny the chances are that it did not actually make a

profit, but the inquiry is made as of the time the transaction was entered into rather than with 20/20 hindsight.ⁿ¹ The question under the objective test, however, is not whether the taxpayer expected to make a profit when the transaction was entered into, but whether a reasonable, prudent investor could have had such an expectation.ⁿ²

Although a reasonable or prudent investor standard is used, courts take into account the taxpayer's actual conduct (and that of other parties to the transaction) to ascertain the true parameters of the transaction and determine whether, under all the circumstances, a reasonable possibility of profit existed.ⁿ³ In *James v Commissioner*, joint ventures in which the taxpayer was a participant purchased computers from a promoter which arranged for the computers to be leased to various business users. Although this is a common type of business transaction often entered into for economic as well as tax reasons,ⁿ⁴ the actual conduct of the joint ventures made it unlikely if not impossible for the transactions to make a profit: the ventures paid inflated purchase prices for the computers in order to increase their participants' investment credit and depreciation deductions, using nonrecourse notes to facilitate early withdrawal from the transaction when these short-term tax benefits had been achieved; the ventures agreed to contractual provisions and acquiesced in unauthorized conduct by the promoter that stripped away all positive cash flow to the ventures during the terms of the computer leases; and the ventures agreed to pay an exorbitant remarketing fee to the promoter if it successfully sold or released the computers at the conclusion of the leases, making it impossible for the ventures to realize any economic benefit from the computers' residual value to earn an overall profit on the transaction.ⁿ⁵

Similarly, if the asserted profitability of a transaction depends on the possibility of the taxpayer or another party taking some voluntary action in the future that would be a "drastic departure" from its past conduct, the court will disregard that possibility. In *James*, the taxpayer argued that the promoter's exorbitant remarketing fee should not be taken into account because the ventures could avoid the fee by using another broker to sell or re-lease the computers (assuming, in one case, that the promoter voluntarily gave up its right of first refusal to broker the deal). The court rejected that argument, finding "little reason to believe" that either the ventures or the promoter "would have stood guard to ensure that the joint venture saved money [on the brokerage fee] at the expense of" the promoter when such action would have been dramatically inconsistent with the actual conduct of the parties throughout the rest of the transaction. Similarly, in *Dow Chemical Co v US*,ⁿ⁶ although the taxpayer conceded that its corporate-owned life insurance contract would be cash-flow negative during its first several years, it claimed it planned to make significant cash infusions midway into the policy that would create a substantial inside build-up over the remainder of the policy term resulting in an overall profit over the entire life of the contract. The taxpayer had no contractual obligation to make these cash infusions, however, and "considering that ... [the taxpayer] had...made no similar cash infusions, [and that] such additional spending would be a drastic departure from the taxpayer's past conduct,"ⁿ⁷ the court of appeals held that the trial court erred when it took the possibility of such cash infusions into account in assessing the policy's potential long-term profitability.

The inquiry into potential profitability is limited to the specific transaction that gave rise to the tax benefits in question. Even actual profits earned by the taxpayer in collateral or related transactions which did not directly produce the challenged tax benefits are excluded from consideration.ⁿ⁸ In *Klamath*, for example, the court disregarded partnership profits made in transactions involving property purchased with partners' cash contributions since the questioned tax benefits resulted exclusively from transactions involving partner contributions of high-basis property financed by "sham" bank loans to the partners. In *ACM Partnership*, the court similarly ignored profits earned on partnership sales of securities for cash because it was the partnership's contingent installment sales of securities that produced the challenged tax benefits.

Further, no significance is attached to the possibility that a transaction, designed to produce substantial tax benefits, might or did incidentally produce economic profits of a relatively nominal amount.ⁿ⁹ This is particularly so when the court is convinced that the taxpayer or promoter of the transaction sought merely to create the appearance of profit potential to better defend against an attack under the economic substance doctrine.ⁿ¹⁰

Potential profitability does not, of course, take into account projected savings in the taxpayer's federal income taxes, but

should foreign income taxes also be excluded from consideration? The taxpayers in *IES Industries, Inc v USn11* and *Compaq Computer Corp and Subsidiaries v Commr,n12* concededly looking for capital losses to offset against their substantial capital gains, entered into "dividend stripping" transactions that produced guaranteed short-term capital losses while nevertheless, it was contended, generating an overall pre-tax profit. The transactions involved American Depository Receipts ("ADRs") representing stock in foreign corporations the dividends on which were reduced by foreign withholding taxes equal to 15 percent of the dividends paid. US taxpayers could offset the amount of these foreign withholding taxes against their US tax liability through foreign tax credits, but some holders of ADRs were tax-exempt entities, such as pension funds, that could not make use of foreign tax credits. In the transactions at issue, a tax-exempt organization would temporarily loan its ADRs to a counterparty which sold them to the US taxpayer *cum-dividend* (that is, shortly before the date on which shareholders of record would be entitled to a previously declared dividend (the "record date")), and immediately thereafter re-purchased the ADRs from the US taxpayer *ex-dividend* (that is, effective as of a settlement date occurring after the record date, when the purchaser of the ADR was no longer entitled to receive the declared dividend.) The US taxpayer's sale back to the counterparty always produced a short-term capital loss substantially equal to the amount of the dividend (less withholding taxes) since the "*cum-dividend*" price paid for the ADR reflected the holder's right to receive the dividend while the "*ex-dividend*" price received for the ADR did not.ⁿ¹³ The US taxpayer received the dividend (net of withholding taxes) and reported it on its federal income tax return ("grossed-up" by the amount of the withholding taxes), using the foreign tax credit to offset US tax liability created by such dividend income.

The taxpayer's calculation of its pre-tax profit on the ADR transactions treated the portion of the dividend used to pay foreign income taxes as part of the income generated by the transaction, while ignoring the negative cash flow that resulted from the withholding of foreign taxes at the source. In *Compaq*, for example, as a result of the ADR transactions the taxpayer actually received dividends of \$19.2 million net of withholding taxes of \$3.3 million, but the taxpayer contended that for purposes of calculating pre-tax profit the dividends should be "grossed up" by the amount of the withholding taxes, producing gross income of \$22.5 million. Deducting from that figure the short-term capital losses sustained in the ADR transactions of \$19.1 million, and a further \$1.5 million in transaction costs, still left a net profit to the taxpayer of \$1.9 million. If the transaction were viewed strictly on a cash flow basis, as the Government contended was appropriate, subtracting the \$3.3 million of foreign income taxes withheld produced a \$1.4 million loss rather than a \$1.9 million profit.

The appellate courts in *Compaq* and *IES Industries* both agreed with the taxpayer that foreign income taxes owed by the recipient of a dividend belong in the recipient's income whether the taxes are withheld at the source or paid at the end of the year, just as federal income taxes withheld at the source from the wages of an employee must be included as wages on the employee's return.ⁿ¹⁴ Neither court discussed the further question of whether the foreign taxes should then be deducted as an expense of the transaction, apparently assuming that both foreign and domestic income taxes should be left out of the calculation of pre-tax profit.

As sometimes happens when the Internal Revenue Service believes taxpayers are reducing their taxes by exploiting a "loophole" in the tax law, Congress responded to the ADR strategy without waiting for a judicial resolution, changing the law for future transactions while leaving the courts to deal with the tax treatment of similar transactions occurring before the effective date of the new statute.ⁿ¹⁵ Typically, neither the Tax Court, which found the ADR transactions lacking in economic substance, nor the appellate courts, which held that the ADR transactions possessed economic substance, drew any inference from the remedial legislation, either from the fact that Congress saw a "problem" requiring correction or from the fact that Congress chose not to apply its solution retroactively.ⁿ¹⁶ Unless Congress provides expressly to the contrary, courts commonly examine pre-effective date transactions under the economic substance and other judicial doctrines without regard to how Congress decided to treat similar future transactions.ⁿ¹⁷

Although potential profitability is the issue most commonly examined under the objective test,ⁿ¹⁸ courts may also look to other indicia of economic substance, such as whether the transaction affected the taxpayer's "net economic position, legal relations, or non-tax business interests."ⁿ¹⁹ *Frank Lyon Co.* is often cited in support of the importance of such

factors; the Supreme Court there viewed the genuine indebtedness incurred by the taxpayer to an unrelated party, which restricted its ability to borrow funds to meet the needs of its business, as one of the grounds for respecting the transaction for tax purposes.ⁿ²⁰ *Frank Lyon* was followed in *United Parcel Service of America, Inc v Commr*,ⁿ²¹ (hereafter "*UPS*"), where the taxpayer's delivery service business was restructured to shift the company's liability to shippers for damaged packages to an unrelated third party insurer, which reinsured the liability with a foreign insurer owned by the taxpayer's employee-stockholders. Finding that the transaction passed the economic substance test, the court of appeals in *UPS* analogized the taxpayer's insurance policy to the loan in *Frank Lyon*: the taxpayer incurred an obligation to pay premiums to an unrelated insurer, thereby giving up the right to use that stream of income to pay other expenses, or capital improvements, or dividends. "And even if the odds of losing money on the policy were slim," said the court, "the insurer had assumed liability for the losses of the ... [taxpayer's] ... shippers, again a genuine obligation."ⁿ²²

A factor often cited as exposing a transaction's lack of economic substance is the production of artificial losses far exceeding the taxpayer's actual investment.ⁿ²³ As Judge Easterbrook noted with wry understatement in *Cemco Investors, LLC v US*,ⁿ²⁴ "[a] transaction with an out-of-pocket cost of \$6,000 and no risk beyond that expense, while generating a tax loss of \$3.6 million, is the sort of thing that the Internal Revenue Service frowns on." Other factors indicating the lack of economic substance include: a "fleeting and economically inconsequential" investment;ⁿ²⁵ a departure in some significant respect from standard industry practice;ⁿ²⁶ marketing of the transaction as a tax-driven investment;ⁿ²⁷ and structuring on non-arm's length terms.ⁿ²⁸

[3] The Role of Subjective Intent and Business Purpose.

The "majority view" of the economic substance doctrine, it will be recalled, holds that inquiry into the taxpayer's motivation is unnecessary when a transaction lacks objective economic substance. It is only when a transaction has met the objective test that a court may inquire into whether it was "solely tax motivated." If the court finds that the taxpayer fails that subjective test, theoretically the transaction may be disregarded even though it possesses non-tax significance.

The possibility is, however, more theoretical than real. There should rarely, if ever, be a case in which a taxpayer who has engaged in a transaction with non-tax significance fails the subjective test. Under *Gregory v Helvering*, taxpayers have the right to structure legitimate transactions in ways that minimize or avoid entirely taxes that might otherwise be imposed. Given that a transaction has objective non-tax significance, the taxpayer's tax avoidance motives should be protected by *Gregory*.

The case law bears out this prediction. In *UPS*, the taxpayer restructured its package delivery business so that its liability for damaged packages, instead of being self-insured as in the past, was insured with a third party insurer, which in turn reinsured its liability with a foreign insurer owned by the taxpayer's employee-stockholders. The court of appeals for the Eleventh Circuit held that the transaction changed the taxpayer's economic position sufficiently to pass the objective economic substance testⁿ¹ but, following the "majority view," observed that the transaction could still be disregarded "if tax avoidance displaced any business purpose."ⁿ² However, it went on to define "business purpose" in such a manner that the taxpayer could hardly fail to pass the subjective test.

[T]he tax court's narrow notion of "business purpose"--which is admittedly implied by the phrase's plain language--stretches the economic-substance doctrine farther than it has been stretched. A "business purpose" does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a "business purpose," when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business. ... This concept of "business purpose" is a necessary corollary to the venerable axiom that tax-planning is permissible. See *Gregory v. Helvering* ... ").ⁿ³

The transaction had no impact on the taxpayer's business, which "continued to operate after its reconfiguration much as before." The taxpayer's "initial and sole reason for the scheme in question," was to structure its business in such a way

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as to permit a deduction for otherwise nondeductible contingent liabilities with respect to packages that would become damaged in transit.ⁿ⁴ Nevertheless, had the taxpayer in *UPS* selected this structure when it initially set up its business the economic substance issue presumably would never have arisen. To the court of appeals, the situation was no different in principle from a corporate taxpayer's decision to finance its business with debt rather than equity because the cost of financing (interest versus dividends) is tax-deductible with debt but not with equity. "There may be no tax-independent reason for a taxpayer to choose between these different ways of financing the business, but it does not mean that the taxpayer lacks a 'business purpose.'" ⁿ⁵ The court of appeals held that the taxpayer passed the subjective test because "the transaction under challenge here simply altered the form of an existing, bona fide business, and this case therefore falls in with those that find an adequate business purpose to neutralize any tax-avoidance motive."ⁿ⁶

Similarly in *IES Industries* and *Compaq*, once the courts of appeal found that the ADR transactions in those cases earned a pre-tax profit,ⁿ⁷ it followed that the taxpayers' motives, which clearly included tax savings, necessarily fell on the legitimate tax planning rather than the tax avoidance side of the line.ⁿ⁸ Indeed, the court of appeals candidly observed in *Compaq* that had the taxpayer not had a sizeable capital gain against which to offset the capital losses generated by the ADR transactions, the transactions would not have made economic sense 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."ⁿ⁹

Finally, the Supreme Court's decision in *Cottage Savings Ass'n v Comm'r*ⁿ¹⁰ makes clear that where real economic losses are involved, tax savings motives regarding the realization of such losses are simply irrelevant.ⁿ¹¹ The taxpayer bank in that case entered into an exchange with another bank of economically equivalent but legally distinct mortgage portfolios that had economically depreciated in value, a transaction that was designed solely to enable both banks to claim losses on their portfolios for tax purposes while avoiding recognition of the losses for accounting and financial statement purposes. The Supreme Court did not find the tax motivation significant. It held that since the exchange involved "materially different" properties the resulting losses could be deducted. Although the court of appeals below had disallowed the losses on economic substance grounds, the Government offered only a "minimal defense" of that position and the Supreme Court summarily dismissed it.ⁿ¹²

Conversely, even under *Rice's Toyota World*, where a subjective tax avoidance motive is supposedly a prerequisite to finding that a transaction lacks economic substance, a transaction viewed objectively as having no non-tax significance will not be respected for tax purposes simply because the taxpayer asserts a business purpose for entering it. The Fourth Circuit, in decisions following *Rice's Toyota World*, has clarified that that a taxpayer's "mere assertion" of subjective belief in the profit opportunity from a transaction "particularly in the face of strong objective evidence that the taxpayer would incur a loss, cannot by itself establish that the transaction was not a sham [T]he ultimate determination of whether an activity is engaged in for profit is to be made ... by reference to objective standards."ⁿ¹³ Stated differently, actions speak louder than words.

The reality, then, regardless of the jurisdiction, is that while manifestations of a taxpayer's subjective intent will often be relevant to the determination of whether a transaction has economic substance, seldom if ever will subjective intent be determinative one way or the other. As the court of appeals for the Federal Circuit (a "majority view" jurisdiction) said in *Coltec Industries, Inc.*: "While the taxpayer's subjective motivation may be pertinent to the existence of a tax avoidance purpose, all courts have looked to the objective reality of the transaction in assessing its economic substance."ⁿ¹⁴

Factors objectively indicating the absence of a profit motive include the fact that the transaction was marketed as a tax-saving vehicle,ⁿ¹⁵ the fact that the taxpayer's investigation of the investment was cursory or non-existent,ⁿ¹⁶ and the fact that the taxpayer's conduct demonstrated indifference to economic profitability or was actually inconsistent with the business purpose asserted as the justification for entering the transaction.ⁿ¹⁷ The taxpayer's willingness to pay large fees or incur significant transaction costs to enter transactions with little or no profit potential, or to forego alternative

opportunities to realize its profit and other goals with significantly less risk and lower costs, are also indicative of a tax avoidance motive.ⁿ¹⁸ Where the taxpayer advances business purpose arguments other than profitability, these will be examined on a case-by-case basis.ⁿ¹⁹

[4] Pre-Codification Tax Consequences of a Determination That Transaction Lacks Economic Substance.

In general, "if a transaction is devoid of economic substance ... it simply is not recognized for federal taxation purposes, for better or for worse. This denial of recognition means that a sham transaction, devoid of economic substance, cannot be the basis for a deductible loss."ⁿ¹ Conversely, any income reported by the taxpayer as a result of a sham transaction is likewise disregarded, and tax paid on such income is refundable.ⁿ²

The court of appeals for the Fourth Circuit departed from this general rule to allow expense deductions with respect to what it considered separable economically substantive elements of an otherwise sham transaction.ⁿ³ In *Rice's Toyota World*, the court determined that the taxpayer's purchase of computers pursuant to a sale and leaseback transaction was a sham, in part because the taxpayer had used nonrecourse indebtedness to pay an inflated purchase price which it never intended to pay in full. However, the taxpayer had also given the promoter its recourse note on which it made an initial cash payment. The taxpayer treated the recourse note as part of the purchase price of the computer, but the Tax Court found that the note actually represented the promoter's fee for initiating and managing the deal. The Tax Court disallowed a deduction for the taxpayer's cash payment on the recourse note on the ground that the expenses of entering a sham transaction were nondeductible since the taxpayer incurred them not to make a profit but to purchase tax savings.ⁿ⁴ On appeal, however, the Fourth Circuit court of appeals allowed the taxpayer to deduct interest on the recourse note, holding that "under *Frank Lyon* ⁿ⁵ the court may not ignore transactions that have economic substance [i.e., the genuine indebtedness represented by the recourse note] even if the motive for the transaction is to avoid taxes."ⁿ⁶

The court of appeals for the Third Circuit followed *Rice's Toyota World* in recognizing that deductions for economically real losses and expenses may be appropriate even though incurred in connection with a sham transaction,ⁿ⁷ although it disagreed with the Fourth Circuit's conclusion that the recourse indebtedness in that case, which by the Fourth Circuit's "own description, had no non-tax consequences and served no non-tax purposes" should be "considered economically substantive even if it was separable from the central aspects of the underlying sham."ⁿ⁸

In *ACM Partnership*, the taxpayer acquired "LIBOR Notes" pursuant to what the court of appeals regarded as a sham transaction designed to artificially increase the basis of the LIBOR Notes so as to produce artificial, non-economic losses on their sale.ⁿ⁹ However, the taxpayer's sales of the LIBOR Notes also produced real economic losses, in part, because a decline in interest rates directly affected the value of the notes during the period in which they were held. The Tax Court, while taxing the interest income received on the LIBOR Notes, denied any deduction for the losses realized by the taxpayer on the sale of the Notes, including that portion that represented a real economic loss due to the decline in interest rates.ⁿ¹⁰ The court of appeals found it "clear that the income and loss aspects of the LIBOR Notes must be treated consistently with one another," and went on to hold that the real economic losses incurred on the sale the Notes should be recognized. "[T]he LIBOR notes, although not intended to serve non-tax purposes, had significant non-tax economic effects, consisting of several million dollars in actual economic losses [E]ven where a transaction is not intended to serve business purposes, it may give rise to a deduction to the extent that it has objective economic consequences apart from tax benefits."ⁿ¹¹

In *Klamath Strategic Investment Fund v US*,ⁿ¹² the court of appeals for the Fifth Circuit reviewed a District Court decision that disallowed losses claimed by the taxpayer on the sale of foreign currency distributed to him by an investment partnership because the losses lacked economic substance. The foreign currency's basis had been artificially inflated through the use of "loans" made to the taxpayer which the District Court disregarded as economic shams since the borrower was prohibited from ever removing the loan funds from the lender's possession. The only purpose of the loans was to inflate the basis of the taxpayer's interest in the investment partnership which in turn inflated the basis of

the foreign currency distributed by the partnership to the taxpayer, ultimately producing losses the taxpayer could use to avoid tax on a substantial amount of legal fees he had received. The District Court allowed the taxpayer to deduct interest actually paid on the loans because the loans were genuine indebtedness owed to an unrelated third party. Furthermore, finding that the taxpayer invested in the partnership in the belief that it would make a profit trading in foreign currency, the District Court allowed the taxpayer to deduct management and other fees paid to the promoter and managing partner of the investment partnership.

The Fifth Circuit, after affirming the District Court's disallowance of the claimed foreign currency losses on economic substance grounds, reversed the District Court's allowance of an interest deduction, holding that since the Court had properly found the "loans" to be fictitious, what was paid to the bank could not have been interest on "indebtedness" as required by section 163 of the Code. Further, said the court, "the overall transaction must have economic substance in order to show genuine indebtedness, otherwise 'every tax shelter ... could qualify for an interest expense deduction as long as there was a real creditor in the transaction that demanded repayment.' "n13

The court of appeals likewise reversed the District Court's decision to allow the taxpayer to deduct management fees and other operating expenses of the investment partnership. Observing that such expenses were deductible under *section 212 of the Internal Revenue Code* only if incurred in a profit-seeking enterprise, the court of appeals did not directly challenge the District Court's finding that the taxpayer had a profit objective but held that it was the partnership's objective, not the taxpayer's, that was critical. Since the partnership agreement committed the management of the partnership exclusively to the promoter, the taxpayer's profit objective was irrelevant to the deductibility of the expenses in question.

The Fifth Circuit's reasoning was more roundabout but ultimately came to the same conclusion as the rule routinely followed by the Tax Court: a transaction lacking in economic substance cannot be the basis for a deductible expense.ⁿ¹⁴ In short, notwithstanding *Rice's Toyota World*, it is unlikely that a taxpayer will be able to salvage interest or operating expense deductions (including a deduction for promoters' fees) out of a transaction disregarded for purposes of realizing gain or loss under the economic substance doctrine. On the other hand, as in *ACM Partnership* or *Coltec*, if a real and severable economic loss is incurred in or associated with such a disregarded transaction, courts seem disinclined to penalize the taxpayer for having suffered it in the context of, or even as a result of having entered, a transaction that otherwise lacked any non-tax significance.

[5] Codification and Clarification of the Economic Substance Doctrine.

To promote consistency in the courts' application of the economic substance doctrine, Congress codified and clarified its basic principles in *IRC Section 7701(o)*.ⁿ¹ The new subsection affirms the appropriateness of an administrative or judicial inquiry into the "economic substance" or "business purpose" of a transaction even though the tax benefits claimed by reason of the transaction appear to be allowable under the literal terms of the Internal Revenue Code.ⁿ² Once such an inquiry is justified by the Internal Revenue Service or the courts, *IRC Section 7701(o)* prescribes a set of rules to help the courts in deciding whether the transaction has "economic substance" and therefore qualifies for the tax benefits in issue.

IRC Section 7701(o)(1) begins by apparently returning the economic substance doctrine to a "two-pronged inquiry" similar to that posited in *Rice's Toyota World, Inc v Commr*.ⁿ³

"A transactionⁿ⁴ is treated as having economic substance only if--

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such

transaction."

Unlike *Rice's Toyota World's* statement of the doctrine, which could be interpreted as allowing a taxpayer to avoid its application by showing *either* a subjective business purpose *or* an objectively reasonable possibility that the transaction would be profitable, under *IRC Section 7701(o)(1)* that the taxpayer must show *both*. It is insufficient, moreover, for the taxpayer merely to show any business purpose; the business purpose must be a "substantial" one.ⁿ⁶

IRC Section 7701(o) goes on to provide specific rules implementing these two tests. For purposes of both, a transaction has a potential for profit only if "the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected tax benefits that would be allowed if the transaction were respected."ⁿ⁷ Furthermore, *IRC Section 7701(o)(3)* provides that the tax savings ("Federal income tax effect") taken into account must include savings of not only Federal income taxes but State and local income taxes related thereto, a rule that appears to be without precedent in any pre-codification decision.

IRC Section 7701(o)(2)(B) addresses two issues relevant to the calculation of pre-tax profit. First, legal and accounting fees and other transaction expenses must be deducted for this purpose, a proposition that has never been thought debatable. Secondly, the subsection addresses but does not resolve the more controversial issue of whether foreign income taxes should be treated as an expense of a transaction or, like domestic income taxes, should be ignored as irrelevant to a calculation of "pre-tax" profit.ⁿ⁸ The issue is left to the Treasury and Internal Revenue Service to resolve in regulations.ⁿ⁹

Demonstrating a transaction's potential profitability may not be the only way to prove that a transaction changed the taxpayer's economic position "in a meaningful way." This statement of the objective test leaves room for argument that a transaction with a significant legal or accounting impact on the parties may bring about a meaningful change in economic position, as in *Frank Lyon Co v US*.ⁿ¹⁰ Nor is the result in *Lyon* inconsistent with *IRC Section 7701(o)(4)*, which provides that, for purposes of the subjective test, achieving a financial accounting benefit may not be taken into account as a non-tax purpose for entering a transaction if the origin of the accounting benefit is a reduction in Federal income tax.ⁿ¹¹ The factor in *Lyon* that was thought to give economic substance to the transaction was a diminution in the taxpayer's borrowing capacity as a result of the mortgage liability the taxpayer was required to show on its balance sheet. Not only was this not a "financial accounting benefit" to the taxpayer, the accounting detriment to the taxpayer did not originate with a reduction in the taxpayer's Federal income tax.

Still, taxpayers in pre-codification cases have enjoyed little success relying solely on *Lyon*-type changes in economic position without also showing a reasonable expectation of profit, and the result is unlikely to be different after codification. The only significant pre-codification case in which the taxpayer was able to prevail on a *Lyon*-based argument was the *UPS* decision,ⁿ¹² where the taxpayer restructured an existing business in a way that lowered its tax burden but also involved undertaking and altering enforceable legal relationships with unrelated parties. The decision of the Court of Appeals for the Ninth Circuit was deeply influenced by the fact that the transaction in *UPS* was typical (apart, perhaps, from its sophistication) of the type of garden-variety tax planning in which taxpayers and their advisors engage every day due to the fact that "the Code treats lots of categories of economically similar behavior differently."ⁿ¹³ The Technical Explanation of the provisions of *IRC Section 7701(o)* prepared by the staff of the Joint Committee on Taxation suggests that Congress did not intend to inject the economic substance doctrine into the sphere of such legitimate tax planning.

"The provision [*IRC Section 7701(o)*] is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity; (2) a US person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of

transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section of section 482 and other applicable concepts are satisfied"n14

[6] Penalty for Engaging in Transactions Lacking Economic Substance.

In a dramatic step towards stopping the "raid on the Treasury" by taxpayers who cross the line between tax planning and tax avoidance, Congress imposed a penalty equal to 20 percent of any underpayment of tax that results from engaging in a transaction "lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law."n1 The penalty increases to 40 percent if the "relevant facts" regarding the transaction are not disclosed in the taxpayer's return or on a statement attached to the return.n2 The penalty also applies to claims for refund to the extent the amount claimed is excessive because it is attributable to one or more transactions lacking economic substance.n3

Once an understatement in income tax has been determined as the result of a finding that a transaction engaged in by the taxpayer lacked economic substance, imposition of the penalty is automatic. Other civil tax penalties imposed in various circumstances by the Internal Revenue Code⁴ ordinarily allow the taxpayer to escape the penalty by showing "reasonable cause" for the taxpayer's position,n5 frequently in the form of a legal opinion or advice from a tax professional supporting that position.n6 However, this defense will not be available to taxpayers subject to the penalty for entering transactions lacking economic substance.n7

FOOTNOTES:

(n1)Footnote 1. It should be kept in mind, however, that the substance over form, step transaction, sham transaction, business purpose, and economic substance doctrines overlap, and that courts sometimes use them interchangeably. See *Rogers v US*, 281 F3d 1108, 1115-1118 (10th Cir 2002) (differences between doctrines "not vast" and described by commentators as "fairly gossamer" and "closely related.") The *Rogers* court concluded that "substance over form" is mainly concerned with properly characterizing transactions for federal tax purposes (for example, whether a sale is really a loan), while the issue in economic substance cases is whether the transaction should be disregarded for tax purposes because its economic effects are either nonexistent or relatively insignificant in relation to the comparatively large tax benefits it is intended to achieve. See also Hariton, Sorting Out the Tangle of Economic Substance, 52 Tax Lawyer 235, 238-239 (1999); Dept of the Treasury, The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals, 46-58 (1999).

(n2)Footnote 2. See § 1.02[2].

(n3)Footnote 3. Just as courts may disregard the label placed on a transaction by the parties, they may also disregard the words of the Internal Revenue Code in cases where the literal text would produce a result inconsistent with Congressional intent. See *Coltec Industries, Inc v US*, 454 F3d 1340, 1354 (Fed Cir 2006) , *cert denied* 549 US 1206 (2007) (economic substance doctrine is applicable "where the literal terms of a statute can undermine the ultimate purpose of the statute."). Such cases, which are sometimes referred to as "economic shams" because the transactions, though real, make no sense from an economic standpoint without regard to their tax saving objective, constitute one major branch of the economic substance doctrine. The other major branch centers around "factual shams," in which it is unnecessary for the court to inquire into the purpose of the statutory provision which gives rise to the hoped-for tax benefit because, on close examination, the transaction is not real at all, or not what it is represented to be. See, *eg*, *Southgate Master Fund, LLC v US*, 651 F Supp 2d 596 (ND Tex 2009) , where the court found that a contribution of property to a partnership, and the partnership itself, were factual shams because the partner never relinquished control over the property he supposedly contributed to the partnership and thus never realized the losses he claimed with respect to the partnership.

(n4)Footnote 4. See *Rose v Commr*, 868 F2d 851, 853 (6th Cir 1989) : "This court will not inquire into whether a ... [transaction satisfies the tests for deductibility under *IRC* § 165] until it determines that the transaction is bona fide

and not a sham ... "

Although many transactions disregarded as shams under the economic substance doctrine involve attempts to deduct artificial losses under *IRC* § 165, the doctrine is not limited to that Code provision. See, eg, *Knetsch v US*, 364 US 361 (1960) (interest deduction disallowed under *IRC* § 163 because transaction giving rise to interest payment was a sham). See also § 19.05[a][1].

(n5)Footnote 5. 293 US 465 (1935) .

(n6)Footnote 6. Section 112(i)(1) of the Revenue Act of 1928, c 852, 45 Stat 791, 818. Under Section 112(g) of the 1928 Act, the distribution of Averill stock to the taxpayer was tax-free, rather than a dividend, only if made in pursuance of a plan of "reorganization" as that term was defined in Section 112(i)(1).

(n7)Footnote 7. 27 BTA 223 (1932) .

(n8)Footnote 8. 293 US at 468-469 .

(n9)Footnote 9. 293 US at 469 .

(n10)Footnote 10. *Id.* The Court resolved the question by "putting aside ... the question of motive ... and fixing the character of the proceeding by what actually occurred." 293 US at 469 . As will be seen, the role of taxpayers' motives in the application of the economic substance doctrine has been a matter of some debate. See § 1.02A[1][b] below.

(n11)Footnote 11. *Ibid.* 293 US at 470 . Judge Learned Hand, an eminent jurist, wrote the opinion for the Court of Appeals for the Second Circuit that the Supreme Court affirmed. *Helvering v Gregory*, 69 F2d 809 (2d Cir 1934) . His response to the taxpayer's argument has also been repeated many times since: "[I]t does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition [The meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create. The purpose of the section is plain enough; men engaged in enterprises--industrial, commercial, financial, or any other--might wish to consolidate, or divide, to add to, or subtract from, their holdings. Such transactions were not to be considered as "realizing" any profit, because the collective interests still remained in solution. But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganizations.'" 69 F2d at 811 .

(n12)Footnote 12. In his notice of deficiency, the Commissioner determined that the transfer of the Monitor shares from United Mortgage to Averill, the issuance of Averill's shares to the taxpayer and the distribution of the Monitor shares to the taxpayer in the complete liquidation of Averill were all "nullities" and should therefore be disregarded, and that United Mortgage should be deemed to have transferred the Monitor shares directly to the taxpayer as a dividend. The Court of Appeals found that these steps were real and could not be disregarded, but since the transactions did not constitute a "reorganization" within the meaning of the statute, the result, properly analyzed, was that the receipt of the Averill shares by the taxpayer was the taxable event. "The Averill Corporation had a juristic personality, whatever the purpose of its organization; the transfer passed title to the Monitor shares and the taxpayer became a shareholder in the transferee. All these steps were real, and their only defect was that they were not what the statute means by a 'reorganization,' because the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham, though all the proceedings had their usual effect. But the result is the same whether the tax be calculated as the Commissioner calculated it, or upon the value of the Averill shares as a dividend" 69 F2d at 811. Although, as the Court of Appeals noted, the differences in approach made no difference to the result in *Gregory*, (the Supreme Court's opinion makes no mention of the issue), later cases have found that the collateral tax consequences of a transaction challenged under the economic substance doctrine can be affected depending on whether a step in the

transaction is a complete "sham" or should be disregarded only for purposes of applying a particular statutory provision. See § 1.02A[4], *infra*.

(n13)Footnote 13. 308 US 473 (1940) .

(n14)Footnote 14. 308 US at 476 ("There is not enough of substance in such a sale finally to determine a loss.").

(n15)Footnote 15. However, *Higgins v Smith* has been invoked to disallow a loss under IRC § 165 where an identity of economic interest was demonstrated in the relationship of the parties to the transaction, even though that relationship was not one described in IRC § 267. *Scully v US*, 840 F2d 478 (7th Cir 1988) . See § 2.07[4] for a discussion of the provisions of IRC § 267. See also IRC § 707(b) (disallowing losses claimed in transactions between partnerships and related parties).

(n16)Footnote 16. See *Klamath Strategic Investment Fund v US*, 568 F3d 537, 543 (5th Cir 2009) ; *Coltec Industries, Inc v US*, 454 F3d 1340, 1355 (Fed Cir 2006) ; *Thomas v US*, 166 F3d 825, 831 (4th Cir 1999) ; *Southgate Master Fund, LLC v US*, 651 F Supp 2d 596, 654 (ND Tex 2009) .

(n17)Footnote 17. 308 US at 477 .

(n18)Footnote 18. 435 US 561 (1978) .

(n19)Footnote 19. The facts in *Frank Lyon* are recited in greater detail at § 1.02[2], *supra* .

(n20)Footnote 20. For example, the seller, a bank, was able to build a new headquarters building that bank regulators had not allowed it to self-finance, and the purchaser, the taxpayer, by taking out a loan in its own name with third party lenders had committed its credit to the transaction and was less able to obtain financing for other business needs.

(n21)Footnote 21. 435 US at 583-584 .

(n22)Footnote 22. See *Rice's Toyota World, Inc v Commr*, 752 F2d 89 (4th Cir 1985) , *aff'g* 81 TC 184 (1983) .

(n23)Footnote 23. *Rice's Toyota World, Inc v Commr*, 752 F2d at 91-92 .

(n24)Footnote 24. See *Coltec Industries, Inc v US*, 454 F3d 1340, 1355 (n 14) (Fed Cir 2006) , *cert denied* 549 US 1206 (2007) ("We think that the rule adopted by the Fourth Circuit ... is not consistent with the Supreme Court's pronouncements in cases such as *Frank Lyon*."); *Klamath Strategic Investment Fund v US*, 568 F3d 537, 544 (5th Cir 2009) ("The [Supreme] Court [in *Frank Lyon*] set up a multifactor test for when a transaction must be honored as legitimate for tax purposes, with factors including whether the transaction (1) has economic substance compelled by business or regulatory realities, (2) is imbued with tax-independent considerations, and (3) is not shaped totally by tax-avoidance features. See *Frank Lyon*, 435 US at 583-84 . Importantly, these factors are phrased in the conjunctive, meaning that the absence of any one of them will render the transaction void for tax purposes. Thus, if a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the taxpayers profess a genuine business purpose without tax-avoidance motivations.")

(n25)Footnote 25. See *Klamath Strategic Investment Fund v US*, 568 F3d at 544 . Other decisions adopting that view include *Dow Chemical Co v US*, 435 F3d 594, 599 (6th Cir 2006) , *cert denied* 549 US 1205 (2007) ("If ... the court determines that the transaction is a sham, the entire transaction is disallowed for federal tax purposes, and the [subjective] inquiry is never made"); *United Parcel Service of America, Inc v Commr*, 254 F3d 1014, 1018 (n 4) (11th Cir 2001) ("*Rice's Toyota World*, unlike [*Kirchman v Commr*, 862 F2d 1486 (11th Cir 1989)] , requires a tax avoidance purpose as well as a lack of substance; *Kirchman* explicitly refuses to examine subjective intent if the transaction lacks economic effects"); and *Coltec Industries, Inc v US*, 454 F3d at 1354 ("a lack of economic substance

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is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance").

(n26)Footnote 26. *ACM Partnership v Commr*, 157 F3d 231, 247 (3d Cir 1998) , cert denied, 526 US 1017 (1999) . See also *James v Commr*, 899 F2d 905, 908-909 (10th Cir 1990) ("The better approach, in our view, holds that 'the consideration of business purpose and economic substance are simply more precise factors to consider in the [determination of] whether the transaction had any practical economic effects other than the creation of income tax losses,' " quoting *Sochin v Commr*, 843 F2d 351, 354 (9th Cir 1988) , cert denied 488 US 824 (1988) .

(n27)Footnote 27. See the discussion of the subjective test in § 1.02A[2][d] below.

(n28)Footnote 28. *New Phoenix Sunrise Corp v Commr*, 132 TC 161, 175 (2009) , citing *Frank Lyon Co v US*, 435 US at 584 . In accordance with the general rule that the burden of proof is on the taxpayer to show that he does not owe taxes asserted by the Internal Revenue Service, the burden of proving that a transaction disregarded by the Service has economic substance is on the taxpayer. See, eg, *Coltec Industries Inc v US*, 454 F3d at 1355 . In some cases, however, the taxpayer may be able to shift the burden of proof to the Government. See *IRC § 7491*; *Southgate Master Fund, LLC v US*, 651 F Supp 2d 596, 648-651 (ND Tex 2009) .

(n29)Footnote 1. *Southgate Master Fund, LLC v US*, 651 F Supp 2d 596, 655 (ND Tex 2009) .

(n30)Footnote 2. *Gilman v Commr*, 933 F2d 143, 148 (2d Cir 1991) cert denied 502 US 1031 (1992) (Tax Court properly gauged potential profitability from standpoint of a prudent investor); *Friedman v Commr*, 869 F2d 785, 793 (4th Cir 1989) ; *Long-Term Capital Holdings, LP v US*, 330 F Supp 2d 122 (D Conn 2004) , aff'd 150 Fed Appx 40 (2d Cir 2005) .

Some transactions may span several years and involve a future stream of income as well as future cash outlays. In such cases, the court may (and normally should) discount future receipts and expenditures to present value using an appropriate discount rate. See *ACM Partnership v Commr*, 157 F3d at 259-260 .

(n31)Footnote 3. In other words, the economic substance doctrine may be applied to disregard superficially "real" transactions, capable of producing economic profit, when they are employed as part of a scheme or strategy that minimizes or eliminates their profit potential in order to produce tax benefits. Such was the case in *Sheldon v Commr*, 94 TC 738 (1990) where partnerships employed T-bill repurchase agreements ("repos") to implement a strategy that minimized or eliminated the profit potential of the repos in order to reliably create interest deductions that deferred income tax on partners' income until an offsetting amount of revenue was realized in the following year. The Tax Court rejected the Government's argument that the repos themselves were "sham" transactions, see 94 TC at 753-758 , but found that the repos nevertheless lacked economic substance as employed by the partnerships. "The transactions were intentionally and cleverly structured to be and are real, but are without substance within the meaning of established case precedent. The transactions occurred at yearend to create deferral for tax purposes irrespective of whether they resulted in gain or loss, which, as structured, were destined to be de minimis in amount." *Sheldon v Commr*, 94 TC at 769 (footnote omitted).

(n32)Footnote 4. See, eg, *Torres v Commr*, 88 TC 702 (1987) .

(n33)Footnote 5. *James v Commr*, 899 F2d at 911-912 . See also *Rice's Toyota World, Inc v Commr*, where, on similar facts, the court held that the purchase of a computer pursuant to a sale and leaseback arrangement was a sham because the taxpayer's conduct consistently demonstrated indifference to the economic (as opposed to tax) consequences of the transaction. Although there was a theoretically possible profit if the taxpayer saw the transaction through to completion, since the taxpayer "paid so obviously inflated a purchase price for the computer and financed the purchase mainly with nonrecourse debt, it was properly inferable by the tax court that [the taxpayer] intended to abandon the transaction down the road by walking away from the nonrecourse note balance before the transaction ran its stated course... . The inference is amply supportable that this intended course of conduct explains ... [the taxpayer's]

apparent lack of concern with residual value or profitability of the transaction apart from tax benefits." 752 F2d at 93 .

The courts' analyses in both these cases seems clearly to conflate objective and subjective factors. Although *Rice's Toyota World's* analysis was performed under the subjective or "business purpose" prong of the Fourth Circuit's two-part test, the court also imported that analysis into the objective test, in which it relied upon the critical inference that potential profit that might have been achieved if the transaction were seen through to its conclusion was illusory because the taxpayer intended to walk away from the transaction well before that time. *Rice's Toyota World, Inc v Commr*, 752 F2d at 95 . The Tax Court's decision in *James* was also made under the *Rice's Toyota World* two-pronged test, 87 TC 905 (1986) , but the Court of Appeals for the Tenth Circuit, in affirming the Tax Court, stated that "the better approach" is to consider both subjective and objective considerations as factors in a single overall analysis of whether a transaction has economic substance. *James v Commr*, 899 F2d at 908-909; note 26, *supra*.

(n34)Footnote 6. 435 F3d 594 (6th Cir 2006) , cert denied 549 US 1205 (2007) .

(n35)Footnote 7. 435 F3d at 602 .

(n36)Footnote 8. See *Klamath Strategic Investment Fund v US*, 568 F3d at 545 ; *Coltec Industries, Inc v US*, 454 F3d at 1356-1357 ; *ACM Partnership v Commr*, 157 F3d at 260 ; *James v Commr*, 899 F2d at 910 (transactions lacking economic substance "cannot be legitimized merely because they were on the periphery of some legitimate transactions"); *Southgate Master Fund, LLC v US*, 651 F Supp 2d 596.

(n37)Footnote 9. *ACM Partnership v Commr*, 157 F3d at 258 . See also *Sheldon v Commr*, 94 TC 738, 768 (1990) ("The potential for "gain," ... is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions.") Profits produced inadvertently, contrary to the parties' expectations, are likewise disregarded. See *Internal Revenue Service v CM Holdings, Inc*, 301 F3d 96 (3d Cir 2002) . In *CM Holdings*, the parties to a corporate-owned life insurance policy crafted its terms with the intent that the taxpayer would experience neither mortality gains nor losses. The fact that the taxpayer nevertheless experienced mortality gains was not viewed as evidence of profit potential in the transaction, particularly when the insurer immediately amended the terms of the policy to enable it to recoup those gains (mortality losses to the insurer) and ensure that they would not recur in the future. 301 F3d at 104-105 .

(n38)Footnote 10. See *Sheldon v Commr*, 94 TC at 738 : "Clearly, ... [the promoters' and taxpayer's] expertise permitted them to structure these deals using real transactions (with one exception). The fact that they permitted open positions for limited periods of time was obviously not for the objective of gain, but to formulate the appearance of potential for gain or loss. If the transactions had been fully offset, straddled, or hedged to obviate the possibility of any loss or gain, the form of the transaction could have been more readily attacked by ... [the Internal Revenue Service]." See also *Schering-Plough Corp v US*, 2009 US Dist LEXIS 77467 at *129-130 where the taxpayer assumed interest rate risk it could easily have avoided on the advice of its tax counsel to bolster its defense against an economic substance attack on the transaction. "Any interest rate risk exposure ... was purposely inflicted and does not create objective economic effects."

(n39)Footnote 11. 253 F3d 350 (8th Cir 2001) (hereafter, *IES Industries*).

(n40)Footnote 12. 277 F3d 778 (5th Cir 2001) (hereafter *Compaq*), reversing 113 TC 214 (1999) (hereafter, *Compaq-Tax Court*).

(n41)Footnote 13. According to the Tax Court, the taxpayer took steps to "eliminate all economic risks and influences from outside market forces on the purchases and sales in the ADR transaction." *Compaq-Tax Court*, 113 TC 214, 219 (1999) (ultimate findings of fact). The Court of Appeals, reversing the Tax Court, said that "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." *Compaq*, 277 F3d at 787 .

(n42)Footnote 14. See *Compaq*, 277 F3d at 783 ; *IES Industries*, 253 F3d at 354 .

(n43)Footnote 15. See *IRC § 901(k)*. To deal with the ADR strategy, Congress amended *section 901 of the Internal Revenue Code* to provide, on a prospective basis, that a foreign tax credit will not be allowed with respect to taxes withheld at the source from foreign dividends unless the taxpayer has held the stock (or ADR) on which the dividends were paid for at least 16 days of a prescribed 30-day period, including the dividend record date.

(n44)Footnote 16. See *Compaq-Tax Court*, 113 TC at 225-226 ("A transaction does not avoid economic substance scrutiny because the transaction predates a statute targeting the specific abuse."); *Compaq*, 277 F3d at 788 ; *IES Industries*, 253 F3d at 356 (n 5) . When Congress enacts remedial legislation with prospective effect, it is not uncommon for committee reports or other legislative history to include language to the effect that no inference is intended as to the proper tax treatment of similar transactions under the pre-existing law. Such language was included in the committee reports explaining the provisions of *IRC § 901(k)*. See S. Rept. 105-33, 175, 177 (1997), quoted in *Compaq-Tax Court*, 113 TC at 225 .

(n45)Footnote 17. See *Knetsch v Commr*, 364 US 361, 367 (1960) ; *Winn-Dixie v Commr*, 254 F3d 1313, 1316 (11th Cir. 2001) ; *IRS v CM Holdings, Inc*, 301 F3d at 106 ; *Southgate Master Fund, LLC v US*, 651 F Supp 2d 596, 652-653 (ND Tex 2009) ; *Sheldon v Commr*, 94 TC at 766 .

(n46)Footnote 18. Potential profitability, though often critically important, may be insufficient to establish that a transaction has economic substance if the court concludes that the taxpayer could have made the same profit in a less risky transaction, especially when the taxpayer's willingness to use a riskier structure is explicable only by an overriding goal to save taxes. See *ACM Partnership v Commr*, 157 F3d at 258 (n 2) ; *Schering-Plough Corp v US*, 2009 US Dist LEXIS at 149 .

(n47)Footnote 19. See *ACM Partnership v Commr*, 157 F3d at 248 (n 31) . However, a change in net economic position does not include a change which results from and assumes the legitimacy of the tax-saving transaction under examination. In *Schering-Plough Corp v US*, the court dismissed as "circular" reasoning the taxpayer's contention that its receipt of \$728 million dollars from the repatriation of earnings of its foreign subsidiary constituted a significant change in its economic position when the transaction which made it possible for the taxpayer to receive those earnings "tax-free" was the same transaction whose economic substance was being questioned. "[The taxpayer] would have the Court believe that the very tax-sheltered money it repatriated can itself provide the objective economic effect it seeks to prove. The repatriated funds in themselves do not constitute an appreciable economic effect any more than shifting money from one pocket to another ... " *Schering-Plough Corp v US*, 2009 US Dist LEXIS at *129 .

(n48)Footnote 20. *Frank Lyon Co v US*, 435 US at 582-583 . The Supreme Court also attached significance to the transaction because of its impact on parties other than the taxpayer. The seller-lessee in the sale and leaseback transaction, a bank, was able to build a new headquarters building that would have been blocked by regulatory and financial problems had the transaction been structured differently. This led the Third Circuit to surmise, in *IRS v CM Holdings, Inc*, 301 F3d at 107 (n 8), that a transaction might have economic substance under *Frank Lyon*, or at least be "more palatable to the IRS," if the other party to the transaction was required to pay tax on income as a result of the deduction of an expense by the taxpayer. In the case before it, where the taxpayer claimed interest deductions on policy loans used to finance premiums on a corporate-owned life insurance contract, the insurer on the other side of the transaction was required to take the interest into income but paid minimal tax because the interest was offset it with additions to reserves under the policy. The minimal tax consequences to the insurer were deemed insufficient to give economic substance to the policy.

(n49)Footnote 21. 254 F3d 1014, 1018 (11th Cir 2001) .

(n50)Footnote 22. *Id.* The fact that the parties in *Frank Lyon* were unrelated has been used to distinguish that case from transactions between related parties. See *Coltec Industries, Inc v US*, 454 F3d at 1357 (*Frank Lyon*, which

involved a "genuine multiple-party transaction" itself distinguished more "familial" arrangements; indeed, "arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny." See also *Schering-Plough Corp v US*, 2009 US Dist LEXIS 77467 at *108 .

(n51)Footnote 23. See *Jade Trading, LLC v US*, 80 Fed Cl 11, 14 (2007) , *aff'd* on economic substance issue, *rev'd and vacated on other grounds*, 598 F3d 1372 (Fed Cir 2010) ("A final indicium of the lack of economic substance here, while not dispositive in and of itself, is the highly disproportionate tax advantage to the underlying monetary outlay--the tax loss ... \$14.9 million, was roughly 65 times greater than [the] \$225,002 financial commitment ... " See also *New Phoenix Sunrise Corp v Commr*, 132 TC 161, 182 ("We note at the outset that ... [none of the participants in the transaction] suffered a \$10 million economic loss during 2001. The loss claimed ... was purely fictional."). *Kornman & Assoc Inc v US*, 527 F3d 443 (5th Cir 2008) involved a transaction similar to the transactions in *Jade Trading* and *New Phoenix Sunrise*; a \$102.6 million loss was claimed on the taxpayer's tax return although it suffered an economic loss of only \$200,000. The court did not apply the economic substance doctrine in that case, however, choosing instead disallow the loss by accepting the Government's interpretation of a statutory provision "in a manner that prevents a taxpayer from deducting non-economic losses." *Id* at 456 (n 11).

(n52)Footnote 24. 515 F3d 749, 751 (7th Cir 2008) .

(n53)Footnote 25. *ACM Partnership v Commr*, 157 F3d at 250 . On the other hand, a long-term arrangement cannot "sanctify a transaction that lacks economic substance." *Internal Revenue Service v CM Holdings, Inc*, 301 F3d at 104 .

(n54)Footnote 26. *Internal Revenue Service v CM Holdings, Inc*, 301 F3d at 108 .

(n55)Footnote 27. *Rice's Toyota World, Inc v Commr*, 752 F2d at 93 ; *Internal Revenue Service v CM Holdings, Inc*, 301 F3d at 105 .

(n56)Footnote 28. *James v Commr*, 899 F2d at 911 ("extraordinary" management fees and "inflated" purchase price).

(n57)Footnote 1. See § 1.02A[2], text at notes 21 and 22, *supra*.

(n58)Footnote 2. *UPS*, 254 F3d at 1019 .

(n59)Footnote 3. *Id*.

(n60)Footnote 4. *UPS*, 254 F3d at 1021 (dissenting opinion).

(n61)Footnote 5. *UPS*, 254 F3d at 1019 .

(n62)Footnote 6. *UPS*, 254 F3d at 1020 .

(n63)Footnote 7. See discussion in § 1.02A[2], *supra*.

(n64)Footnote 8. See *IES Industries, Inc v US*, 253 F3d at 356 ("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.")

(n65)Footnote 9. *Compaq Computer Corp and Subsidiaries v Commr*, 277 F3d at 787 (n 8) .

(n66)Footnote 10. 499 US 554 (1991) . *Cottage Savings* is discussed at § 1.02[3][a][i], *supra*.

(n67)Footnote 11. See *ACM Partnership v Commr*, 157 F3d at 254 (n 44) .

(n68)Footnote 12. *499 US at 568* . The fact that actual economic losses had been sustained with respect to the portfolios exchanged in *Cottage Savings* of course distinguishes that case from transactions found to lack economic substance under the objective test. See, eg, *ACM Partnership v Commr*, *157 F3d at 251-252* : "[T]he disposition in *Cottage Savings* precipitated the realization of actual economic losses arising from a long-term, economically significant investment, while the disposition in this case was without economic effect as it merely terminated a fleeting and economically inconsequential investment, effectively returning ... [the taxpayer] to the same economic position it had occupied before the ... acquisition [of its investment] 24 days earlier."

(n69)Footnote 13. *Hines v US*, *912 F2d 736, 740 (4th Cir 1990)* ; *Black & Decker Corp*, *436 F3d 431,443 (4th Cir 2006)* . "[W]hile it is important to examine both the subjective motivations of the taxpayer and the objective reasonableness of the investment, in both instances our inquiry is directed to the same question: whether the transaction contained economic substance aside from the tax consequences." *Hines v US*, *912 F2d at 739* ; *Black & Decker Corp v US*, *436 F3d at 441* .

(n70)Footnote 14. *Coltec Industries, Inc v US*, *454 F3d 1340, 1356 (Fed Cir 2006)*, *cert denied*, *549 US 1206 (2007)*.

(n71)Footnote 15. See n 55, *supra*.

(n72)Footnote 16. See, eg, *Rice's Toyota World v Commr*, *752 F2d at 92* (taxpayer did not "seriously evaluate" whether computer purchased in sale and leaseback transaction would have sufficient residual value to allow taxpayer to make a profit on the transaction; its principal officer "knew virtually nothing" about computers and failed to obtain an objective expert appraisal); *ACM Partnership v Commr*, *157 F3d at 257* ("ACM's lack of regard for the relative costs and benefits of the contemplated transaction and its failure to conduct a contemporaneous profitability analysis support the Tax Court's conclusion that ACM's transactions were not designed or reasonably anticipated to yield a pre-tax profit ..."); *Pasternak v Commr*, *990 F2d 893, 903 (6th Cir 1993)* (taxpayers' "complete indifference to the risks involved" demonstrated by fact that they "invested in [recordings] of artists they had never heard of, without listening to the master recordings prior to investing, and without even inquiring whether a reliable independent evaluation of profit potential had ever been made."). But see *Southgate Master Fund, LLC v US*, *651 F Supp 2d 596, 655 (ND Tex 2009)* , where the District Court found that the taxpayer's relatively brief due diligence did not support an inference of indifference to profitability since the properties involved, distressed loans, were worth only pennies on the dollar. A more thorough but costly investigation would have eliminated much of its profit potential, and was in any case impractical given that this was a "relatively time-sensitive" transaction.

(n73)Footnote 17. See *ACM Partnership v Commr*, *157 F3d at 254-256* .; *James v Commr*, *899 F2d at 910-1 911* (taxpayers "did not exercise the care that would be expected from owners of multimillion dollar computer systems"); *Rice's Toyota World v Commr*.

(n74)Footnote 18. See *ACM Partnership v Commr*, *157 F3d at 258*, n 52 (court may consider, in its analysis of whether there was a profit motive behind the taxpayer's transactions, that the transaction under examination "involved substantial transaction costs, entailed significant risks ... , and compared unfavorably to the higher profitability and lower risk of ... cash deposit accounts which [the taxpayer] affirmatively relinquished [in order] to pursue ... [its tax avoidance] strategy."); *Schering-Plough Corp v US*, *2009 US Dist LEXIS 77467*, at *132 (taxpayer's willingness to spend \$35 million on advisory fees and transaction costs to accomplish transaction with little or no profit potential is "persuasive" of tax avoidance motivation.)

(n75)Footnote 19. *Coltec Industries, Inc v US* , is illustrative. In that case, Garlock, a member of an affiliated group of corporations headed by Coltec, contributed a \$375 million note to Garrison, another member of the group, plus all the stock of its subsidiary, Anchor, in exchange for Garrison's assumption of Garlock's contingent asbestos liabilities, expected ultimately to require the expenditure of \$375 million, plus shares of Garrison's stock. Garrison also agreed to manage the asbestos liabilities of both Garlock and Anchor, although it did not assume Anchor's contingent asbestos

liabilities. Garlock immediately made a pre-arranged sale of the Garrison stock it acquired in this transaction to third parties outside the group for \$500 thousand, claiming a basis in the Garrison stock of \$375 million (taking into account its basis in the \$375 million note transferred to Garrison but not the \$375 million of contingent liabilities assumed by Garrison in the transaction) and a capital loss of \$374.5 million. When the Internal Revenue Service challenged the economic substance of the note for asbestos liabilities plus stock transaction, the parent company of the group, Coltec, argued that the transaction had two business purposes: first, it made Coltec a more attractive acquisition target because concentrating management of the asbestos liabilities in a single corporation showed prospective investors it was taking positive steps to manage its asbestos problem; and second, inserting Garrison into the picture protected Coltec from the possibility that asbestos claimants could "pierce the corporate veil" and hold Coltec responsible for Garlock's and Anchor's liabilities.

The court of appeals rejected the first purpose because it focused on the wrong transaction: it was not Garrison's assumption of managerial responsibility for Garlock and Anchor's asbestos liabilities that was in issue, but Garrison's assumption of Garlock's liabilities. It was not essential that Garrison assume Garlock's asbestos liabilities in order to manage them, as was demonstrated by the fact that Garrison managed, but did not assume, Anchor's asbestos liabilities. The Court dismissed the second asserted purpose because it was simply untrue that inserting Garrison into the picture and having it assume Garlock's liabilities decreased the risk of a claimant's piercing Garlock's or Anchor's corporate veil. As a matter of law, Garrison's assumption of Garlock's liabilities affected only relations between members of the affiliated group, not the rights of third party claimants against them. Although Coltec and Garlock executives testified that they believed Garrison's assumption gave them an advantage in dealing with insurance carriers and claimants, their subjective views could not outweigh the reality that the transaction did not affect the rights of third parties outside the group. "[E]conomic substance is measured from an objective, reasonable viewpoint, not by the subjective views of taxpayer's corporate officers." 454 F3d at 1359 .

A third asserted business purpose of the transaction, involving the subsequent sale of Garrison stock to Coltec's outside legal counsel to incentivize their performance in asbestos-related litigation, was disregarded because it was too distant in time from and would not have played any role in the taxpayer's decision to undertake the transaction. Cf *ACM Partnership v Commr*, 57 F3d at 257 (n 31) (taxpayer's expert's report on the potential profitability of a transaction, prepared in the context of litigation with the IRS and which "had not entered into [the taxpayer's] calculations at the outset" of the transaction, may be disregarded by the court, quoting *Goldstein v Commr*, 364 F2d 734, 740 (2d Cir 1966)) .

(n76)Footnote 1. See *US v Wexler*, 31 F3d 117, 122 (3d Cir 1994) , quoting *Lerman v Commr*, 939 F2d 44, 45 (3d Cir 1991) , cert denied, 502 US 984 (1992) .

(n77)Footnote 2. See, eg, *Sheldon v Commr*, 94 TC 738, 762 (1990) .

(n78)Footnote 3. *Rice's Toyota World, Inc v Commr*, 752 F2d 89, 96 (4th Cir 1985) .

(n79)Footnote 4. *Rice's Toyota World, Inc v Commr*, 81 TC 184, 210 (1983) , reversed on this issue, 752 F2d 89 (4th Cir 1985) .

(n80)Footnote 5. 435 US 561 (1978) .

(n81)Footnote 6. *Rice's Toyota World, Inc v Commr*, 752 F2d at 96 .

(n82)Footnote 7. *ACM Partnership v Commr*, 157 F3d 231, 247, 262-263 (3d Cir 1998) , cert denied 526 US 1017 (1999) .

(n83)Footnote 8. See *ACM Partnership v Commr*, 157 F3d at 262 (quoting from *US v Wexler*, 31 F3d at 125) .

(n84)Footnote 9. The LIBOR notes were short-term notional principal contracts providing for payments that varied

with movements in interest rates as determined by the London Interbank Offering Rate (LIBOR).

(n85)Footnote 10. *ACM Partnership v Commr*, *TC Memo 1997-115*, reversed on this issue, *157 F3d 231*.

(n86)Footnote 11. *ACM Partnership v Commr*, *157 F3d at 262*. In *Coltec Industries, Inc v US*, *454 F3d 1340, 1360 (Fed Cir 2006)*, cert denied *549 US 1206 (2007)*, the court of appeals for the Federal Circuit remanded to the Court of Federal Claims to determine whether a genuine economic loss had been incurred as a part of a transaction otherwise lacking in economic substance. The taxpayer had contributed a \$375 million note and offsetting contingent liabilities of equal value, plus other consideration including tangible assets worth approximately \$4 million, in exchange for stock in an affiliated corporation, which it immediately sold to third parties for \$500,000. Although the taxpayer claimed a basis in the stock sold of \$379 million (including its basis in the note but excluding any reduction in basis for the liabilities assumed by the issuing corporation), the court of appeals reduced its basis to \$4 million after disregarding as a sham the contribution of the note and offsetting liabilities. The court remanded the case to the Court of Federal Claims to determine whether the taxpayer was entitled to claim a capital loss equal to the difference between the amount it received for the stock, \$500,000, and the basis of the stock sold as recalculated to eliminate the effect of the sham transaction.

(n87)Footnote 12. *568 F3d 537 (5th Cir 2009)*.

(n88)Footnote 13. *Klamath Strategic Investment Fund v US*, *568 F3d at 550* (quoting from the Tax Court's opinion in *Winn-Dixie Stores, Inc v Commr*, *113 TC 254, 279 (1999)*, *aff'd 254 F3d 1313 (11th Cir 2001)*). See also *Lee v Commr*, *155 F3d 584, 587 (2d Cir 1998)*, where the court of appeals for the Second Circuit rejected, on similar grounds, the taxpayer's attempt to obtain an interest deduction on a genuine recourse loan incurred as part of a transaction lacking economic substance: "To adopt ... [taxpayer's position] would be to permit every shelter, no matter how transparently sham, to qualify for an interest expense deduction as long as the money used to finance the not-for-profit transactions involved were borrowed from a lender--any commercial bank would do--that demanded repayment."

(n89)Footnote 14. *Winn-Dixie Stores, Inc v Commr*, *113 TC at 294*, quoted in *Klamath Strategic Investment Fund v US*, *568 F3d at 549*. See also *New Phoenix Sunrise Corp and Subs v Commr*, *132 TC 161 (2009)* for a more recent application of this principle by the Tax Court.

(n90)Footnote 1. *IRC § 7701(o)* was added by § 1409 of the Health Care and Education Affordability Reconciliation Act of 2010 (Pub L No 111-152) (hereafter, the "Reconciliation Act of 2010.") Its provisions are effective with respect to transactions entered into after the date of enactment, March 30, 2010.

(n91)Footnote 2. *IRC § 7701(o)(5)(A)* defines the term "economic substance doctrine" as "the common law doctrine under which tax benefits under subtitle A [containing the income tax provisions of the Internal Revenue Code] with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose." *IRC § 7701(o)(5)(C)* goes on to provide that "the determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted."

(n92)Footnote 3. *Rice's Toyota World, Inc v Commr*, *752 F2d 89 (4th Cir 1985)*, *aff'g 81 TC 184 (1983)*.

(n93)Footnote 4. The term "transaction" can include a series of transactions. *IRC § 7701(o)(5)(D)*.

(n94)Footnote 6. *IRC § 7701(o)(1)(B)*.

(n95)Footnote 7. *IRC § 7701(o)(2)(A)*. Despite the statute's initial statement of the economic substance doctrine as a "two part inquiry" per *Rice's Toyota World*, the test of *IRC § 7701(o)(2)(A)* reflects the approach taken by more recent decisions under pre-codification law that the subjective and objective tests are not "discrete prongs ... but rather ... related factors both of which inform the analysis" See, eg, *ACM Partnership v Commr*, *157 F3d 231, 247, cert*

denied, 526 US 1017 (1999). See also § 1.02A[1][b], fn 26, *supra*, and accompanying text.

(n96)Footnote 8. See *Compaq Computer Corp and Subsidiaries v Commr*, 277 F3d 778 (5th Cir 2001) ; *IES Industries, Inc v US*, 253 F3d 350 (8th Cir 2001) . The issue in those cases was put somewhat differently: whether the taxpayer could include in anticipated pre-tax profit the portion of foreign dividends withheld to pay foreign income taxes imposed on the dividend income. See § 1.02A[2], *supra*.

(n97)Footnote 9. Since the statute directs the issuance of regulations ("the Secretary shall issue regulations") that require foreign taxes to be treated as expenses for purposes of calculating pre-tax profit "in appropriate cases," it is difficult to understand how the Joint Committee can conclude that "there is no intention to restrict the ability of the courts to consider the appropriate treatment of foreign taxes in particular cases, as under present law," Technical Explanation, p. 155 (n 357); that seems precisely what the statute is intended to do, once Treasury exercises its authority by issuing the contemplated regulations.

(n98)Footnote 10. 435 US 561 (1978) . The taxpayer did demonstrate potential if minimal profitability in *Lyon*. However, the sales/leaseback transaction between the seller/lessee bank and the purchaser/lessor taxpayer was respected in part because the off-balance sheet financing technique enabled the bank to finance the construction of a headquarters building that would not otherwise have received required governmental approvals, while the taxpayer, which was required to show the mortgage financing as a liability on its balance sheet, was restricted in its ability to obtain credit for other business needs. Pre-codification economic substance cases have observed that the parties in *Lyon* were unrelated, and have refused to accord the same significance to alleged changes in economic position resulting from transactions between related parties. *Coltec Industries, Inc v US*, 454 F3d 1340, 1357 (Fed Cir 2006), *cert denied*, 549 US 1206 (2007); *Schering-Plough Corp v US*, 2009 US Dist LEXIS 77467 at *108 (DNJ 2009) . See § 1.02A[a][2], fn 50.

(n99)Footnote 11. IRC § 7704(o)(4) is consistent with pre-codification cases such as *Wells Fargo & Co and Subsidiaries v US*, 91 Fed Cl 35, 84 (2010) and *Am Elec Power, Inc v US*, 136 F Supp 2d 762, 791-792 (SD Ohio 2001) . Taxpayers have generally been unsuccessful in their attempts to bootstrap their way to a showing of potential profitability or business purpose by relying on the very tax savings their right to which has been challenged under the economic substance doctrine. "If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose is to reduce taxes, [then] every sham tax-shelter device might succeed.' " *Am Elec Power, Inc v US*, 136 F Supp 2d at 791-792 , quoting *Winn-Dixie Stores, Inc v Commr*, 113 TC 254, 287 (1999) , *aff'd* 254 F3d 1313 (11th Cir 2001) .

(n100)Footnote 12. *United Parcel Service of America, Inc v Commr*, 254 F3d 1014, 1018 (11th Cir 2001) , discussed in § 1.02A[2], *supra*.

(n101)Footnote 13. *United Parcel Service of America, Inc v Commr*, 254 F3d 1014, 1019 (11th Cir 2001) .

(n102)Footnote 14. Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act"* (JCX-18-10), March 21, 2010, (hereafter, "Technical Explanation") pp 152-153. The Technical Explanation was released shortly before final passage of the legislation adding IRC § 7701(o) to the Code, giving it some claim to authority as part of the provision's legislative history. Cf *Alfaro v Commr*, 349 F3d 225, 230 (5th Cir 2003) . The courts usually treat Joint Committee explanations deferentially, even when, as in the case of the Joint Committee's so-called "Blue Books," they are not part of the legislative history because they are published as guides to major tax legislation after the legislation has been enacted. *Alfaro v Commr*, 349 F3d 225, 230 , fns 18-19 (5th Cir 2003).

(n103)Footnote 1. IRC § 6662(b)(6). "Similar rules of law" which overlap the economic substance doctrine and may also trigger the IRC § 6662(b)(6) penalty, include the substance over form, step transaction, sham transaction, and business purpose doctrines. See IRC § 1.02A[1], fn 1. The differences between these doctrines have been described as "not vast" and "fairly gossamer." See *Rogers v US*, 281 F3d 1108, 1115-1118 (10th Cir 2002) .

(n104)Footnote 2. See *IRC § 6662(i)*. Disclosure in an amended return will avoid the 40 percent penalty provided the amended return is filed before the taxpayer is notified by the Internal Revenue Service that his return for the year in which the transaction occurred is being audited, or such other date as may be specified by regulation.

(n105)Footnote 3. *IRC § 6676(c)*.

(n106)Footnote 4. In addition to the economic substance penalty, *IRC § 6662* imposes penalties on underpayments of tax attributable to (1) negligence or disregard of rules or regulations, (2) a substantial understatement of income tax, (3) a substantial valuation misstatement, (4) a substantial overstatement of pension liabilities, (5) a substantial estate or gift tax valuation understatement, and (6) an undisclosed foreign financial asset understatement. Additionally, *IRC § 6662A* imposes penalties on reportable transaction understatements; in general, understatements of tax resulting from transactions specifically required by Treasury regulations to be disclosed because of their potential for tax avoidance or evasion, as well as transactions substantially similar to those specifically required to be disclosed (see *IRC § 6707A*). Finally, *IRC § 6663* imposes a civil tax penalty for underpayments due to fraud.

(n107)Footnote 5. See *IRC §§ 6664(c)* and *(d)*. The reasonable cause exception is qualified considerably, however, and may be inapplicable entirely, in certain cases involving penalties on reportable transaction understatements under *IRC § 6662A* (in general, understatements due to transactions which have been determined by the Treasury as having a potential for tax avoidance or evasion).

(n108)Footnote 6. See *US v Boyle, 469 US 241, 251 (1985)*.

(n109)Footnote 7. *IRC § 6664(c)(2)*.



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Taxation of Securities Transactions

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CHAPTER 1 Gains and Losses From the Disposition of Property

1-1 Taxation of Securities Transactions § 1.03

§ 1.03 The Elements of Gain or Loss--The Amount Realized

[1] General Rule.

Once it is concluded that a transaction results in the realization of gain or loss, it becomes necessary to determine the amount of that gain or loss. The statutory formula for computing gain is expressed in terms of the excess of the amount realized over the adjusted basis. For loss, it is the excess of basis over amount realized.ⁿ¹

The first term of the formula, amount realized, is defined as "the sum of money received plus the fair market value of the property (other than money) received."ⁿ² While the statutory definition appears to require an amount realized equal to the gross receipts of the sale without any reduction whatsoever, it is clear that expenses, such as brokerage commissions incurred in connection with the sale, are to be deducted from the gross proceeds to arrive at the amount realized.ⁿ³

In determining the amount realized, it is important to distinguish between payments on account of the purchase price and those which, although made contemporaneously, represent something other than the consideration for the transfer.ⁿ⁴ A second concern, present when the receipt consists of property other than cash, is the correct date for ascertaining the fair market value of such property. Generally, one simply looks at the value at the closing date, for that is the time when both physical possession and legal title are transferred. However there are instances when one must depart from this general rule. For example, in *Herbert J. Inv. Co. v. United States*,ⁿ⁵ the proper valuation date was held to be the date on which the purchaser took control of the assets and assumed all of the risks and benefits of the business. The delay in final closing was caused by the need for regulatory agency approval, a condition which the court viewed as a mere formality.ⁿ⁶

[2] Special Situations.

The normal sale provides no obstacle in determining the amount realized on the transaction. The total consideration is paid in cash at the time of the sale, the expenses of sale are known, and computing the amount realized becomes a mere arithmetic exercise. But when the disposition assumes a form different from the normal sale, the determination is not quite as simple.

[a] Inability to Value the Amount Realized. What is the amount realized in the year of disposition when a taxpayer sells property in exchange for the purchaser's promise to make payments over a period of years, the total

amount of payments being dependent on contingencies whose final resolution must await some future date? The first case to consider the problem was *Burnet v. Logan*,ⁿ¹ in which the consideration received by the taxpayer consisted of cash plus a share of a per-ton royalty for iron ore to be obtained in the future by the purchaser of the stock. The contingency related to the royalty payments, since the amount of ore which the purchaser was entitled to receive was not fixed, nor were there any minimum or maximum limits within which production had to fall. The Commissioner ruled that the purchaser's royalty-payment obligation had an ascertainable fair market value on the date of sale. The taxpayer claimed it did not and, for this reason, she should not be required to include any amount in gross income until she had recovered an amount equal to her basis for the stock. The Supreme Court held that since the promise of future payments could not be foretold with fair certainty, the promise had no ascertainable fair market value, and the amount realized in the year of disposition could not be computed. Therefore, no amount would be includable in gross income in the year of sale or any subsequent year until the taxpayer had received a complete return of capital, i.e., recovered her basis in the stock.

The Service has not wavered from the position asserted by the Commissioner in *Logan*. It maintains that "fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value."ⁿ² Although the Commissioner continues to press his contention that the *Burnet v. Logan* doctrine should be limited to rare situations, courts have been loath to sustain his claim of ascertainable value when the contingencies affecting payment are such that any estimate of value must rest on surmise and speculation.ⁿ³

What are the consequences of a finding that a transaction is "open" (the value of the contingent payment contract cannot be ascertained) rather than "closed"? If the transaction is held to be "open," the taxpayer will first treat payments received as a return of capital, and apply the same against his basis in the property sold until that basis has been completely recovered.ⁿ⁴ Any additional payments will constitute realized gain in the year such payments are received. Two major benefits accrue from a finding that a transaction is "open." First, gain is reportable in the year payments are received and not in the year of sale, a year in which the funds necessary for the payment of tax may not be available. Second, if the property sold was a capital asset in the hands of the taxpayer, all of the reportable gain will be capital gain.ⁿ⁵

If the transaction is deemed "closed" in the year of sale, the taxpayer will realize gain or loss, as the case may be, in that year. The taxpayer will not realize any additional income until he has recovered an amount equal to the value placed upon the right to receive the contingent payments. Any excess payments will produce ordinary income, and not capital gain, even if the original sale involved a capital asset, since the additional gain does not result from a sale or exchange, a requisite for capital gains treatment.ⁿ⁶ If the estimate was too high so that total receipts are less than the originally ascribed value, a loss is realized in the last year that payments are received. However, no judicial decision or administrative ruling has ever considered whether the loss is an ordinary loss (because of the lack of the requisite sale or exchange), or a capital loss (on the theory that the loss relates back to the original sale).ⁿ⁷

The Installment Sales Revision Act of 1980 expanded the category of deferred payment sales which can be reported under the installment method to include sales for a contingent price. Because of this, in the opinion of Congress:

"[I]n the future there should be little incentive to devise convoluted forms of deferred payment obligations to attempt to obtain deferred reporting. In any event, the effect of the new rules is to reduce substantially the justification for treating transactions as 'open' and permitting the use of the cost-recovery method sanctioned by *Burnet v. Logan*, 283 U.S. 404 (1931)."ⁿ⁸

If the entire consideration due the transferor is received in the year of disposition, but the amount realized is still incapable of being valued, *Burnet v. Logan* does not apply. Instead the transferor is presumed to realize an amount equal to the value of the property transferred.ⁿ⁹ This rule is grounded on the assumption that persons dealing at arm's length will bargain for and receive equivalent value in an exchange.

[b] Disposition of Property Subject to Liabilities. If a taxpayer sells property encumbered by a mortgage or other liability, and the buyer expressly assumes the liability or takes the property subject to it, the amount of such liability is included in the amount realized.ⁿ¹⁰ This result obtains in the instance where the liability is attached to the property when originally purchased by the seller, as well as where the encumbrance results from a subsequent borrowing by the seller.ⁿ¹¹

[c] Disposition of Property in Satisfaction of an Obligation. The borrowing of money does not result in the realization of gain since the concomitant obligation to repay acts as a complete offset to the "amount realized." Repayment of the principal amount of the debt will likewise produce no income unless the borrower chooses to satisfy his obligation not with a cash payment, but by transferring property to the lender. In such event, gain will be realized to the extent that the amount realized exceeds the taxpayer's basis in the property.ⁿ¹²

If the value of the property transferred is equal to the obligation to be satisfied, it matters not whether the value of property or the amount of the obligation determines the amount realized, since the result must be the same in both instances. Say, however, that a taxpayer transfers property having a basis of \$50,000, and a value of \$75,000, in complete satisfaction of a debt of \$100,000. If the determinant of amount realized is the value of the property, the gain is \$25,000. If the amount of the debt controls, it is \$50,000. The latter result is more logical, for the transaction can now be viewed as a sale with the consideration received being the original loan proceeds. This is the result the courts always reached when the taxpayer was personally liable on the debt,ⁿ¹³ whether the transfer was of property which secured the debt or of property which did not, and whether the disposition was voluntary or involuntary.ⁿ¹⁴ However, while the Service pressed for an identical result when the debt was nonrecourse,ⁿ¹⁵ the courts were not in agreement until the Supreme Court resolved the issue in favor of the government's position.ⁿ¹⁶

In *Aizawa v Commr*,ⁿ¹⁷ property secured by recourse indebtedness was sold at foreclosure for a price less than the amount of the debt, leaving a deficiency judgment against the debtor. The Government argued that, after *Tufts*, the "amount realized" on a transfer of encumbered property is always, at a minimum, the amount of the mortgage indebtedness to which it is subject. The Tax Court, rejecting the Government's argument, held that the "amount realized" by the taxpayers was the foreclosure sales price, which the Court assumed in the absence of evidence to the contrary was equivalent to the property's fair market value. *Tufts* is inapplicable to a transfer of property encumbered by a recourse (as opposed to a nonrecourse) mortgage because the debtor remains liable to repay any deficiency (that is, the difference between the mortgage indebtedness and the foreclosure sale price).ⁿ¹⁸

Moreover, if the lender accepts property with a value less than the recourse indebtedness in complete satisfaction of the debt, or as satisfying indebtedness greater than the value of the property to any extent, the difference between the amount of debt discharged and the fair market value of the property surrendered constitutes income from discharge of indebtedness under *IRC Section 61(a)(12)*, not gain or loss from the sale or disposition of the property under *IRC Section 61(a)(3)*.ⁿ¹⁹ Likewise, when encumbered property with a value less than the unpaid indebtedness on the mortgage is surrendered in full satisfaction of the debt, the taxpayer may not claim the entire difference between the amount of the debt and the value of the property as income from discharge of indebtedness subject to *IRC § 108* since, to the extent of the difference, if any, between the fair market value of the property and its basis, income or loss is attributable to the disposition of the property and not to cancellation of debt.ⁿ²⁰

[3] Effect of the Taxpayer's Method of Accounting on the Amount Realized.

When property is held for resale to customers, the time of inclusion in income depends upon the method of accounting utilized by the taxpayer. If the taxpayer is on the accrual method, the inclusion criterion is the existence of an unconditional right to payment.ⁿ¹ Thus, if property is sold on open account, the seller must include in income the face amount of the debt, rather than its fair market value, at the time the unconditional right to payment arises.ⁿ² If the seller is a cash basis taxpayer, the receivable becomes includable only when the same can be held to be the equivalent of cash.ⁿ³ While cash equivalence can often be found if the amount due is evidenced by a negotiable note, it is rare for any

other types of receivables, such as open accounts receivable, contract rights to payment, and nonnegotiable notes, to constitute income prior to actual payment.ⁿ⁴

Should the same rules apply to a casual or isolated sale? The problem may be illustrated by the following:

Example:

Suppose a taxpayer sells property which he had not held for resale for \$20,000, receiving \$10,000 in cash, and the buyer's nonnegotiable demand note for the balance, the note having a fair market value of \$8,000. If accounting methods are a factor in determining the amount realized, an accrual method taxpayer would report an amount realized of \$20,000. On the other hand, since a nonnegotiable note is usually deemed to be only evidence of the debt and not the equivalent of cash, the cash basis taxpayer's amount realized would be \$10,000. If, however, accounting methods play no role in the determination of the amount realized in a casual sale, the cash received combined with the fair market value of the note would make an amount realized of \$18,000.

The statutory definition of amount realized, namely, money and the fair market value of other property received,ⁿ⁵ would seem to preclude any difference in result turning upon the method of accounting employed by the taxpayer. As construed by the Tax Court, however, an accrual basis taxpayer is required to treat an unconditional right to receive money as the equivalent of "money" for purposes of *IRC Section 1001(b)* while a cash basis taxpayer is not required to do so unless evidence of the right received is actually the equivalent of cash.ⁿ⁶

The Tax Court's position regarding accrual basis taxpayers was further explained in *Nestle Holdings, Inc v Commr.*ⁿ⁷ The accrual basis taxpayer in that case made a bulk sale of inventory of a discontinued line of products in exchange for the purchaser's long- and short-term promissory notes and preferred stock having a "mandatory" redemption price of \$15 million. In reporting a loss on the sale in its tax return, the taxpayer included the short-term promissory note at face value in computing the "amount realized" but the long-term note and the preferred stock were discounted to fair market value. Before the Tax Court, the taxpayer conceded that the long-term note should also have been included at face value in computing the "amount realized,"ⁿ⁸ but argued that, under *IRC Section 1011(b)*, the preferred stock had been properly included at fair market value. The Commissioner, maintaining the position taken in *Rev Rul 79-292*,ⁿ⁹ insisted that taxpayer's accrual method of accounting and *IRC Section 451* took precedence over the "fair market value" standard of *IRC Section 1001(b)* and that the preferred should have been valued at its mandatory redemption price. The ruling, the Commissioner reminded the Court, merely followed the Tax Court's own prior decisions in *First Savings & Loan* and *Western Oaks Building Corporation* cases.ⁿ¹⁰

The Tax Court found the earlier cases distinguishable because they involved evidences of indebtedness rather than preferred stock. "The essence of these cases is that, under section 1001(b), 'an accrual basis taxpayer does not treat an unconditional right to receive money as property received, but rather as money received to the full extent of the face value of the right' ... [Citation Omitted]"ⁿ¹¹ However, unlike an evidence of indebtedness, which unconditionally confers a right to receive a payment of money in the future regardless of the financial condition of the obligor, preferred stock can only be redeemed if the issuer has adequate capital or equity on the date of the redemption. Since the preferred stock did not give the taxpayer an unrestricted right to income that it was required to accrue,ⁿ¹² the preferred stock was appropriately taken into account as "property (other than money)" for purposes of *IRC Section 1011(b)* at its fair market value.ⁿ¹³

In *Brown v. Commissioner*,ⁿ¹⁴ an accrual basis taxpayer was required to include the face amount of a note in the amount realized on sale of a part interest in his business. The taxpayer argued that the note had no fair market value, and therefore, should not form any part of the amount realized in the year of sale. The Tax Court dismissed this contention on the ground that the argument had no merit when the taxpayer kept his records on the accrual method.ⁿ¹⁵

While the taxpayer in *Brown* was penalized because of the accounting method he utilized, cash basis taxpayers reap a benefit when their contention that a nonnegotiable note or contract right does not constitute the equivalent of cash and should not be added to the amount realized is upheld.ⁿ¹⁶ The effect is to defer a portion of the gain from the year of sale to the year of payment even though the transaction is closed.

The problem of cash equivalence no longer poses a problem when the obligation is received as consideration for the sale of property. The 1980 change in the installment method mandates the deferral of the reporting of income until actual payment is received.ⁿ¹⁷

FOOTNOTES:

(n1)Footnote 1. *IRC § 1001(a)*.

(n2)Footnote 2. *IRC § 1001(b)*; *Treas Reg § 1.1001-1(a)*.

(n3)Footnote 3. *Treas Reg § 1.263(a)-2(e)*; *Spreckels v Commr*, 315 US 626 (1942) . A dealer in the property sold can treat the expense as a deductible item rather than an offset to the amount received.

(n4)Footnote 4. See, eg, *Lewis & Taylor, Inc v Commr*, 447 F2d 1074 (9th Cir 1971) (additional amount a deferred employment compensation payment); *Wood v Commr*, TC Memo 1975-189 (portion allocable to settlement of employment contract); *Sigman v Commr*, TC Memo 1972-256 (Commissioner attempted to allocate portion to covenant not to compete) .

(n5)Footnote 5. 360 F Supp 825 (ED Wis 1973) , *affd per curiam*, 500 F2d 44 (7th Cir 1974) .

(n6)Footnote 6. Shareholder approval was deemed a condition precedent to closing in *Bankers Trust Co v US*, 518 F2d 1210 (Ct Cl 1975) . *Herbert J Inv Corp* was distinguished on the ground that the approval there was a formality or condition subsequent.

(n7)Footnote 1. 283 US 404 (1931) .

(n8)Footnote 2. Reg § 1.1000-1(a). This position was echoed in *Rev Rul 58-402*, 1958-2 CB 15, 18 . For Service recognition of a rare or extraordinary case, see *Rev Rul 68-194*, 1968-1 CB 87 .

The transaction will not be "open" if the property transferred to the buyer is capable of valuation; the amount realized will be the fair market value of the transferred property. See, eg, *Ltr Rul 9034002* .

(n9)Footnote 3. See, eg, *Steen v US*, 509 F2d 1398 (9th Cir 1975) ; *Dorsey v Commr*, 49 TC 606 (1968) . Taxpayers have generally been successful in claiming that the promise has no ascertainable value in the case of a transfer to an individual in exchange for his promise to pay the transferor an annuity. *Commr v Estate of Kann*, 174 F2d 357 (3d Cir 1949) ; *Stern v Commr*, TC Memo 1992-374 ; *Lloyd v Commr*, 33 BTA 903 (1936) , *acq* 1950-2 CB 3 . A transfer of stock in exchange for a promise to pay a private annuity resulted in the realization of gain in *Estate of Bell v Commr*, 60 TC 469 (1973) . The difference in result stemmed from the fact that the agreement provided for the stock to be placed in escrow and for a cognovit judgment in case of default. This removed any uncertainty as to whether the payments would be made.

In *McCormac v US*, 424 F2d 607 (Ct Cl 1970) , the court rejected the taxpayer's claim of an "open" transaction when the expert witness called by the taxpayer was able to place a value on the amount realized.

(n10)Footnote 4. If the total payments received under the contract are less than the taxpayer's basis in the property sold, the loss will be realized in the last payment year.

If the deferred payments do not bear interest or bear insufficient interest, a portion of each payment received may be deemed imputed interest. See Ch 2.

(n11)Footnote 5. See Ch 2.

(n12)Footnote 6. *IRC § 1222; Osenbach v Commr, 198 F2d 235 (4th Cir 1952)* .

(n13)Footnote 7. The relation-back theory is based on *Arrowsmith v Commr, 344 US 6 (1952)* . See § 2.03[3], *infra*.

(n14)Footnote 8. S Rep No 96-1000, 96th Cong, 2d Sess 24 (1980). The subject of installment sales is *covered in § 1.05[2], infra* .

If the transaction is such that the price is truly contingent and unascertainable and cannot fit within the installment sales provisions, the details of the transaction should be set forth in a statement annexed to the return for the year of sale. This will preclude application of an extended period of limitations on assessment. *IRC § 6501(e)(1)(A)(ii)*.

(n15)Footnote 9. *US v Davis, 370 US 65 (1962)* (transfer of property pursuant to divorce settlement in satisfaction of all marital obligations of husband to wife); *Philadelphia Park Amusement Co v US, 126 F Supp 184 (Ct Cl 1954)* (transfer of property in exchange for extension of franchise).

The Fifth Circuit, in *Bar L Ranch, Inc v Phinney, 426 F2d 995 (5th Cir 1970)* , held that the district court erred when it failed to take cognizance of the value of the property transferred in determining the value of the property received.

(n16)Footnote 10. *Crane v Commr, 331 US 1 (1947)* ; *Parker v Delaney, 186 F2d 455 (1st Cir 1950)* . The amount realized on the sale or other disposition of property that secures a recourse liability does not include any amount treated as discharge of indebtedness income. *Reg § 1.1001-2(a)(2)*.

(n17)Footnote 11. *Woodsam Associates, Inc v Commr, 198 F2d 357 (2d Cir 1952)* .

(n18)Footnote 12. *US v Davis, 370 US 65 (1962)* ; *Kenan v Commr, 114 F2d 217 (2d Cir 1940)* . A disposition occurs and income is realized by the lender if he receives property having a value in excess of the amount due. *Est of Herbert v Commr, 139 F2d 756 (3d Cir 1943)* , *cert denied 322 US 752 (1944)* ; *Elverson Corp v Helvering, 122 F2d 295 (2d Cir 1941)* .

The Tax Court has held that there is no amount realized when a taxpayer transfers property in discharge of a debt owed to the transferee by another. See, eg, *Friedland v Commr, TC Memo 2001-236* .

A recognized loss results whenever the transferred property has a basis that exceeds the amount of the discharged debt. *Rev Rul 76-111, 1976-1 CB 214* .

(n19)Footnote 13. *Parker v Delaney, 186 F2d 455 (1st Cir 1950)* ; *Lutz & Schram Co v Commr, 1 TC 682 (1943)* .

The Ninth Circuit has taken the position that there is no amount realized if the taxpayer remains personally liable on the debt after the transfer. *Jackson v Commr, 708 F2d 1402 (9th Cir 1983)* .

(n20)Footnote 14. *R O'Dell & Sons, Inc v Commr, 169 F2d 247 (3d Cir 1948)* (involuntary transfer of property securing obligation); *Pender v Commr, 110 F2d 477 (4th Cir 1940)* (voluntary transfer of encumbered property); *Suisman v Eaton, 15 F Supp 113 (D Conn 1935)* , *affd 83 F2d 1019 (2d Cir 1936)* , *cert denied 299 US 573* (voluntary transfer of property in kind to satisfy a bequest).

(n21)Footnote 15. *Reg § 1.1001-2(a)(1), (4)(i)*; *Rev Rul 78-164, 1978-1 CB 264* ; *Rev Rul 76-111, 1976-1 CB 214* .

(n22)Footnote 16. *Commr v Tufts*, 461 US 300 (1983) . Evidence of the conflict can be seen by comparing *Millar v Commr*, 67 TC 656 (1977) , *affd* 577 F2d 212 (3d Cir 1978) , *cert denied* 439 US 1046 , using the balance of the debt as the amount realized with *Tufts v Commr*, 651 F2d 1058 (5th Cir 1981) , limiting gain to the difference between basis and fair market value. The source of the difference was dictum contained in a footnote in the opinion in *Crane v Commr*, 331 US 1 (1947) , where the Supreme Court observed that

"Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage."

The *Tufts* case is discussed in Geier, "Tufts and the Evolution of Debt-Discharge Theory," 1 *Fla Tax Rev* 115 (1992).

According to the Tax Court, a taxpayer realizes cancellation of indebtedness income in a year that stock securing a nonrecourse debt becomes worthless. *Carlin v Commr*, TC Memo 1988-79 .

(n23)Footnote 17. 99 TC 197 (1992) , *affd without published opinion*, 29 F3d 630 (1994) .

(n24)Footnote 18. "The language of the Supreme Court [in *Tufts*], which suggests that fair market value is irrelevant where that value is less than the amount of the unpaid mortgage principal ... was directed to the situation where that mortgage obligation was discharged--a situation which does not obtain [where the lender still has recourse against the borrower personally, as in the case of a recourse debt]." 99 TC at 201 .

(n25)Footnote 19. See *Frazier v Commr*, 111 TC 243 (1998) , where the Tax Court found that the price bid on foreclosed property and credited against the mortgage indebtedness by the lender exceeded the property's fair market value. The Court used the lower fair market value rather than the foreclosure sale price as the "amount realized" for purposes of computing the property owner's gain or loss on the sale of the property at foreclosure. The difference between the property's fair market value and the greater amount bid by the lender was treated as discharge of indebtedness income, excluded from the taxpayer's income by the provisions of IRC § 108. *Frazier v Commr*, 111 TC at 249 ; see also *Gehl v Commr*, 102 TC 784 (1994) , *affd without published opinion* 50 F3d 12 (8th Cir 1995) . Both *Frazier* and *Gehl* relied on *Treas Reg* §§ 1.1001-2(a)(2) and 1.1002-2(c), Ex 8, which provide that "the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under IRC § 61(a)(12)."

(n26)Footnote 20. *Frazier v Commr*, 111 TC 243 (1998) ; *Gehl v Commr*, 102 TC 784 (1994) ; *Danenburg v Commr*, 73 TC 370 (1979) ; *Estate of Delman v Commr*, 73 TC 15 (1979) .

(n27)Footnote 1. *Treas Reg* § 1.451-1(a).

(n28)Footnote 2. See *First Savings & Loan Ass'n v Commr*, 40 TC 474 (1963) ; *Western Oaks Bldg Corp v Commr*, 49 TC 365 (1968) , *nonacq on another issue* 1968-2 CB 3 ; *Rev Rul* 79-292, 1979-2 CB 287 .

(n29)Footnote 3. *Treas Reg* § 1.451-1(a); *Cherokee Motor Coach Co v Commr*, 135 F2d 840 (6th Cir 1943) ; *Williams v Commr*, 28 TC 1000 (1957) ; Note, "Checks and Notes as Income When Received by a Cash Basis Taxpayer," 73 *Harv L Rev* 1199 (1960).

A portion of the proceeds of a stock redemption was placed in escrow to secure payment of certain corporate liabilities. Since there was a significant risk that the shareholder might never receive the funds, the escrowed amount was not reportable in income until actually received. *Bette v Commr*, TC Memo 1977-404 .

(n30)Footnote 4. The Tax Court, in *Cowden v Commr*, 32 TC 853 (1959) , found cash equivalence in a contract promise to pay. The Fifth Circuit reversed and remanded for a reconsideration of the issue, basing its action on the ground that the Tax Court arrived at its decision by considering matters other than the fair market cash equivalent of the

obligation. 289 F2d 20 (5th Cir 1961) . On remand, the Tax Court once again found cash equivalence. TC Memo 1961-229 .

(n31)Footnote 5. IRC § 1001(b).

(n32)Footnote 6. Compare *Western Oaks Building Corporation*, 49 TC 365, n 2 with *Humphrey v Commr*, 32 BTA 280 (1935) .

(n33)Footnote 7. 94 TC 803 (1990) .

(n34)Footnote 8. 94 TC at 806 .

(n35)Footnote 9. 94 TC 803, n 2 .

(n36)Footnote 10. 94 TC at 808-809 .

(n37)Footnote 11. 94 TC at 813 .

(n38)Footnote 12. See IRC § 451 and Treas Reg § 1.451-1(a).

(n39)Footnote 13. 94 TC at 815 .

(n40)Footnote 14. 1950 Tax Ct Memo LEXIS 39 .

(n41)Footnote 15. Accord, Rev Rul 79-292, 1979-2 CB 292 ; *George L Castner Co v Commr*, 30 TC 1061 (1958) .

(n42)Footnote 16. *Humphrey v Commr*, 32 BTA 280 (1935) , nonacq 1939-2 CB 54 ; *Johnston v Commr*, 14 TC 560 (1950) ; *Ennis v Commr*, 17 TC 465 (1951) ; *McIntosh v Commr*, TC Memo 1967-230 .

(n43)Footnote 17. See § 1.05[2], *infra*.



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Taxation of Securities Transactions

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CHAPTER 1 Gains and Losses From the Disposition of Property

1-1 Taxation of Securities Transactions § 1.04

§ 1.04 The Elements of Gain or Loss--Basis

We have seen that, under the statutory formula, the amount realized must be reduced by that portion which represents a return of capital to the taxpayer. The basis provisions of the Code serve to measure the amount which must be recovered before gain can be realized.

[1] Cost Basis.

IRC Section 1012 sets forth the general rule that, unless the Code specifically provides otherwise, the basis of property is its cost. Three of the exceptions to the general rule, the basis of property acquired before March 1, 1913, the basis of property acquired by gift, and the basis of property acquired from a decedent will be covered in this chapter. Other exceptions, insofar as they relate to securities, will be discussed in connection with the transactions to which they relate.

The Regulations define cost as "the amount paid for ... property in cash or other property."ⁿ¹ The usual form of acquisition calling for a cost basis is an outright purchase for cash, but the cost basis provisions of *IRC Section 1012* are applicable when property is acquired other than by a normal cash purchase and the Code does not specifically provide some other manner of determining basis.

[a] Assumption of Seller's Liabilities. It will be recalled that the seller of property must include in his amount realized, the amount of any liabilities which the purchaser expressly assumes, or to which the property remains subject after the conveyance. The coin has two sides, for the purchaser includes the indebtedness in his basis for the property,ⁿ² even if he undertakes no personal liability with respect to the indebtedness,ⁿ³ unless the liability is so speculative, contingent, or indefinite that it cannot be determined with any reasonable accuracy that the liability will ever be paid. In the latter event, no amount is added to basis until such time as the liability becomes fixed and absolute, and capable of determination with some degree of certainty.ⁿ⁴

It is important to note that basis is affected only if the liability is assumed as part of the transaction or attaches to the property at the time of purchase. A subsequent borrowing, even one in which the property is pledged as security, will not increase the basis of the property, although the unpaid balance of the indebtedness will enter into the amount realized on a subsequent sale if the buyer assumes the liability or takes the property subject to it.ⁿ⁵

[b] Basis of Property Acquired at a Cost in Excess of Fair Market Value. If a taxpayer purchases stock for \$12,000 at a time when the value of the stock is \$10,000, should the basis of the stock be \$12,000, the price actually

paid, or \$10,000, the fair market value on the date of acquisition? There would appear to be no room for choice, since \$12,000 is the cost of the stock as measured by the amount paid in cash,ⁿ⁶ and if the only reason for payment of the higher price is the acquisition of the property, basis will be actual cost.ⁿ⁷

If, however, special factors other than the acquisition of the property contribute to the excess price, the basis will be the value of the property, and not actual cost. For example, in *Pennsylvania Indemnity Co. v. Commissioner*,ⁿ⁸ securities worth \$420,000 were purchased by a parent from its wholly owned subsidiary at a cost of some \$250,000 more than value and then immediately sold for an amount equal to value. The subsidiary's financial standing had previously been impaired by a decrease in the value of its assets of approximately \$250,000. The Third Circuit held the basis to be \$420,000, and likened the transaction to "the old story of a father making good the loss of his son's business and starting him again with an unimpaired capital."ⁿ⁹

A reversal of the normal roles assumed by taxpayer and Government occurred in *Lewis & Taylor, Inc v. Commissioner*.ⁿ¹⁰ The transaction in question involved the purchase of stock by a corporation from the estate of a deceased shareholder-employee. As originally written, the agreement called for a purchase price of \$17,500. As amended, it fixed the price of \$10,000 and characterized the balance as a payment of deferred employment compensation. The corporation sought a deduction for this payment under *IRC Section 162(a)(1)*; the Commissioner argued that it represented part of the amount paid for the stock. The Ninth Circuit upheld the taxpayer by focusing on the fact that the \$10,000 purchase price mirrored the value of the stock at the time of purchase and, therefore, was reflective of economic reality.

[c] Basis of Property Acquired at a Cost Less Than Fair Market Value. If parties to a transaction deal at arm's length, then the fact that a purchaser may have made a good deal and paid less for the property than it was worth should have no effect on the general cost basis rule.ⁿ¹¹ However, as in the case of an excess price, special factors may account for the disparate purchase price. For example, if property worth \$1,000 is sold for \$800, the seller intending the \$200 difference to be a gift to the purchaser, the actual purchase price will not be the sole determinant of basis, for the basis rules pertaining to gifts must also be taken into account.ⁿ¹²

[d] Basis of Property Acquired in an Exchange. The basis of property acquired in a taxable exchange is its fair market value at the time of transfer.ⁿ¹³ The consequence of this rule is that the basis of the new property equals the adjusted basis of the property given up, increased by the amount of any gain, or decreased by the amount of any loss, produced by the exchange.

When the property to be valued consists of stock or securities traded on an exchange or in some other public market, the mean exchange price (the average of the high and low quoted prices) furnishes the most accurate and most readily ascertainable measure of fair market value.ⁿ¹⁴ This general rule is predicated on the existence of a market, of supply and demand, and of sellers and buyers. In addition, market price can be an index of value only when the property to be valued is substantially similar to the property traded in the market. If the market reflects only limited or forced sales,ⁿ¹⁵ or if the stock is subject to restrictions on alienation,ⁿ¹⁶ the stock may have to be valued at a discount. On the other hand, an upward adjustment in value may be required because acquisition of stock carries with it certain extras such as control.ⁿ¹⁷ Yet, even when circumstances warrant a departure from the general rule, market price is often the point of departure.

Where the fair market value of the acquired property cannot be ascertained, its basis will be determined by reference to the value of the property transferred, since the properties exchanged in an arm's-length transaction are presumed to be of equal value. In the rare situation where neither the property transferred nor that received can be valued, the basis of the property transferred should carry over and become the basis of the property acquired.ⁿ¹⁸

[e] Basis of Property Constituting Income or Deduction Items. If a taxpayer receives property under circumstances requiring its value to be included in gross income, eg, as compensation for services, the basis of the

property is the amount so included.ⁿ¹⁹ This is a logical extension of the principles governing the basis of property acquired in a taxable exchange, the services rendered being viewed as the property transferred.

The reverse situation, the acquisition of property giving rise to an immediate deduction (such as a business taxpayer's purchase of property having a useful life of less than one year) produces a zero basis. The rationale here is that the taxpayer recovers his cost in the property through the allowance of the deduction.

[2] Basis of Property Acquired Before March 1, 1913.

IRC Section 1053 provides the basis rules for property acquired prior to March 1, 1913 (the effective date of the first income tax legislation enacted after ratification of the *Sixteenth Amendment*). The basis for the purpose of computing gain is either the basis as determined under the applicable provision of the Code (cost, etc.), or the fair market value of the property on March 1, 1913, whichever is greater. The basis for computing loss is determined solely in accordance with the regular basis rules of the Code, without any consideration of the March 1, 1913 value.ⁿ¹ It is readily apparent that if the value of the property on March 1, 1913 was greater than the cost of the property, the property can have two bases, one to compute gain, and the other, loss. Consequently, a taxable disposition of the property may produce a "no-man's land" in which neither gain nor loss is realized, the amount realized being less than the basis for determining gain, but more than the basis for determining loss.

[3] Basis of Property Acquired by Gift.

[a] The General Rule. We have previously seen that generally a gift of appreciated property does not produce realizable gain for the donor. It is manifest that if the fair market value of the property at the time of the gift became the donee's basis for the property, the increase in value from the date of the donor's acquisition to the time of gift would forever be eliminated from the computation of gain.ⁿ¹ The rules of *IRC Section 1015(a)* no longer permit this result, calling instead for a "substituted basis," i.e., the donee must take the basis that the property had in the hands of the donor.ⁿ² If the donor himself acquired the property by gift, the basis must be traced back to his donor, or the last person who did not acquire the property by gift.

The donee's basis for determining loss will differ from his basis for determining gain whenever the donor's basis for the property exceeds its fair market value at the time of the gift. In such event, the basis for loss purposes is its fair market value,ⁿ³ thereby removing the decrease in value to the time of the gift from the determination of loss. As in the case of property acquired prior to March 1, 1913, the end result of different bases for gain and loss may be a transaction producing neither taxable gain nor loss.

The basis determined under *IRC Section 1015(a)* is then adjusted by increasing it in an amount equal to the gift tax paid with respect to the gift.ⁿ⁴ In the case of property acquired on or after September 2, 1958, the basis cannot be increased above the fair market value of the property at the time of the gift.ⁿ⁵ Where property was acquired before September 2, 1958, an adjustment is allowed only if the property was still held on that date, with the increase in basis limited to the amount by which the fair market value at the time of the gift exceeded the donor's basis in the property at that time.ⁿ⁶

The formula for determining the amount of gift tax paid with respect to the gifts made before 1977 is:

$$\frac{\text{amount of the gift}}{\text{total taxable gifts for the year}} \times \text{total gift tax paid}^{\text{n7}}$$

The "amount of the gift" is the value of the gift less the total of any exclusion or deduction allowed by reason of *IRC Section 2503(b)* (annual exclusion), *IRC Section 2522* (charitable deduction), and *IRC Section 2523* (marital deduction). The amount of "total taxable gifts for the year," is the same as shown on the gift tax return except that any deduction then allowed by *IRC Section 2521* (specific exemption) is not taken into account.ⁿ⁸

Example:

Assume that in a year after 1958, but before 1977, a donor, who never made any taxable gifts, made two outright gifts, one a gift to A of securities having a basis of \$20,000 and a value of \$23,000, and the other a cash gift to B of \$33,000. Since the donor could then claim an annual exclusion of \$3,000 for each of the gifts,⁹ as well as a specific exemption of \$30,000, the taxable gifts for the year amounted to \$20,000 and the gift tax to \$1,200. The resulting increase in the basis of the securities given to A was \$480.¹⁰

In the case of gifts made after December 31, 1976, the adjustment is limited to the amount of gift tax paid with respect to the net appreciation in the value of the gift, and the applicable formula becomes:¹¹

$$\frac{\text{Net appreciation in value of gift}}{\text{Amount of gift}} \times \text{Total Gift Tax Paid}$$

The net appreciation in value is the amount by which the fair market value of the gift exceeds the donor's adjusted basis.¹²

A variation in the gift basis rules occurs when property is acquired in a transaction which is in part a sale and in part a gift. The basis for determining gain, excluding any increase for gift taxes paid with respect to the gift, is the amount paid by the transferee or the adjusted basis of the property in the hands of the transferor, whichever is greater. The basis for loss purposes is either the same as the basis for gain or the fair market value of the property at the time of transfer, whichever is less.¹³ For example, suppose a father sells stock having a basis of \$3,000 and worth \$10,000 at the time of the transaction to his son for \$5,000, intending the difference between purchase price and value as a gift. Without considering the amount of gift tax paid, the basis of the stock in the son's hands for both gain and loss purposes will be \$5,000. If the father's basis for the stock had been \$6,000, the son would employ that figure as his basis since it is greater than the amount paid by him for the stock.

The threshold question is: When is property acquired by gift? Does the gift tax requirement, that consideration be measurable in terms of "money or money's worth,"¹⁴ control this determination? In the usual transfer falling within the scope of the gift tax, no consideration flows to the transferor so that the transaction can be labeled a gift for income tax basis purposes. However, because of the restricted definition of consideration found in the gift tax, a transfer may give rise to gift tax liability and yet may not be considered a gift under the income tax. An example of such a situation is found in *Farid-es-Sultaneh v. Commissioner*,¹⁵ where the Second Circuit was called upon to decide the basis of stock acquired in exchange for a release of marital and support rights. The court held that for income tax purposes, the release constituted consideration for the transfer of stock, and therefore the stock was acquired by purchase and not by gift. The court could find nothing that required an income tax definition of consideration coextensive with that obtaining under the gift tax.

Neither the rule of *Farid-es-Sultaneh* nor the provisions of *IRC Section 1015* apply to transfers of property between spouses after July 18, 1984 (or December 31, 1983, if both parties elect). Pursuant to *IRC Section 1041(b)*, a transfer of property to a spouse, or to a former spouse incident to a divorce, is treated as a gift by the transferee, whose basis in the property is always the adjusted basis of the transferor.¹⁶

[b] Appreciated Property Acquired by Political Organizations. It will be remembered that a gift of appreciated property to a political organization constitutes a taxable event resulting in the realization and recognition of gain by the transferor. Because of this, the circumstances dictate, and *IRC Section 84(b)* provides, that the basis of the contributed property in the hands of the transferee organization is "the same as it would be in the hands of the transferor, increased by the amount of gain recognized to the transferor, by reason of such transfer." Put more simply, the transferee's basis is equal to fair market value of the property on the date of contribution.

[4] Basis of Property Acquired From a Decedent.

Logic would seem to dictate that because a transfer of property at death is not treated as a realizable event, a person receiving property from a decedent should employ the same substituted basis as the donee of a gift. However, such is not the case, for *IRC Section 1014* provides that property acquired from such a decedent takes a basis equal to the value thereof at the time of death, or if the alternate valuation is elected, the value at the applicable valuation date.ⁿ¹ Thus, any increase or decrease in value occurring during the period the property was held by the decedent is forever removed from income taxation. (The Tax Reform Act of 1976 contained a set of carryover basis rules which, to some extent, would have placed the person acquiring property from a decedent in the same position as an inter vivos donee. Dissatisfaction with the legislation led, first, to a postponement of the effective date of the rules and, then, to their repeal.)

IRC Section 1014(a) applies not only to property actually owned by the decedent at death and acquired by bequest, devise, or inheritance, but also to other property which must be included in the decedent's gross estate for estate tax purposes, namely:

- (1) Inter vivos transfers of property in trust where the decedent retained (a) the right to income for life and (b) the power to revoke, alter, amend, or terminate the trust;ⁿ²
- (2) Property passing under the decedent's testamentary exercise of a general power of appointment;ⁿ³
- (3) Property which represents the surviving spouse's one half share of community property held by the decedent and his surviving spouse, if at least one half of the entire community property interest was includable in the decedent's gross estate;ⁿ⁴
- (4) Property acquired from the decedent by reason of death, form of ownership, or other conditionsⁿ⁵ (this brings property acquired by the surviving tenant of a joint tenancy within the ambit of *IRC Section 1014(a)*).ⁿ⁶

One proviso attends inter vivos transfers considered as property acquired from a decedent by *IRC Section 1014(b)*. If the person acquiring the property disposed of it prior to the decedent's death, the fair market value-basis rule of *IRC Section 1014(a)* is no longer applicable and basis must be determined in accordance with some other applicable provision of the Code.ⁿ⁷

An important exception to the application of *IRC Section 1014*, found in subsection (c), affects the treatment of items denominated income in respect of a decedent.ⁿ⁸ The effect of *IRC Section 1014(c)* can be illustrated in the following manner. Suppose a cash basis taxpayer died on April 1, 1989, owning corporate bonds which pay interest on July 1 and January 1. Because of the decedent's method of accounting, the interest accruing from January 1, 1989, to the date of death is not includable in income for the taxable year ending on the date of his death or any prior taxable year.ⁿ⁹ By definition, the amount of accrued interest is income in respect of a decedent,ⁿ¹⁰ and, when received, is properly includable in income by the person acquiring the right to receive the same from the decedent.ⁿ¹¹ If the basis of the right to receive the accrued interest was controlled by *IRC Section 1014(a)*, the basis would, in most cases, be equal to the amount accrued at death. Subsequent payment of that amount would give rise to a recovery of basis and never enter the recipient's gross income. This would, in essence, serve to nullify the provisions of *IRC Section 691*. *IRC Section 1014(c)* prevents this resultⁿ¹² by denying income in respect of a decedent a basis equal to fair market value. The effect is to require a carryover of the decedent's basis in the interest, usually zero.

A second exception concerns stock and securities in foreign personal holding companies acquired from a decedent by bequest or inheritance before January 1, 2005. Here the basis will be fair market value at the decedent's death or the basis in the decedent's hands, whichever is lower.ⁿ¹³

IRC Section 1014(d) contains a third exception, applicable to stock in a Domestic International Sales Corporation. The basis of such stock was set at fair market value reduced by the amount of gain that would have been treated as ordinary income under *IRC Section 995(c)* had the decedent sold the stock on the applicable valuation date.

A final exception, found in *IRC Section 1014(e)* and applicable to persons dying after 1981, denies a step-up in basis for appreciated property that is acquired by gift by the decedent within one year of death and then passes from the decedent to the donor or the donor's spouse.ⁿ¹⁴ The stated rule also applies to a sale of appreciated property by the estate of the decedent or by a trust of which the decedent was the grantor, to the extent that the donor or the donor's spouse is entitled to the proceeds from such sale. A question that is not entirely resolved is the applicability of *IRC Section 1014(e)* to the situation where the decedent transfers appreciated property to a trust that includes as a beneficiary the donor or the donor's spouse. Ultimately this is something that may be resolved on a case-by-case basis, depending on the power that the donor or the donor's spouse has over the trust. Notably, *IRC Section 1014(e)* does not expressly include indirect or beneficial transfers to the donor or the donor's spouse.

[a] Ascertaining the Basis--The Presumption as to Fair Market Value. The Regulations provide that the value of property as reported on the federal estate tax return will be deemed its fair market value for the purposes of *IRC Section 1014(a)*.ⁿ¹⁵ If no return is required to be filed, then the values returned for state death tax purposes control. While the Regulations appear not to permit any deviation from estate tax values, the Commissioner has ruled that, for basis purposes, the values appraised for estate tax purposes are not conclusive, but merely presumptive, and may be rebutted by clear and convincing evidence.ⁿ¹⁶

The major problem a taxpayer faces when asserting a valuation other than that reported for estate tax purposes is obviously one of proof. Assuming this burden can be met, the taxpayer will probably encounter the Government's second line of defense, viz., that he is estopped from claiming a different value.ⁿ¹⁷ The likelihood of this contention being raised is increased if the taxpayer is the person who filed the estate tax return containing the original determination of fair market value. As valid as the defense may appear to be, it has not always been successful.ⁿ¹⁸

[5] Adjustments to Basis.

The previous discussion concerning basis has focused mainly on what might be termed "unadjusted basis,"ⁿ¹ However, the statutory formula for computing gain or loss is cast in terms of "adjusted basis,"ⁿ² defined by *IRC Section 1011* as "basis [determined under the applicable provisions of the Code] adjusted as provided in *IRC Section 1016*." The purpose of these adjustments is to insure that the thrust of basis, a return of capital, occurs only once with respect to any particular item of property. So, if the property is of the type which is subject to depreciation, the allowance of a deduction for depreciation itself is considered a recovery of capital, and, accordingly, the basis of the property must be reduced by an amount equal to the deduction.ⁿ³

While most required adjustments result in a decrease in basis, an adjustment upward is called for when an expenditure is properly chargeable to capital accountⁿ⁴ and not currently deductible, as for example, the expense of litigation to settle title to property.ⁿ⁵ By adding the amount of the expenditure to basis, ultimate cost recovery is achieved. Adjustments affecting the basis of securities are spread throughout the Code. These will be detailed when the transaction triggering the adjustment is discussed.

[6] Multi-Unit Property--The Need for Allocation of Basis.

When a taxpayer sells part of a group of securities (or any other property) in a single transaction, gain or loss on the part sold must be separately computed and cannot be deferred until disposition of all of the property.ⁿ¹ This requires an apportionment of the basis of the whole to the part sold and the part retained. If the property consists of multiple units of the same property (eg, 100 shares of one class of stock of a single corporation), the allocation is made by spreading the

basis equally over the total number of units. If the original purchase encompassed different kinds of property, the allocation is based on relative fair market values of the component properties at the date of acquisition.ⁿ² Applying these rules, if 100 shares of common stock and a like number of preferred are purchased in a single transaction for \$7,000, the common having a value of \$5,000, and the preferred a value of \$2,000, the basis of each share of common will be \$50, and of each preferred share, \$20.

If there is no reasonable method of allocating the basis of a multi-unit property among its constituent parts because the fair market value of one or more of those parts cannot be readily ascertained, a variant of the "open transaction" doctrine will allow the taxpayer to recover his basis in the entire property before recognizing gain on the sale of any unit.ⁿ³ Correspondingly, under the same circumstances, a taxpayer may not recognize loss on the sale of any unit until the entire multi-unit property has been sold or becomes worthless.ⁿ⁴

[7] Allocation of Basis in Part-Sale, Part-Gift to Charity.

The general rule when appreciated property is transferred for less than its fair market value, and the transferor intends to make a gift to the transferee of the difference between the property's fair market value and the sales price, is to allocate the taxpayer's entire basis in the property to the "sale" element of the transaction, allowing the transferor to recover the property's basis before recognizing gain on the transfer.ⁿ¹ This rule is advantageous to the transferor, at least when compared to the alternative of selling the property for fair market value to a third party, paying tax on the entire appreciation in value (including the portion to be given away), and then making a gift of the cash remaining (after payment of the tax) to the donee.

Congress decided that, when the transferor receives a charitable contribution deduction for the appreciation in value that is given away, the taxpayer should not be able to escape tax on that portion of the gain that would have been recognized had the noncontributed portion of the property been sold.ⁿ² Under *IRC Section 1011(b)*, therefore--

"If a deduction is allowable under Section 170 (relating to charitable contributions) by reason of a sale, then the adjusted basis for determining the gain from such sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property."

The difference in tax consequences is illustrated by the following example.

Example:

A sells X Company stock held for more than one year to a public charity. The stock has an adjusted basis of \$5,000 and fair market value of \$10,000, but is sold to the charity for \$5,000. A has made a charitable gift of \$5,000, the difference between the \$10,000 fair market value of the stock and the \$5,000 sale proceeds. A is entitled a charitable contribution deduction, assuming none of the limitations on the deduction are applicable,ⁿ³ of \$5,000 (\$10,000 value of stock less \$5,000 received in exchange for the stock). In determining taxable gain on the bargain sale of the X Company stock, A deducts that portion of the stock's basis deemed allocable to the portion of the stock sold from the \$5,000 amount realized. That portion is calculated under *IRC Section 1011(b)* as follows: \$5,000 (total basis) x (\$5,000 (the amount realized from sale of the stock)/\$10,000 (the actual fair market value of the stock)) = \$5,000 x 50% = \$2,500. A must therefore recognize gain of \$2,500 (\$5,000 "sale price" less \$2,500 allocable basis). The remaining \$2,500 of basis is allocated to the portion of the stock A contributed to charity. Under the "general rule" applicable to noncharitable gifts, by contrast, A's gain on the bargain sale would have been zero (\$5,000 amount realized less \$5,000 basis).

The allocation of basis requirement in *IRC Section 1101(b)* applies only if "a deduction is allowable under *[IRC] Section 170* ... by reason of a sale." In some cases, a bargain sale may not result in a

charitable contribution deduction in the year of sale because, for example, the taxpayer has already exceeded the limitations on the charitable contribution for the taxable year in which the bargain sale occurs. However, a deduction for the contribution is "allowable" for purpose of making *IRC Section 1011(b)* operative if the contribution can be carried over and deducted in a subsequent taxable year under *IRC Section 170(b)(1)(D)(ii)* or *IRC Section 170(d)*, or the deduction is postponed to a subsequent taxable year by *IRC Section 170(a)(3)* (concerning contributions of future interests in tangible personal property),ⁿ⁴ even though the carryover is in fact never useable prior to its expiration.ⁿ⁵ The regulation's stance on this issue (as opposed, for example, to adopting a "wait and see" position in which the allocation of basis rule is applied retroactively if a charitable contribution deduction is actually allowed in a future year) was deemed reasonable by the Tax Court in light of the fact that the contribution carryforward period is five years, while the statute of limitations period for assessments and refunds is generally only three years.ⁿ⁶

Another issue raised by the "allowable" language is best described by an illustration. Suppose the facts are the same as those in the Example above except that the X Company stock sold by A to a public charity had been held by A for one year or less. Under *IRC Section 170(e)(1)(A)*, no charitable contribution deduction is allowable to the extent that the donated property has appreciated in value (over the donor's basis) and the appreciation in value would have been taxable as "other than long-term capital gain" had the property been sold by the donor at its fair market value. Viewing A's gift as consisting solely of the appreciation (over A's cost) in the value of his X Company stock, his charitable contribution would be nondeductible under *IRC Section 170(e)*. *IRC Section 1101(b)* would therefore be inapplicable as well since no deduction would be allowable with respect to the bargain sale, and A's entire \$5,000 basis in the X Company stock could be used to offset the \$5,000 received from the public charity, leaving A with zero gain on the bargain sale.

The above view of the transaction assumes that, by selling the X Company stock to charity at cost, A could, for tax purposes, allocate all of his short-term capital gain (appreciation above cost) to the charity. An alternative perspective, adopting the theory of *IRC Section 1011(b)* itself, is that both A's basis and the implicit short-term gain should be allocated between the sale and gift elements of the bargain sale transaction before determining its tax consequences. Adopting that view, A's donation to charity consists of 50% (\$5,000 sales price/\$10,000 fair market value) of A's \$5,000 basis in the X Company stock, and 50% of the \$5,000 short-term capital gain. This view leaves A with a deductible charitable contribution of \$2,500 for the gift of one-half of his cost basis, and a nondeductible charitable contribution for the gift of half of the unrealized short-term capital gain. A would then be required to recognize gain on the sale element of the transaction in the amount of \$2,500, since only half of his \$5,000 basis would be available under *IRC Section 1101(b)* to offset the \$5,000 cash payment received from the charity.ⁿ⁷

The Treasury and Internal Revenue Service initially took the position in regulations that the appreciation in the value of the gifted property should be allocated entirely to the gift to charity to the extent that such appreciation did not exceed the value of the gift, but these regulations were declared invalid by the Tax Court,ⁿ⁸ after which they were amended to take the alternative "pro rata allocation" position. The regulations under *IRC Section 1101(b)* now provide that--

"In ascertaining whether or not a charitable contributions deduction is allowable under section 170 for the taxable year ... the amount by which *the contributed portion of the property* must be reduced under section 170(e)(1) is the amount determined by taking into account the amount of gain which would have been ordinary income or long-term capital gain if *the contributed portion of the property* had been sold by the donor at its fair market value at the time of the sale or exchange." (Emphasis added).ⁿ⁹

[8] Disposition of Less than the Whole--The Need to Identify the Securities Sold.

A person who purchases more than one block of a specific security at different prices, and then sells all of his holdings in a single transaction, encounters no difficulty in computing the gain or loss realized on the transaction. However, if only a part of the total investment is sold, it becomes necessary to identify the lot from which the securities were sold in order to fix gain or loss. Identification is also important in determining the holding period of the securities, and thus whether capital gain or loss is long-or short-term.ⁿ¹

[a] The First-In, First-Out Default Method. If the taxpayer is unable adequately to identify the lot from which the securities were sold, regulations provide that the sale is deemed to be of those securities acquired first,ⁿ² irrespective of the manner in which the securities were acquiredⁿ³ or the time at which the securities were placed in a particular account.ⁿ⁴

There are, however, certain instances in which the earliest-acquired securities in a total holding will not be considered the ones sold. If the securities are held in a number of depositories or accounts, and the taxpayer can identify the depository or account from which delivery has been made, the first-in, first-out rule will be applied solely with respect to the securities in the particular depository.ⁿ⁵ In addition, if it can be shown that it would have been impossible to sell the first-acquired securities, as the same were held as collateral, these securities can be disregarded when applying the first-in, first-out rule.ⁿ⁶

Normally, the date of purchase or actual acquisition by the taxpayer is the controlling date for purposes of the first-in, first-out rule, but this is not always so. Securities acquired by specific bequest from a decedent are deemed acquired on the date of death, even if distribution is delayed.ⁿ⁷ Securities acquired in satisfaction of a residuary legacy are subject to one of two relation-back rules. If the taxpayer receives securities which the decedent owned, the applicable date is the date of death; if he receives securities purchased by the executor, it is the date of purchase.ⁿ⁸ Stock acquired by reason of a stock dividend or stock split should be considered as acquired on the same date as the stock with respect to which the dividend or split is made.

Interesting treatment is afforded stock acquired through the exercise of rights. The time of acquisition is the date of exercise. However, if rights issued with respect to different lots of stock are exercised at the same time, any sale of less than the total shares of stock so acquired is treated as having been made from stock acquired through the exercise of rights issued in respect of the earliest-acquired lots.ⁿ⁹

[b] The "Adequate Identification" Method.

The first-in, first-out rule will not be applied if the lot from which the stock is sold is adequately identified by the taxpayer.ⁿ¹⁰ Effective identification may be achieved in a number of ways, but it is clear that the absence of adequately kept records showing acquisition dates and prices, and, where feasible, certificate numbers, will severely hamper, if not render impossible, adequate identification.

[i] Identification Through Actual Delivery.

Proper identification is effected when it is shown that a particular certificate representing shares of stock purchased on a certain day, at a certain price, is delivered to the transferee in settlement of the transaction.ⁿ¹¹ Except as discussed below, certificate-delivery identification will govern the transaction even though the taxpayer intended to sell a different lot, and so instructed his broker.ⁿ¹²

[ii] Identification by Broker's Confirmation.

Where the taxpayer sells or transfers stock left in the custody of a broker or other agent, adequate identification is achieved if the taxpayer specifies to the custodian the particular lot from which the stock is to be sold or transferred and,

within a reasonable time thereafter, receives from the custodian written confirmation of these instructions.ⁿ¹³ The regulations currently require that the taxpayer's specification be made at the time of the sale or transfer, but this requirement will be deemed satisfied as long as lot identification is made by the time the shares are delivered to the purchaser.ⁿ¹⁴

When identification is made by broker confirmation the taxpayer's intention prevails; unlike identification by actual delivery, a mistake in delivery on the part of the taxpayer's broker or other agent will not affect the result.ⁿ¹⁵ Identification by broker confirmation is equally acceptable for isolated sales of stock, sales made pursuant to a systematic plan of liquidation,ⁿ¹⁶ sales of stock held in margin accounts,ⁿ¹⁷ and sales of bonds.ⁿ¹⁸ When the taxpayer sells or transfers a "book-entry security," *i.e.*, certain government securities issued in the form of an entry made on the records of a Federal Reserve Bank,ⁿ¹⁹ adequate identification by broker confirmation requires written instructions from the taxpayer (as well as a written confirmation) and the specification of a unique lot number, determined in accordance with a prescribed procedure, that identifies the lot containing the securities being sold or transferred.ⁿ²⁰

[iii] Identification by Fiduciaries.

A trustee, executor, or administrator can make adequate identification of stock not held by a custodian if, at the time of a sale or distribution, the fiduciary specifies in writing, in the books and records of the trust or estate, the particular stock sold or distributed.ⁿ²¹ Where stock is distributed to a beneficiary rather than sold, the fiduciary has the additional requirement of furnishing the distributee with a written document indicating the particular stock distributed to him.ⁿ²² Stock so identified will be considered the stock sold, transferred or distributed even though stock certificates from a different lot are actually delivered to the purchaser, transferee, or distributee.ⁿ²³

[c] The Average Cost Method.

Regulations currently allow a taxpayer who sells less than all his stock in a regulated investment company (sometimes called a "RIC" or "mutual fund")ⁿ²⁴ to determine the basis of the shares sold under the average cost method. In general, average cost is determined by dividing the aggregate basis of the taxpayer's shares in the RIC by the aggregate number of shares held. The average cost so determined is then multiplied by the number of shares sold to arrive at the aggregate basis of those shares.ⁿ²⁵

The 2008 amendments to *Section 1012 of the Internal Revenue Code*ⁿ²⁶ make important changes to these rules. Beginning in 2011, the average cost method may be used to determine the basis not only of RIC stock but, in addition, any corporate stock acquired after December 31, 2010 in connection with a dividend reinvestment plan ("DRP").ⁿ²⁷ Second, average basis for any eligible stock must be elected on an account-by-account basis beginning January 1, 2012.ⁿ²⁸ Finally, in the absence of an election to the contrary, the average basis of shares of any RIC or DRP stock acquired before January 1, 2012 must be determined separately from RIC or DRP shares acquired after that date, whether or not such shares are held in separate accounts.ⁿ²⁹

The Treasury Department and Internal Revenue Service have proposed changes to the average cost regulations to reflect the 2008 amendments to Section 1012 (the "proposed regulations").ⁿ³⁰ The provisions of the current regulations as well as the proposed regulations are discussed below.

[i] Eligibility For the Average Cost Method.

In permitting the use of the average cost method for stock in a regulated investment company, current regulations prescribe four requirements: (1) the RIC shares must be left by the taxpayer in a custodial account maintained for the acquisition or redemption of RIC shares;ⁿ³¹ (2) the shares must have been purchased or otherwise acquired at different

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prices or bases;ⁿ³² (3) the account in which the shares are held must not contain shares acquired by gift if the basis of the gifted shares in the hands of the donor exceeds the fair market value of such shares at the time of gift unless the taxpayer files a statement electing to use such fair market value as the basis of the gifted shares in computing average basis;ⁿ³³ and (4) the taxpayer must file an election to use the average cost method in an income tax return (including a timely filed amended return) for the first taxable year for which the taxpayer desires the election to apply, which election may only be revoked with the Commissioner's prior written consent.ⁿ³⁴

Under the 2008 amendments to *IRC Section 1012*, and the proposed regulations interpreting those amendments, the basis of corporate stock acquired after December 31, 2010 in connection with a dividend reinvestment plan ("DRP") may also be determined under the average cost method.ⁿ³⁵ A DRP is statutorily defined as an arrangement under which dividends are reinvested in stock identical to the stock with respect to which the dividends were paid.ⁿ³⁶ The proposed regulations further require that the arrangement or plan be in writing and that at least 10 percent of every dividend be reinvested in identical stock.ⁿ³⁷ A DRP is allowed to hold stock on which no dividends have ever been declared or paid as well as stock on which the issuer has ceased paying dividends, may reinvest a different percentage of dividends with respect to different stocks, and may be administered either by the issuer of the stock or by a non-issuer.ⁿ³⁸ Apart from these definitional provisions, the proposed regulations treat DRP stock acquired after December 31, 2010 in the same manner as RIC stock.ⁿ³⁹

Beginning in 2012, the 2008 amendments and the proposed regulations change the rules for electing and calculating the average cost of RIC and DRP shares that are "covered securities" as defined in *Section 6045(g)(3)* of the Code. In general, covered securities include shares in a RIC or DRP purchased in a brokerage or other custodial account on or after January 1, 2012, regarding which the broker or custodian is responsible for reporting to the Internal Revenue Service the taxpayer's adjusted basis, gain or loss, and holding period when the shares are sold.ⁿ⁴⁰

To assure that brokers have the information necessary to calculate the taxpayer's basis and holding period when RIC or DRP "covered securities" are sold or otherwise transferred, the proposed regulations provide that the taxpayer's election to use average cost must be made by notifying the broker or other custodian of the account in which the shares are held that the taxpayer desires to use the average cost method with respect to such shares.ⁿ⁴¹ The notice must be in writing but can be given "by any reasonable means."ⁿ⁴² The average cost election is effective only for sales or other dispositions occurring in the account after the taxpayer provides such notification and applies only to identical RIC or DRP stock in the particular account for which the election is made.ⁿ⁴³ An election to use the average cost method for RIC or DRP shares in one account neither requires nor allows the taxpayer to use the average cost method for shares of identical RIC or DRP stock held in a different account; a separate election must be made for each account in which RIC or DRP stock is held.ⁿ⁴⁴ Thus, if a taxpayer notifies Broker A of her election to use the average cost method to determine the basis of eligible covered securities in the account, but thereafter transfers the securities to an account with Broker B, the election filed with Broker A is of no further effect and the taxpayer's right to use the average cost method with respect to those securities depends on her filing a similar notification with Broker B prior to sale.ⁿ⁴⁵

Shares of stock in a RIC or DRP acquired prior to January 1, 2012, and shares considered noncovered securities for any other reason, are treated as if held in a separate account from shares of identical RIC or DRP stock acquired on or after January 1, 2012 that meet the definition of covered securities.ⁿ⁴⁶ The taxpayer may still elect to use the average basis method for all RIC shares or DRP shares acquired after December 31, 2010, whether the shares are covered or noncovered securities, but an election to use average basis for noncovered securities will not apply to shares of identical stock in the same account classified as covered securities, and vice-versa.ⁿ⁴⁷ Moreover, if separate elections are made for covered and noncovered securities, the average bases covered and noncovered securities must be computed separately.ⁿ⁴⁸

An irrevocable "single account election" can be made to treat all shares of identical RIC or DRP stock in an account as covered securities, requiring that the broker report adjusted basis and holding period information on the sale of every share of the RIC's or DRP's stock in the account, regardless of date of purchase.ⁿ⁴⁹ The single account election cannot

be made by the taxpayer, however. It can only be made by the RIC or DRP which maintains the account or accounts in which the taxpayer's stock is held, or by the broker which holds RIC or DRP stock as a nominee for the taxpayer,ⁿ⁵⁰ by "clearly noting it [the election] on its books and records."ⁿ⁵¹ The election may be made at any time, may be made for one or more taxpayers for which the RIC, DRP or broker maintains an account, and for one or more stocks held for a given taxpayer.ⁿ⁵² The single account election applies to all identical shares of RIC or DRP stock for which the taxpayer elects to use the average cost method, but only if the electing RIC, DRP or broker has accurate basis information with respect to all such stock.ⁿ⁵³

The proposed regulations provide that a taxpayer who makes an election to use the average cost method may revoke that election with retroactive effect by so notifying the custodian of the account, by any reasonable means, within one year after the election is made (or a longer period if the period is extended by the custodian or other agent), but only if no stock covered by the election has been sold out of the account prior to the notification of revocation.ⁿ⁵⁴ Once RIC or DRP covered securities have been sold out of the account, any change from the average cost method elected for that account is a change in method of accounting that can only be prospective in effect, and requires the consent of the Commissioner under prescribed procedures.ⁿ⁵⁵

[ii] Computation of Basis and Holding Period.

The average cost regulations currently permit the taxpayer to choose either of two methods of determining the average cost of a share of stock. Under the "double-category method," all shares in an account at the time of each sale or transfer of stock are divided into two categories, one for shares then having a holding period of more than one year (the "more-than-one-year" category), and the other for all shares having a holding period of one year or less (the "one-year-or-less" category).ⁿ⁵⁶ The taxpayer is allowed to specify the category out of which shares are sold, and the basis of each share in that category is then computed by dividing the aggregate basis of all shares in that category by the number of shares in the same category.ⁿ⁵⁷ The determination of average basis under the second method, the "single-category method," is made without regard to the holding period of the shares involved. Instead, average basis is computed by aggregating the cost or other basis of all shares in the account at the time of transfer or sale, and then dividing such total basis by the number of shares in the account.ⁿ⁵⁸ While taxpayers are permitted to use different average cost methods for different RICs, the regulations require that the same method be used with respect to all of the taxpayer's accounts that hold shares in the same RIC.ⁿ⁵⁹

The proposed regulations would eliminate the double-category method, leaving the single-category method as the only valid method for determining average cost.ⁿ⁶⁰ Taxpayers presently using the double-category method would be required to switch to the single-category method in calculating the basis of shares sold, exchanged or otherwise disposed of after the date the proposed regulations are published as final regulations in the Federal Register.ⁿ⁶¹ Further, taxpayers holding stock of the same RIC (or DRP) in more than one account are no longer required to use average costing in all such accounts or none; average cost may be elected for RIC stock held in one account but not for stock in the same RIC held in a different account.ⁿ⁶²

Under the single-category method, the holding period of shares sold is determined under the first-in, first-out method.ⁿ⁶³ The proposed regulations apply the same methodology.ⁿ⁶⁴ Thus, if an account holding shares of identical RIC stock contains 100 shares held for more than one year and 100 shares held for one year or less, and the taxpayer sells 50 of the shares, all 50 would be deemed to have been held for more than one year.ⁿ⁶⁵

Example 1 illustrates the application of the proposed regulations in a number of different circumstances. The first demonstrates the consequences of electing the average cost method for stock enrolled a dividend reinvestment plan and later selling other shares in the same company that have not been enrolled in the plan.

Example 1:

T, a taxpayer, acquires 100 shares of H Company stock at \$15 per share on February 1, 2011, and enrolls

the shares in a dividend reinvestment plan administered by D. T elects to use the average cost method for the H Company shares. D later acquires an additional 100 shares of H Company stock on T's behalf on April 1, 2011, at \$10 per share, but does not enroll that stock in the dividend reinvestment plan. On December 1, 2011, D sells the 100 shares of H Company stock not enrolled in the dividend reinvestment plan on T's behalf for \$12 per share.

The basis of the 100 non-enrolled shares of H Company sold on December 1, 2011 is determined using their \$10 per share actual cost. T's profit is \$2 per share (\$12 selling price less \$10 basis) or \$200. A taxpayer's election to use the average cost method for RIC or DRP shares sold before January 1, 2012 ordinarily requires that identical stock held by the taxpayer in other accounts be taken into account in calculating the average basis of the shares sold.ⁿ⁶⁶ However, shares of stock enrolled in a DRP are not considered "identical" to shares in the same company that are not held in a DRP.ⁿ⁶⁷ Since the enrolled and unenrolled shares of H Company stock are not "identical," T may not average their acquisition costs when calculating the basis of the H Company stock sold on December 1, 2011.ⁿ⁶⁸

Example 2 demonstrates the application of the proposed average cost regulations when a taxpayer holds shares of stock in a RIC (or shares that were acquired in connection with a DRP) and such shares consist of both covered and noncovered securities in the same account.

Example 2:

T, a taxpayer, acquires 100 shares of J Company stock at \$15 per share on February 1, 2011 and enrolls the shares in a dividend reinvestment plan administered by E. T elects to use the average cost method to determine the basis of the J Company shares. On February 1, 2012, T purchases an additional 100 shares of J Company stock at \$10 per share and adds them to the dividend reinvestment plan account with E. On March 1, 2012, on T's instructions, E sells 100 of the J Company shares held in the plan for \$12 per share. At settlement, E delivers the certificate for the 100 J Company shares purchased by T on February 1, 2011.

The basis of the J Company shares sold on March 1, 2012 is \$15 per share, the cost of the 100 share lot acquired on February 1, 2011. T has a long-term capital loss of \$3 per share (\$12-\$15) or \$300. The cost basis of the 100 shares purchased on February 1, 2011 for \$15 per share cannot be averaged with the 100 shares purchased on February 1, 2012 for \$10 per share because the former are noncovered securities, acquired before January 1, 2012, while the latter are covered securities acquired on or after January 1, 2012.ⁿ⁶⁹ The average cost method may not be used to average the costs of noncovered securities and covered securities in the same fund or plan unless the broker or other custodian makes a single account election, which E has not done in this case.ⁿ⁷⁰ Since E delivered the certificate for the 100 J Company shares acquired on February 1, 2011 to close the sale, the basis of the 100 shares sold is \$15 per share under the actual delivery method.ⁿ⁷¹

Had E made a single account election to treat all J Company shares in T's account as covered securities regardless of their date of acquisition,ⁿ⁷² each share of J Company stock would receive an average basis of \$12.50 per share $((\$1500 + \$1000) = \$2500 / 200 \text{ shares} = \$12.50)$, and, under the first-in, first-out holding period rule, the J Company shares sold would be deemed to come from the 100 share purchase made on February 1, 2011. T would then have a long-term capital loss of \$50 on the March 1, 2012 sale $(\$12 \text{ sale price less } \$12.50 \text{ basis per share} = \$-.50 \text{ loss multiplied by } 100 \text{ shares})$.ⁿ⁷³

The final three examples illustrate the calculation of a moving average cost and the effect of a revocation or termination of an average cost election.

Example 3:

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On February 1, 2012, Taxpayer T enters into an agreement with custodian F establishing an account for the periodic acquisition of shares of R Company, a regulated investment company, and elects to determine the basis of R Company shares using the average cost method. F acquires R Company stock for F's account, and sells R Company stock at T's direction, on the following dates and amounts.

DATE	TRANSACTION	QUANTITY	PRICE PER SHARE	TOTAL COST
March 1, 2012	PURCHASE	100 shares	\$140 per share	\$14,000
July 1, 2012	PURCHASE	100 shares	\$100 per share	10,000
March 3, 2013	SALE	100 shares	\$120 per share	12,000
June 1, 2013	PURCHASE	100 shares	\$90 per share	9,000
August 1, 2013	SALE	150 shares	\$120 per share	18,000

The 100 shares of R Company sold on March 3, 2013 have an average cost of \$120 per share (total basis of R Company stock in account-\$24,000-divided by 200 shares held equals \$120 per share). Since T received \$120 per share for the 100 shares sold on March 3, there is neither gain nor loss on the sale. The 100 shares sold are deemed to come from the 100 share lot acquired on March 1, 2012 under the first-in, first-out holding period rule. The 100 shares of R Company remaining in T's account, all of which were acquired on July 1, 2012, now have an average basis of \$120 per share. The \$100 per share actual cost of those shares is now irrelevant.

The average cost basis of each of the 150 shares of R Company stock sold on August 1, 2013 is \$105 per share, calculated as follows: There are 200 shares of R Company stock in the account immediately prior to the August 1, 2013 sale. Of these, 100 shares were purchased on July 1, 2012 for \$100 per share but, after the March 3, 2013 sale, have an average basis of \$120 per share, or a total basis of \$12,000. The remaining 100 shares of R Company stock acquired on June 1, 2013 at a cost of \$90 per share have a basis of \$9,000. The total basis of the 200 shares of R Company stock in T's account on August 1, 2013 is therefore \$21,000 (\$12,000+\$9,000), which when divided by the 200 shares held in the account yields a new average basis of \$105 per share. Since T received \$120 per share for the 150 shares sold on August 1, 2013, T's total gain on the sale is \$2,250 (\$120-\$105 = \$15 gain x 150 shares). \$1,500 of that gain is deemed made on the sale of the 100 share lot acquired on July 1, 2012, and is therefore long-term capital gain. The remaining \$750 gain is deemed made on the sale of 50 shares out of the 100 share lot acquired on April 1, 2013, and is short-term capital gain.

Example 4:

The facts are the same as Example 3 except that, on January 29, 2013, T validly revokes his February 1, 2012 election to determine the basis of R Company stock using average cost, and notifies F to determine the basis of such stock using the first-in, first-out method. The basis of the 100 shares sold on March 3, 2012 is therefore determined as though the average cost method had never been elected. Under the first-in, first-out method elected by T, the shares sold are those purchased on March 1, 2012 at a cost of \$140 per share, resulting in a long-term capital loss of \$20 per share (\$120-\$140) or \$2,000.ⁿ⁷⁴ The 150 shares sold on August 1, 2013 for \$120 per share would be deemed to come first, from the 100 share lot purchased on July 1, 2012 for \$100 per share, producing a long-term capital gain of \$20 per share (\$120-\$100) or \$2,000 (100 shares x \$20), and second, from the sale of 50 of the 100 shares purchased by T two months earlier, on June 1, 2013, for \$90 per share, resulting in short-term gain of \$30 per share (\$120-\$90) or a total short-term capital gain of \$1,500 (50 shares x \$30). Note that the proposed regulations do not preclude T from re-electing the average cost method of determining the basis of the R Company stock at any time after revoking the original election, but the new election can only be made effective prospectively.ⁿ⁷⁵

Example 5:

The facts are the same as Example 3 except that, on March 15, 2013, T changes from the average cost method to the first-in, first-out method of determining the basis of R Company stock in his account with F. T cannot revoke the average cost method election retroactively since R Company stock has already been sold out of the account on March 1, 2013 (and the one-year revocation period has expired without extension by F), but T can still change from the average cost method to another permissible method for future sales of R Company stock with the consent of the Commissioner. For purposes of applying the newly elected first-in, first-out method, stock in the account keeps the same basis immediately after the change it had under the average cost method immediately before the change.ⁿ⁷⁶

The 200 shares of R Company stock in T's account immediately before the sale of 150 shares on August 1, 2013 come from two different lots: 100 shares attributable to a purchase on July 1, 2012 at \$100 per share, and 100 shares acquired on June 1, 2013, at \$90 per share. The 100 shares attributable to the July 1, 2012 purchase had a basis under the average cost method, immediately prior to T's March 15, 2013 change in method, of \$120 per share (see Example 1 above); accordingly, for purposes of applying the newly elected first-in, first-out method, the basis of each of those shares remains \$120.ⁿ⁷⁷ The basis of the 100 shares purchased on June 1, 2013, after the change in method, is their actual cost, \$90 per share. Therefore, the basis of the 150 shares of R Company stock sold by T on August 1, 2013 is determined under the first-in, first-out method as follows: 100 shares are sold out of the lot acquired on July 1, 2012 at an average basis of \$120 per share, and the remaining 50 shares are sold out of the 100-share lot acquired on June 1, 2013, which has a cost basis of \$90 per share. Since the August 1, 2013 sale is executed at a sales price of \$120 per share, the first-in first out method produces no gain or loss on the sale of 100 shares out of the July 1, 2012 lot ($\$120 - \$120 = 0$), and a \$1,500 short-term capital gain on the sale of 50 shares out of the June 1, 2013 lot ($\$120 - \$90 = \$30 \times 50 \text{ shares} = \$1,500$).

[9] Information Reporting of Securities Transactions By Brokers.

Since 1983, securities brokers have been required to file information returns with the Internal Revenue Service reporting the gross proceeds from each sale of securities effected by the broker on behalf of a customer along with the customer's name, address, taxpayer identification number, and date of sale.ⁿ¹ Each customer is entitled to receive a written statement from the broker containing the information provided to the Internal Revenue Service no later than February 15 of the year following the year in which the sale occurred.ⁿ²

Beginning in 2011, Section 403 of the Energy Improvement and Extension Act of 2008ⁿ³ requires brokers presently obligated to report the gross proceeds from the sale of customer securities to also report, in connection with every sale of "covered securities," the adjusted basis of the securities sold and whether gain or loss on the sale was long-term or short-term.ⁿ⁴ In general, the term "covered securities" initially refers to shares of corporate stock purchased in an account on or after January 1, 2011.ⁿ⁵ Stock in a regulated investment company (mutual fund) and corporate stock acquired in connection with a dividend reinvestment plan are exceptions to this rule and will not be considered "covered securities" unless purchased on or after January 1, 2012.ⁿ⁶ Other types of securities, (including notes, bonds, debentures and other evidence of indebtedness, commodity contracts, and derivatives), will be classified as "covered securities" subject to the new reporting rules if purchased on or after January 1, 2013.ⁿ⁷

If the broker's customer sells covered securities that were acquired through a sale transaction in the same account, the broker calculates the stock's initial basis by using the total amount paid by the customer or credited against the customer's account for the stock sold, increased by commissions and transfer taxes related to its acquisition.ⁿ⁸ If the covered securities are shares in a regulated investment company or stock acquired in connection with a dividend reinvestment plan, and the owner has elected to use the average cost method of determining basis (or the owner has not designated any method of determining basis and the broker uses the average cost method as its "default method" for such securities), initial basis is determined using the average basis of all identical shares in the account.ⁿ⁹

In determining adjustments to initial basis, the broker is required to take into account organizational actions of the issuer affecting the basis of the security (*e.g.*, stock splits, mergers and acquisitions), but only if such actions have been reported by the issuer as prescribed by *IRC Section 6045B* and the regulations thereunder.ⁿ¹⁰ Otherwise, the broker is not required to consider the effect on basis of transactions, elections or events occurring outside the account,ⁿ¹¹ though it is permitted to take account of outside transactions in calculating adjusted basis and holding period if it chooses to do so.ⁿ¹²

Example 1:

The "wash sale" provisions of *IRC Section 1091*, discussed in detail at § 2.07[3], *infra*, provide that if stock is sold at a loss and substantially identical stock is purchased within 30 days before or 30 days after the sale date, the loss is disallowed and the basis of the repurchased stock equals the basis of the stock sold at a loss, adjusted for any difference between the purchase price of the stock sold and the purchase price of the repurchased stock. So, if T purchases 100 shares of C Company stock for \$1,000 on February 1, 2011, sells those shares on March 1, 2011 for \$900; and repurchases 100 identical shares for \$950 on March 15, 2011, the \$100 loss on the March 1 sale is disallowed and the 100 shares repurchased on March 15 receive a basis of \$1,050 (\$1,000 basis of shares sold on March 1, 2011 plus \$50 difference between \$900 cost of shares sold on March 1 and \$950 cost of shares repurchased on March 15, 2011). If the 100 repurchased shares are sold on July 1, 2011 for \$1,000, and there are no further repurchases, T recognizes a \$50 loss at that time (\$1,000 proceeds less \$1,050 adjusted basis).

Suppose that the original 100 share lot of C Company stock was purchased and sold in T's account with broker F, while the repurchase and later sale of 100 identical shares were made in T's account with broker G. Whether or not F has knowledge of T's repurchase of identical stock in an account with G within 30 days of the March 1 sale, F's Form 1099B may report a \$100 short-term capital loss on the March 1, 2011 sale based solely on F's own account records.ⁿ¹³ T would be responsible for reporting the transaction correctly on his return for the year.ⁿ¹⁴ Similarly, G's Form 1099B for the July 1, 2011 sale of the stock, prepared consistently with its account records, would show gross proceeds of \$1,000 and an adjusted basis of \$950, producing a short-term capital gain on the sale of \$50. G can report the transaction in that manner even if T provides G with complete information regarding the transactions in the account with F that implicate the wash sale provisions. However, either F or G is permitted (but not required) to use relevant information from outside the account in preparing Form 1099B so long as they do not know and have no reason to know that the outside information is incorrect. Thus, using the information obtained from T, G may report an adjusted basis of \$1,050 for the C Company shares sold by T on July 1 (\$1,000 carryover basis of T's original 100 share lot + \$50 increase in the purchase price of the repurchased stock) instead of the \$950 cost basis in its own account records, which, when compared with gross proceeds of \$1,000, produces a \$50 loss rather than a \$50 gain on the July 1 sale.ⁿ¹⁵

Example 2:

The facts are the same as in Example 1, except that T has two accounts with G, Account A and Account B; the 100 shares of C Company stock sold on March 1, 2011 are purchased as well as sold in Account A; and the repurchase of 100 shares of identical C Company stock on March 15, 2011 and the sale of those shares on July 1, 2011 take place in Account B. G may report the adjusted basis of the 100 C Company shares sold out of Account B on July 1, 2011 without regard to the wash sale provisions since the sale that triggered those provisions was made in Account A.ⁿ¹⁶ G may instead choose to apply the wash sale rules to the July 1, 2011 sale as though the sale and repurchase transactions took place in the same account, in which case G may recalculate the basis of the 100 C Company shares in accordance with the wash sale provisions.ⁿ¹⁷

Example 3:

The facts are the same as in Example 1 except that all of T's purchases and sales of C Company's stock take place in a single account with G. In these circumstances, where all the transactions affecting the basis of the C Company stock sold on July 1, 2011 have taken place in the same account, G is required to take the March 1 sale and March 15 repurchase into account in reporting the adjusted basis of the C Company stock sold on July 1; in addition, G must report the loss disallowed under *IRC Section 1091* as well as the gross proceeds and adjusted basis of the C Company stock sold on March 1.ⁿ¹⁸

Brokers are not required to report the adjusted basis and holding period of "noncovered securities" (for example, corporate stock acquired in the customer's account prior to January 1, 2011), regardless of when they are sold.ⁿ¹⁹ Further, if the broker's customer was an "exempt recipient" within the meaning of *Section 1.6045-1(d)(3)* of the Regulationsⁿ²⁰ at the time securities were acquired but the customer loses its exempt recipient status before the securities are sold, the securities are treated as "noncovered securities" and the broker need not report their adjusted basis or holding period on the information return that will be required when the securities are sold.ⁿ²¹ In either case, if the broker does not report adjusted basis and holding period information it is instructed to indicate on the information return that the reported sale is a sale of noncovered securities.ⁿ²² Once again, the proposed regulations allow a broker to volunteer adjusted basis and holding period information on returns relating to sales of noncovered securities even though not required to do so, and provide that in such circumstances penaltiesⁿ²³ will not be imposed for a failure to report basis and holding period information correctly as long as the broker has indicated on the information return that the reported sale is a sale of a noncovered security.ⁿ²⁴

If a broker sells securities acquired in the customer's account through a non-sale transfer, the broker will have to look outside its account records for information concerning the securities' initial basis and holding period. The mechanism provided by the statute for supplying this information is a transfer statement, which the transferor must prepare and provide to the receiving broker no later than 15 days after the settlement date of the transfer, provided the transferee is a broker and the transfer is effected by another broker, a professional custodian of securities or any issuer of securities.ⁿ²⁵ If the securities transferred are covered securities, the transferor must calculate the adjusted basis and holding period of the transferred securities in the same manner as a broker selling securities on behalf of a customer, except that the transferor need not take into account the effect on the basis of the transferred securities of organizational actions reported on issuer statements pursuant to *IRC Section 6045B*.ⁿ²⁶ If the transferred securities are noncovered securities,ⁿ²⁷ adjusted basis and holding period need not be included in the transfer statement, but other information regarding the transfer must still be supplied and the transfer statement must indicate that the securities transferred are noncovered securities.ⁿ²⁸

What if a broker receives securities on behalf of a customer in a non-sale transfer but does not receive the transfer statement required by *IRC Section 6045A*? Once the due date for receipt of the transfer statement has past and the broker has not received such a statement, or has received an incomplete statement, the broker is required to notify the transferor and request a complete statement. This request need not be made more than once. If a complete transfer statement is not received after making the request, the broker may treat the transferred securities as noncovered securities when they are sold. If the broker subsequently receives a complete transfer statement after the sale indicating that the securities sold were "covered securities," the broker must file a corrected Form 1099-B, if necessary, within 30 days of receiving the transfer statement.ⁿ²⁹

Additional information must be included in the transfer statement when securities are transferred pursuant to an inheritance. The transfer statement must indicate that the transfer consists of an inherited security, report the date of death as the original acquisition date, and report adjusted basis according to instructions or valuations provided by an authorized representative of the estate.ⁿ³⁰ If an authorized

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estate representative does not provide such instructions or valuations at the time the transfer of the securities is requested, the transferor must ask for such instructions or valuations before preparing the transfer statement, but need not ask more than once.ⁿ³¹ If no instructions or valuations are forthcoming from the estate the transferor may prepare the transfer statement without information as to date of death or basis as though the securities transferred were noncovered securities, but must still identify the transferred securities as inherited securities.ⁿ³²

When a non-sale transfer of securities from one account to another effects a change in ownership other than by reason of inheritance, the transfer statement must indicate that the securities are gifts, report the date of the gift and the fair market value of the securities on that date, and report the adjusted basis and original acquisition date as equal to the donor's adjusted basis and original acquisition date.ⁿ³³ However, the date of the gift need not be reported if it is not known to the transferor (no further inquiries are required), and the fair market value of the securities on the date of the gift need not be reported if such fair market value is neither known nor reasonably ascertainable at the time the transfer statement is prepared. If the gift securities are subsequently transferred to a different account of the donee in a non-sale transaction, the transfer statement prepared for the latter transfer must include the information regarding the gift found in the original transfer statement as well as any information regarding date of gift and fair market value of the securities known to the second transferor that was not included in the original transfer statement.ⁿ³⁴

While a short sale of securities is literally a "sale" and would normally require the selling broker to file an information return, information regarding the adjusted basis and holding period of the securities sold cannot be determined, and therefore cannot be reported, until the short sale is closed by the customer's delivery of securities to cover the short sale.ⁿ³⁵ Brokers originally were required to file an information return in the year the short sale was effected, when only the gross proceeds of sale had to be reported on the return. Under the new reporting rules, if the short sale is entered into on or after January 1, 2010, brokers are instructed to defer filing an information return until the year the short sale is closed.ⁿ³⁶ Whether the broker is required to report adjusted basis and holding period depends on whether the customer uses "covered securities" or "noncovered securities" to close the short sale.ⁿ³⁷ Further, since a short sale is not considered closed for tax purposes by the short seller's delivery to the broker of securities borrowed from another person,ⁿ³⁸ no information return is required at such time.ⁿ³⁹ If the borrowed securities are transferred to the short seller's account by a second broker, the latter must provide a transfer statement notifying the original broker that the transferred securities have been borrowed. The original broker is then required to furnish a statement to the transferor which includes, among other information, the date of the short sale and the gross proceeds of the sale. The transferor broker becomes responsible for filing an information return with the Internal Revenue Service, using in part the information received from the original broker, when it receives securities from the customer in a transaction that finally closes the short sale for tax purposes.ⁿ⁴⁰

Example:

On December 20, 2010, T opens a short sale of corporate stock (not stock in a regulated investment company or acquired in connection with a dividend reinvestment plan) in an account with broker B1. T satisfies his obligation to B1 by borrowing the same quantity of identical stock in the same corporation from broker B2 and having B2 transfer the stock into T's account with B1 on January 20, 2011. T purchases identical corporate stock on March 1, 2011 in his account with B2 which he uses to satisfy his obligation to B2, closing the short sale. B2 is required to furnish B1 with a transfer statement indicating that the stock transferred into T's account with B1 on January 20, 2011, was borrowed from B2. B1 is required to furnish a statement to B2 reporting the gross proceeds from T's December 20, 2010 short sale, the date the short sale was opened, the CUSIP number of the stock T borrowed from B1 to open the short sale, the date B2 initiated the transfer of stock as reported on B2's transfer statement, and the name

and contact information of B1, B2 and T. Since the short sale was effected on or after January 1, 2010, the information return with respect to the short sale is to be filed with the Internal Revenue Service in the year that T closes the short sale (2011), not the year the short sale is effected (2010). Moreover, the return is filed by B2, not B1, since T covered the short sale by delivering securities to B2 in an account with B2. Finally, B2 must include in the information return the adjusted basis and holding period of the stock used by T to close the short sale (in addition to the date of the short sale and the gross proceeds of sale, as determined by the statement previously furnished to B2 by B1). The stock used by T to close the short sale is a "covered security" since it is corporate stock (other than regulated investment company or dividend reinvestment plan stock) acquired on or after January 1, 2011. Had T used stock purchased prior to January 1, 2011 to cover the short sale, on the other hand, the stock would have been a "noncovered security" and B2 would not be required to report basis and holding period information, even though the short sale was covered after January 1, 2011.ⁿ⁴¹

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.1012-1(a)*. If a debt instrument is issued in exchange for property, the cost of the property that is attributable to the debt instrument is the issue price of the debt instrument as determined under *Treas Reg § 1.1273-2(b)* or *Treas Reg § 1.1274-2(b)*, whichever is applicable. If, however, the issue price of the debt instrument is determined under *IRC § 1273(b)(4)*, the cost of the property attributable to that debt instrument is its stated principal amount reduced by any unstated interest (as determined under *IRC § 483*). *Treas Reg § 1.1012-1(g)*.

If a tax-exempt contingent payment debt instrument, or a tax-exempt variable rate instrument that provides for interest-based or revenue-based payments, is issued for property, the cost of the property that is attributable to the obligation is the sum of the present values of the noncontingent payments. *Treas Reg § 1.1012-1(g)(2)*.

(n2)Footnote 2. *Crane v Commr*, 331 US 1 (1946) .

(n3)Footnote 3. Two of the more unusual cases illustrating this rule are *Bolger v Commr*, 59 TC 760 (1973) , *acq* 1976-1 CB 1 , and *Mayerson v Commr*, 47 TC 340 (1966) , *acq* 1969-1 CB 21 .

(n4)Footnote 4. *Albany Car Wheel Co v Commr*, 40 TC 831 (1963) , *affd* 333 F2d 653 (2d Cir 1964) ; *Rev Rul* 55-675, 1955-2 CB 567 .

(n5)Footnote 5. *Woodsam Associates, Inc v Commr*, 198 F2d 357 (2d Cir 1952) .

(n6)Footnote 6. *IRC § 1012*; *Treas Reg § 1.1012-1(a)*.

(n7)Footnote 7. *Matheson v Commr*, 31 BTA 493 (1934) , *affd* 82 F2d 380 (5th Cir 1936) . The burden of proving that the amount paid in excess of value was not for a purpose other than purchase rests upon the taxpayer. *Majestic Sec Corp v Commr*, 120 F2d 12 (8th Cir 1941) .

(n8)Footnote 8. 77 F2d 92 (3d Cir 1935) .

(n9)Footnote 9. *Ibid*. Where a father's desire to alleviate the financial difficulties of a daughter was the reason for a price greater than value, basis was held to be value instead of cost. *McDonald v Commr*, 28 BTA 64 (1933) .

(n10)Footnote 10. 447 F2d 1074 (9th Cir 1971) .

(n11)Footnote 11. *Beck-Brown Realty Co v Commr*, 46 BTA 1225 (1942) .

(n12)Footnote 12. *Reg § 1.1012-2*; *Reg § 1.1015-4*.

(n13)Footnote 13. *Philadelphia Park Amusement Co v US*, 126 F Supp 184 (Ct Cl 1954) ; *Rev Rul* 55-757, 1955-2

CB 557 .

The value of property transferred in exchange for a private annuity is the amount of the taxpayer's investment in the contract. 212 *Corp v Commr*, 70 TC 788 .

(n14)Footnote 14. *Hazeltine Corp v Commr*, 89 F2d 513 (3d Cir 1937) .

(n15)Footnote 15. *Heiner v Crosby*, 24 F2d 191 (3d Cir 1928) . Part of the consideration for an asset purchase consisted of a specified number of publicly traded shares valued in the purchase agreement at \$48.50 per share. At the time of closing the stock had a per share value of only \$36. The seller used the market value of the stock on the exchange date to determine its amount realized. The purchaser used the contract valuation to fix its basis in the acquired assets. The Tax Court approved the higher basis, giving great weight to the assigned value. *White Farm Equip Co v Commr*, 61 TC 189 (1973) . The Third Circuit rejected use of the "barter-equation" method to fix value and held the market price to be proper index. Nothing in the facts of the case indicated any reason for resorting to other than the normal rule. *Amerada Hess Corp v Commr*, 517 F2d 75 (3d Cir 1975) , *cert denied* 423 US 1037 (1975) .

(n16)Footnote 16. *LeVant v Commr*, 376 F2d 434 (7th Cir 1967) .

(n17)Footnote 17. *Commr v Stewart's Estate*, 153 F2d 17 (3d Cir 1946) .

(n18)Footnote 18. *Philadelphia Park Amusement Co v US*, N 13 *supra*.

(n19)Footnote 19. The rule will be applied as long as the item should have been included in income, even if the taxpayer failed to do so. *US v du Pont*, 47 F Supp 894 (D Del 1942) .

(n20)Footnote 1. *Reg § 1.1053-1(b)*.

(n21)Footnote 1. This is the result if the gift was made prior to Jan 1, 1921. *IRC § 1015(c)*.

(n22)Footnote 2. In *Taft v Bowers*, 278 US 470 (1929) , the Supreme Court denied the taxpayer's contention that it was unconstitutional for the donee to be taxed on the increase in value during the period the property was held by the donor.

The burden of proving the donor's basis rests with the taxpayer. *Gibson v Commr*, TC Memo 1981-240 ; *Hamilton v Commr*, TC Memo 1974-310 .

(n23)Footnote 3. *IRC § 1015(a)*.

(n24)Footnote 4. *IRC § 1015(d)*. No increase is permitted if gift taxes due were not paid. *Church v Commr*, TC Memo 1978-295 .

(n25)Footnote 5. *IRC § 1015(d)(1)(A)*.

(n26)Footnote 6. *IRC § 1015(d)(1)(B)*. The basis is adjusted as of September 2, 1958.

(n27)Footnote 7. The "total gift tax paid" is the amount of tax due as per the gift tax return on which the gift is reported. *IRC § 1015(d)(2)*.

(n28)Footnote 8. *IRC § 1015(d)(2)*; *Reg § 1.1015-5(b)*. The specific exemption was repealed effective Jan 1, 1977.

(n29)Footnote 9. For gifts made after 1981, the annual exclusion is \$10,000.

(n30)Footnote 10. The amount of the gift was \$20,000 (total gift of \$23,000 less \$3,000 annual exclusion), and the

amount of total taxable gifts for the year without deducting the specific exemption, \$50,000. Substituting these values in the formula we find:

$$\begin{array}{r} \$20,000 \\ \$50,000 \end{array} \times \$1,200 = \$480$$

Determination of gift tax paid with respect to the gift becomes more complex when a donee receives more than one gift of property from the same donor in the same year. See *Reg § 1.1015-5(b)* and the examples contained therein.

(n31)Footnote 11. *IRC § 1015(d)(6)(A)*.

(n32)Footnote 12. *IRC § 1015(d)(6)(B)*.

(n33)Footnote 13. *Reg § 1.1015-4(a)*.

(n34)Footnote 14. *IRC § 2512(b)*.

(n35)Footnote 15. *160 F2d 812 (2d Cir 1947)*.

(n36)Footnote 16. *IRC § 1015(e)* states that the basis of property obtained in a transfer between spouses governed by *IRC § 1041* is to be determined under *IRC § 1041(b)(2)* and not *IRC § 1015*. An important difference in result occurs when the transferred property has a fair market value less than the transferor's basis. Under *IRC § 1015*, the transferee's basis for determining loss is the fair market value of the property on the date of transfer; the basis for determining gain is the transferor's basis. Under *IRC § 1041*, the transferor's basis becomes the transferee's basis for all purposes.

(n37)Footnote 1. *IRC § 2032* is the provision which presently allows the alternate valuation election. If application of the special valuation rule of *IRC § 2032A* (relating to certain real property owned by the decedent) is elected, the basis of the property is that value.

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") Pub L No 107-16, which repealed the federal estate tax for the individuals who die in the year 2010 only, also created a limited stepped-up basis for such decedents. Under *IRC § 1022(b)*, for individuals who die in 2010, the maximum step-up in basis is generally \$1.3 million, or \$3 million in the case of a bequest to a surviving spouse or to a qualified terminable interest property trust for the benefit of the surviving spouse. These rules should be watched closely for future legislative changes relative to federal taxation of estates.

The basis of property subject to an option exercisable only after the optionee's death is determined under *IRC § 1014(a)*, taking into account the existence of the option on the property. *Rev Rul 71-265, 1971-1 CB 223*.

(n38)Footnote 2. *IRC § 1014(b)(2), (3)*.

(n39)Footnote 3. *IRC § 1014(b)(4)*.

(n40)Footnote 4. *IRC § 1014(b)(6)*.

(n41)Footnote 5. *IRC § 1014(b)(9)*. The provision does not apply to "annuities described in section 72," but only if the annuity was purchased on or after Oct 21, 1979. *IRC § 1014(b)(9)(A)*; *Rev Rul 79-335, 1979-2 CB 292*. A deferred variable annuity contract acquired after Oct 21, 1979 in a tax-free exchange for an annuity purchased before that date is not entitled to a step-up in basis. *Rev Rul 85-139, 1985-2 CB 29*; *Ltr Rul 9346002*; *Ltr Rul 9245035*.

A surviving joint tenant can claim a stepped-up basis to the extent that the subject property was includable in the estate of the deceased joint tenant. For property acquired before 1977 (the effective date of *IRC § 2040(b)*), the amount

includable is a function of the portion of the total consideration furnished by the decedent in the acquisition of the property. Thus, if the decedent furnished all of the consideration, all of the property is includable and the step up in basis applies to the entire property. For years governed by *IRC § 2040(b)*, the 50-percent inclusion rule for qualified joint interests limits the application of *IRC § 1014* to one half of the property; the balance of the property retains its original basis. See *Gallenstein v US*, 68 AFTR2d 91-5721 (ED Ky 1991) , *affd* 975 F2d 286 (6th Cir 1992) ; *Hahn v Commr*, 110 TC 140 (1998) . The Service has acquiesced in *Hahn* and will no longer litigate that *IRC § 2040(b)(1)* applies to joint interests created before Jan 1, 1977, where the deceased joint tenant died after Dec 31, 1981.

Foreign property inherited by a US resident from a nonresident alien is entitled to a basis equal to its fair market value at the decedent's death even though the property is not includable in the decedent's federal estate tax return. *IRC § 1014(b)(9)* has no application to foreign situs property owned by a nonresident alien that is acquired from a decedent by a means described in any other paragraph of *IRC § 1014(b)*. *Rev Rul 84-139, 1984-1 CB 168* .

(n42)Footnote 6. An audit of a decedent's federal estate tax return produced an increase in the gross estate to reflect the value of an interest in stock transferred to a trust in contemplation of death. A contest of the issue resulted in a settlement of the additional tax due. The settlement was not based on a compromise of the fair market value of the stock, nor was it based on the exclusion of specific shares of stock. However, it did have the effect of excluding a portion of each share of stock held by the trust from the gross estate. Accordingly, only the portion of each share of stock that generated additional estate tax liability could take a basis equal to fair market value. The portion of each share that did not produce any additional estate tax would resume a basis determined under either *IRC § 1012* (cost basis), or *IRC § 1015* (basis of property acquired by gift). *Rev Rul 72-441, 1972-2 CB 465* .

(n43)Footnote 7. *IRC § 1014(a)*.

(n44)Footnote 8. An important consequence of this rule is that gain on installment obligations held by a decedent is income in respect of a decedent and that the person succeeding to the decedent's interest in the obligations does not receive a stepped-up basis in them. *IRC § 691(a)(4)*; *Holt v US*, 39 Fed Cl 525 (1997) .

(n45)Footnote 9. *Reg § 1.451-1(a)* (1957).

(n46)Footnote 10. *Reg § 1.691(a)-1(b)* (1957).

(n47)Footnote 11. *IRC § 691(a)*.

(n48)Footnote 12. The deduction of any estate tax attributable to the item included in the recipient's gross income is permitted by *IRC § 691(c)*. Congress considered this a substitute for *IRC § 1014(a)* treatment. S Rep No 1622, 83d Cong, 2d Sess, 107 (1954).

(n49)Footnote 13. *IRC § 1014(b)(5)*. The same rule applies to marketable passive foreign investment stock for which a mark-to-market election is in effect. *IRC § 1296(i)*. The mark-to-market election is discussed in § 20.05A[2].

There is also no step-up if stock or securities are acquired in a manner that would normally call for application of *IRC § 1014(b)(9)*. *IRC § 1014(b)(9)(B)*.

IRC § 1014(b)(5) applies whether or not the income of the foreign personal holding company was included in income by a US taxpayer. *Ltr Rul 9110019* .

(n50)Footnote 14. The legislative history underlying *IRC § 1014(e)* expresses Congress' concern that an individual could transfer appreciated property to a family member immediately prior to the family member's death anticipating that, on the family member's death, the individual would receive the property back by devise or bequest. Under the circumstances, there is little substance to the initial transfer, because of the short period of time between the two transfers. H Rep No 201, 97th Cong, 1st Sess 188 (1981). See also *Ltr Rul 9308002* .

(n51)Footnote 15. *Treas Reg § 1.1014-3(a)*.

The value of an asset was overstated on the estate tax return of a decedent. No estate tax was due because of the taking of the marital deduction. The beneficiary adopted the inflated value as the basis of the asset for income tax purposes. Held, such action can subject the beneficiary to the penalty for valuation overstatements prescribed by *IRC § 6662*. *Rev Rul 85-75, 1985-1 CB 376* . At the time of the ruling, the applicable provision was *IRC § 6659*.

A husband and wife residing in a community property state held treasury bonds that could be redeemed at par in payment of federal estate taxes. If so used, the bonds must be included in the decedent's gross estate at their par value. However, since the bonds were community property, only-one half of the total holding could be used to pay estate taxes; the other half was deemed owned by the surviving spouse. The proper measure of basis for the half deemed owned by the surviving spouse was fair market value at the time of the husband's death. *Neuhoff v Commr, 75 TC 36 (1980)* , *affd 669 F2d 291 (5th Cir 1982)* ; *Rev Rul 76-68, 1976-1 CB 216* .

(n52)Footnote 16. *Rev Rul 54-97, 1954-1 CB 113* . The courts had arrived at this position prior to the Service's ruling. Eg, *Rogers v Commr, 31 BTA 994 (1935)* , *affd 107 F2d 394 (2d Cir 1939)* .

(n53)Footnote 17. *Hess v US, 537 F2d 457 (Ct Cl 1976)* , *cert denied 430 US 931* ; *McMillan v US, 1964-2 USTC P 9720 (SD W Va 1964)* . The objection actually rests on some duty of consistency since the element of reliance required by the doctrine of estoppel is lacking. *Beltzer v US, 495 F2d 211 (8th Cir 1974)* (Commissioner correctly invoked doctrines of quasi-estopped and duty of consistency); *Alamo Natl Bank v Commr, 95 F2d 622 (5th Cir 1938)* .

The duty of consistency was applied in *Janis v Commr, 461 F3d 1080 (9[th] Cir 2006)* , to require the taxpayers to use, as the basis for property acquired from the decedent, the fair market value of the property as reported for estate tax purposes. The executors of the estate had employed the concept of "blockage" to reduce the value of the property for estate tax purposes. They sought to use the value of the property without reduction of the discount as the basis for gain, but were rebuffed in that attempt. The Second Circuit reached the same result in the case of another beneficiary of the estate. *Janis v Commr, 469 F3d 256 (2d Cir 2006)* .

In *Shook v US, 713 F2d 662 (11th Cir 1983)* , estoppel was not extended to an estate beneficiary who merely indicated approval of an executor's handling of the estate; the executor had total control and the beneficiary none. Facts similar to *Shook* can be found in *TAM 199933001* .

(n54)Footnote 18. *Rogers v Commr, 31 BTA 994 (1935)* , *affd 107 F2d 394 (2d Cir 1939)* ; *Northport Shores, Inc v Commr, 31 BTA 1013 (1935)* , *nonacq 1935-1 CB 34* . See also *Ford v US, 276 F2d 17 (Ct Cl 1960)* .

(n55)Footnote 1. An exception is the increase in basis on account of gift tax paid. *IRC § 1015(d)*. This is deemed an adjustment to basis. *IRC § 1015(d)(4)*.

(n56)Footnote 2. *IRC § 1001(a)*.

(n57)Footnote 3. *IRC § 1016(a)(2)*.

(n58)Footnote 4. *IRC § 1016(a)(1)*; *Treas Reg § 1.1016-2(a)*.

(n59)Footnote 5. *IRC § 263*; *Reg § 1.263(a)-2(c)*; *Berger v Commr, 1954 TC Memo Lexis 287* , *affd per curiam 234 F2d 959 (2d Cir 1956)* . *Prop Treas Reg 1.263(a)-2(d)(2)*.

(n60)Footnote 1. *Reg § 1.61-6(a)*.

(n61)Footnote 2. *Id*, Examples (1) and (2).

(n62)Footnote 3. See *Fisher v US*, 82 Fed Cl 780 (2008) , which collects the cases and traces the history of this branch of the open transaction doctrine.

In *Piper v Commr*, 5 TC 1104 (1945) , acq 1946-1 CB 4 , the taxpayer acquired a package of stock and warrants in a reorganization exchange, and later sold the warrants for less than the basis of the stock given up in the exchange. Holding that the taxpayer realized no gain on the sale of the warrants, the Court said: "Where there is no market value, as is the situation with respect to the warrants, there is no practical basis upon which an allocation can be made and the taxpayer is entitled to recover his entire original basis before gain or loss will be recognized." 5 TC at 1111-1112 .

The text at § 1.03[2][a] discusses the open transaction doctrine as applied to the "amount realized" side of the gain or loss equation when property received in a sale or exchange has no readily ascertainable fair market value.

(n63)Footnote 4. See *Pierce v US*, 49 F Supp 324 (Ct Cl 1943) ; *Orvilletta v Commr*, 47 BTA 10 (1942) . The property at issue in *Pierce* and *Orvilletta* was "stapled stock"--i.e., stock in two corporations that could not be purchased separately but only as part of a unit consisting of one share in each of the corporations. Subsequent to the taxpayer's acquisition of the stapled units, the restrictions on separate sales were removed and the taxpayer sold stock in one of the corporations. Since there was no market for the shares of either corporation alone when the taxpayer acquired the multi-unit property, the courts found it "impossible to determine separate cost bases for the component parts of the inseparable units of...stock...Thus, [taxpayers] can only compute the gain or loss after the disposition of both parts of the unit..." *Orvilletta v Commr*, 47 BTA at 15 .

(n64)Footnote 1. *Treas Reg* § 1.1001-1(e); § 1.02[3][b], *supra* .

(n65)Footnote 2. See *Estate of Bullard v Commr*, 87 TC 261, 273-281 (1986) , which gives a full account of the legislative history of *IRC* § 1011(b). Cf § 1.02[6], *supra* (when part of a multi-unit property is sold, gain or loss on the sale of the portion disposed of must be calculated by allocating basis between the sold and retained portions of the property).

(n66)Footnote 3. Some of those limitations are reviewed in § 1.02[3][c], *supra* .

(n67)Footnote 4. *Treas Reg* § 1.1011-2(a)(2).

(n68)Footnote 5. *Treas Reg* § 1.1011-2(a)(2); *Hodgdon v Commr*, 98 TC 424 (1992) .

(n69)Footnote 6. *Hodgdon v Commr*, 98 TC 424, 432-434 (1992) .

(n70)Footnote 7. It is apparent that the two approaches will often arrive at the same net tax result. However, the two alternatives can also produce different tax results; for example, when A has otherwise unusable capital losses against which to offset the short-term capital gain that results from the alternative view. When a taxpayer makes a bargain sale of property to a private nonoperating foundation, unrealized long-term capital gains reduce the charitable contribution deduction on a dollar-for-dollar basis, see *IRC* § 170(e)(1)(B), so increasing the amount allowable as a charitable contribution deduction at the cost of recognizing additional capital gain under the alternative view could well be a good trade-off. See *Estate of Bullard v Commr*, 87 TC 261 (1986) (where the taxpayer successfully argued for the alternative view, resulting in an increase in capital gains resulting from the application of the allocation of basis rules in *IRC* § 1011(b) which was more advantageous in the taxpayer's circumstances than complete disallowance of a charitable contribution deduction and recognition of capital gain by reason of *IRC* § 1011(b)).

(n71)Footnote 8. *Estate of Bullard v Commr*, 87 TC 261 (1986) . A majority of the Tax Court found the original regulations "unreasonable" because, in the Court's view, they were inconsistent with *IRC* § 1011(b) and its legislative history, producing "arbitrary and capricious" results. "If, for example, the amount of the contribution (excess of fair market value over sales price) is \$1 more than the section 170(e)(1) amount [the amount of gain that would exactly offset the charitable contribution deduction if the transaction were viewed as a whole], the regulations prescribe the

proper basis and gain allocations between the contributed and sold portions of the property. If the sales price is increased by \$1, however, (in which case section 170(e)(1) as interpreted by the regulations reduces the contribution to zero), the distortion occurs in full. Certainly this is an "arbitrary and capricious" effect, and Congress could not have intended that such insignificant economic differences would result in such dramatic differences in tax liability." *Estate of Bullard v Commr*, 87 TC 261, 280-281 .

(n72)Footnote 9. *Treas Reg* § 1.1011-2(a)(1). See also *Treas Reg* § 1.170A-4(c)(2)(i).

(n73)Footnote 1. Beginning January 1, 2011, brokers previously required to report to the Internal Revenue Service the gross proceeds from sales of stock by their customers are also required to report the adjusted basis of the stock sold and whether gain or loss on the sale is long-term or short-term. See *IRC* § 6045(g); § 1.04[9], *infra* . The Energy Improvement and Extension Act of 2008, which amended *IRC* § 6045 to impose the new basis and holding period reporting requirements, also changed certain of the substantive basis rules so that brokers could more easily comply with the new reporting requirements, especially when the customer sells less than all of his holdings in a specific security. The changes to the basis rules made by the 2008 Act are discussed in this § 1.04[8], where they are sometimes referred to as the "2008 amendments."

(n74)Footnote 2. *Treas Reg* § 1.1012-1(c)(1); *Prop Treas Reg* 1.1012-1(c)(1). Although the Regulation refers to stock, it is expressly made applicable to bonds by *Treas Reg* § 1.1012-1(c)(6). It applies as well to "when issued" securities, *IT* 3858, 1947-2 CB 71, and to noncertificate shares. *Hall v Commr*, 92 TC 1027 (1989) . An attack on the validity of the Regulation was rejected in *Joseph Gann, Inc v Commr*, 701 F2d 3 (1st Cir 1983), *cert denied* 464 US 821.

(n75)Footnote 3. *Curtis v Helvering*, 101 F2d 40 (2d Cir 1939) (shares acquired by gift prior to the purchase of additional shares of the same security were the ones charged under the first-in, first-out rule). *Cf Helvering v Campbell*, 313 US 15 (1941) .

(n76)Footnote 4. *Forrester v Commr*, 32 BTA 745 (1935) .

(n77)Footnote 5. See *IRC* § 1012(c)(1) which, as amended by The Energy Improvement and Extension Act of 2008, explicitly provides that "the basis conventions prescribed by the regulations," including the first-in, first-out rule, "shall be applied on an account by account basis." See also *Bancitaly Corp v Commr*, 34 BTA 494, 507-508 (1936) . Compare *Canelo v Commr*, 41 BTA 713, 729-730 (1940) , where the taxpayer maintained a number of separate margin accounts with the same broker who combined the accounts for the purpose of applying the first-in, first-out rule because the broker had combined the accounts for the purpose of computing margin requirements, and the taxpayer "himself treated the several accounts ... as if they constituted but one single account". By frequently transferring securities and credit balances from one account to another the accounts had to be considered as one for the purpose of applying the first-in, first-out rule. *Canelo v Commr*, 41 BTA 713 (1940) .

(n78)Footnote 6. *GCM* 8426, IX-2 CB 92 (1930). See also *Millikan v Commr*, 83 F2d 213 (2d Cir 1936) . A deposit of shares in escrow under an agreement constituting an assignment of shares is a transfer of those shares for purposes of the first-in, first-out rule. *Malkan v Commr*, 54 TC 1305 (1970), *acq* 1971-1 CB 3.

(n79)Footnote 7. *Helvering v Campbell*, 313 US 15 (1941) .

(n80)Footnote 8. *Id*; *Helvering v Gambrill*, 313 US 11 (1941) .

(n81)Footnote 9. *GCM* 11743, XII-2 CB 31 (1933).

(n82)Footnote 10. *Treas Reg* § 1.1012-1(c)(1); *Prop Treas Reg* § 1.1012-1(c)(1). See also *Rev Rul* 72-415, 1972-2 CB 463 , prescribing a procedure for adequately identifying shares sold when the taxpayer holds shares acquired in more than one lot at different times or for different prices.

(n83)Footnote 11. *Treas Reg § 1.1012-1(c)(2)*. A numerical matching of shares purchased and sold is not the equivalent of actual delivery. *Beran v Commr, TC Memo 1980-119*.

(n84)Footnote 12. *Ibid.* The Supreme Court reached this result in *Davidson v Commr, 305 US 44 (1938)*. The taxpayer in that case instructed his broker to sell, and a bank holding the stock to deliver, shares which he had purchased in 1929 at an approximate cost of \$50 a share. The bank erred and delivered shares which had been acquired in earlier years for about \$4 a share. The Court, in holding that the actual fact of delivery controlled over the taxpayer's intention, denied the taxpayer's contention that an adequate identification was achieved by his instructions to the broker and bank, and that the bank's mistake should in no way change the result. In contrast, the taxpayer in *Kluger Associates, Inc v Commr, 69 TC 925 (1978), affd 617 F2d 323 (2d Cir 1980)*, was required to use the first-in, first-out method when the certificate delivered did not represent the shares identified as sold by the taxpayer.

(n85)Footnote 13. *Treas Reg § 1.1012-1(c)(3)(i)*. Similarly, adequate identification will be achieved when a taxpayer holds a single stock certificate representing stock from different lots and sells a part of the stock represented by the certificate through a broker or other agent, if the taxpayer specifies to the broker or other agent the particular stock to be sold and receives a written confirmation of such specification from the broker or other agent within a reasonable time thereafter. *Treas Reg § 1.1012-1(c)(3)(ii)*. If the taxpayer does not sell through a broker but deals directly with the purchaser, adequate identification is made if the taxpayer maintains his own written record of the particular stock he intended to sell. *Id.* Where the transfer is of a "book-entry security," i.e., certain government securities issued in the form of an entry made on the records of a Federal Reserve Bank, proper identification is made by specifying the unique lot number which the taxpayer has assigned to the lot containing the securities being transferred. *Treas Reg § 1.1012-1(c)(7)*.

(n86)Footnote 14. In *Rev Rul 67-436, 1967-2 CB 266*, the Internal Revenue Service held that an adequate identification made by the taxpayer at the time of delivery, occurring within four days of the date of sale, timely satisfied the requirement that identification of the stock sold be made at the time of sale or transfer. Treasury and the Internal Revenue Service have proposed adding a new paragraph (8) to *Treas Reg § 1.1012-1(c)* that would make explicit (consistently with *Rev Rul 67-436*, which would become obsolete) that an identification is timely if the taxpayer identifies the lot from which the shares are sold or transferred no later than the earlier of the settlement date or the time for settlement required by SEC rules. *Prop Treas Reg § 1.1012-1(c)(8)*. A standing order or instruction for the specific identification of stock would also be treated as a timely specification. In addition, *Prop Treas Reg § 1.1012-1(c)(9)* clarifies that a written confirmation of the taxpayer's instructions from a broker or other custodian can be made in electronic format. The proposed regulations, like the current regulations, do not specify a particular mode by which the taxpayer's instructions should be conveyed to the custodian; communication can be made orally, in writing, or by any other reasonable method. See Dept of the Treasury, "Basis Reporting by Securities Brokers and Basis Determination for Stock; Proposed Rules," *74 Fed Reg 67010*.

(n87)Footnote 15. *Treas Reg § 1.1012-1(c)(3)(i)*.

(n88)Footnote 16. *Rev Rul 61-97, 1961-1 CB 394*.

(n89)Footnote 17. *Helvering v Rankin, 295 US 123 (1935)*.

(n90)Footnote 18. *Treas Reg § 1.1012-1(c)(6)*.

(n91)Footnote 19. See *Treas Reg § 1.1012-1(c)(7)(iii)(a)*; *Prop Treas Reg § 1.1012-1(c)(7)(iii)(a)*.

(n92)Footnote 20. To adequately identify lots from which book-entry securities are sold, the taxpayer must assign lot numbers in numerical sequence to successive purchases of securities of the same loan title (series) and maturity date, although securities of the same loan title (series) and maturity date which are purchased at the same price on the same date may be included within the same lot. *Treas Reg § 1.1012-1(c)(7)(i)*. The unique lot number from which the securities are sold may be specified either in the taxpayer's written instructions or, in the case of a taxpayer in whose

name the book entry by the Federal Reserve Bank is made, in a list of lot numbers with respect to all book-entry securities on the books of the Federal Reserve Bank sold or transferred on that date by the taxpayer, provided such list is mailed to or received by the Federal Reserve Bank on or before its next business day. *Id.* The requirement that the taxpayer receive a written confirmation is satisfied if the taxpayer is furnished with a written advice of transaction by the Federal Reserve Bank or the person through whom the taxpayer sells or transfers the securities, which advice must specify the amount and description of the securities sold or transferred and the date of the transaction. *Treas Reg § 1.1012-1(c)(7)(ii)(a); Prop Treas Reg § 1.1012-1(c)(7)(ii).*

(n93)Footnote 21. *Treas Reg § 1.1012-1(c)(4)(i).* Proposed regulations clarify that when the trust or estate's stock is sold through a broker or other agent, the trustee, executor or administrator may adequately identify the lot from which the shares are sold by using the broker's confirmation method. *Prop Treas Reg § 1.1012-1(c)(4)(i)(c).*

(n94)Footnote 22. *Treas Reg § 1.1012(c)(4)(ii).*

(n95)Footnote 23. *Treas Reg § 1.1012(c)(4).*

(n96)Footnote 24. A "regulated investment company" is defined for this purpose as any domestic corporation (other than a personal holding company as defined in *IRC § 542*) which meets the limitations of *IRC § 851(b)* and *Treas Reg § 1.851-2*, and which is registered at all times during the taxable year under the Investment Company Act of 1940. *Treas Reg § 1.1012-1(e)(5).* Regulated investment companies are the subject of Ch 12.

(n97)Footnote 25. *Treas Reg § 1.1012-1(e)(1).*

(n98)Footnote 26. See fn 1, *supra*.

(n99)Footnote 27. See *IRC § 1012(d).*

(n100)Footnote 28. See *IRC § 1012(c)(1).*

(n101)Footnote 29. See *IRC § 1012(c)(2).*

(n102)Footnote 30. See Dept of the Treasury, "Basis Reporting by Securities Brokers and Basis Determination for Stock; Proposed Rules," 74 *Fed Reg* 67010, 67025-67029 (Dec 17, 2009) .

(n103)Footnote 31. *Treas Reg § 1.1012-1(e)(1)(i)(a).*

(n104)Footnote 32. *Treas Reg § 1.1012-1(e)(1)(i)(b).*

(n105)Footnote 33. *Treas Reg § 1.1012-1(e)(1)(ii).*

(n106)Footnote 34. *Treas Reg § 1.1012-1(e)(6).* The taxpayer's election to use average cost applies to all of the taxpayer's shares in the RIC, whether held in a single account or separate accounts. It does not, however, apply to accounts in which the taxpayer holds shares of gifted RIC stock the basis of which was greater than the stock's fair market value at the time of the gift, unless the taxpayer has filed a statement agreeing to use the lower fair market value as the gifted stock's basis in calculating average cost. See *Treas Reg § 1.1012-1(e)(1)(ii).*

(n107)Footnote 35. Stock acquired "in connection with" a DRP includes not only stock purchased with reinvested dividends but also the initial purchase of stock in the DRP, transfers of identical stock into the DRP, and additional periodic purchases of identical stock in the DRP. See *IRC § 1012(d)(4)(B); Prop Treas Reg § 1012-1(e)(6)(ii).*

(n108)Footnote 36. *IRC § 1012(d)(4)(A).* The proposed regulations define "identical stock" as stock having the same Committee on Uniform Security Identification Procedures ("CUSIP") number. *Prop Treas Reg § 1.1012-1(e)(4).* Dividends declared before or pending a merger, consolidation, spinoff or similar corporate action and subsequently paid

and reinvested in shares of stock in the successor entity or entities are considered reinvested in identical stock even though the CUSIP number of the successor entity's stock may be different. *Prop Treas Reg § 1.1012-1(e)(6)(iii)*. On the other hand, shares of corporate stock in a dividend reinvestment plan are not "identical" to shares of stock in the same corporation that are not in a dividend reinvestment plan, even though both have the same CUSIP number. *Prop Treas Reg § 1.1012-1(e)(4)*.

(n109)Footnote 37. *Prop Treas Reg § 1.1012-1(e)(6)(i)*.

(n110)Footnote 38. *Prop Treas Reg § 1.1012-1(e)(6)(i)*.

(n111)Footnote 39. Thus, to be eligible to use the average cost method, shares of stock acquired in connection with a DRP, like RIC stock, must be left in an account with a custodian or agent, *Prop Treas Reg § 1.1012-1(e)(1)(i)*, the account must contain identical stock acquired at different prices or bases, *Prop Treas Reg § 1.1012-1(e)(1)(ii)*, the account may not include gifted stock the basis of which in the hands of the donor is higher than its fair market value at the time of the gift unless the taxpayer files a statement agreeing to use the lower fair market value as the gifted stock's basis, *Prop Treas Reg § 1.1012-1(e)(8)*; and the taxpayer must make an election to apply the average cost method in the manner specified in the proposed regulations. See *Prop Treas Reg § 1.1012-1(e)(9)*. If the taxpayer withdraws from a DRP, or the plan administrator terminates the plan, the basis of each share of stock received by the taxpayer from the DRP will be the same as the average cost basis of such stock immediately before the withdrawal or termination, but the distributed stock is no longer considered acquired in connection with a dividend reinvestment plan and the taxpayer may not continue to use the average cost method with respect to such stock. *Prop Treas Reg §§ 1.1012-1(e)(6)(iv)* and *1.1012-1(e)(7)(v)*.

(n112)Footnote 40. Under *IRC § 6045(g)(3)*, a "covered security" is defined as any "specified security" acquired on or after the "applicable date" if the security was (1) acquired through a transaction in the account in which such security is held or (2) was a covered security in another account and was transferred into the account in which it is presently held with a statement providing details regarding the customer's basis and holding period in the security. A "specified security" means, among other things, any share of stock in a corporation, *IRC § 6045(g)(3)(B)(i)*, including a share of stock in a RIC or stock acquired in connection with a DRP. Although the "applicable date" for most corporate stock is January 1, 2011, in the case of any stock "for which an average basis is permissible" (namely, RIC and DRP stock), the applicable date is deferred to January 1, 2012. *IRC § 6045(g)(3)(C)(ii)*. The proposed regulations merely restate the statutory definition of a "covered security," see *Prop Treas Reg 1.6045-1(a)(15)*, but in addition define a "noncovered security" as a security that is not a "covered security." *Prop Treas Reg 1.6045-1(a)(16)*. RIC or DRP stock, although acquired by the taxpayer in an account on or after January 1, 2012, could nevertheless be a noncovered security under certain circumstances; namely, if the stock was transferred from another account in which the stock was a "noncovered security," or the stock was transferred from another account unaccompanied by a statement, ordinarily required by *IRC § 6045A*, containing the adjusted basis and holding period of the stock. See *Prop Treas Reg § 1.6045-1(a)(15)(iv)* and *Treas Reg § 1.1012-1(e)(10)(iv)*, Example 5.

(n113)Footnote 41. *Prop Treas Reg § 1.1012-1(e)(9)(i)*. For RIC or DRP shares that are covered securities, this replaces the previous procedure under which an election to use average cost is made by filing a statement with the taxpayer's return for the year in which the election first applies. However, the proposed regulations continue to require that the election to use the average cost method be made with the taxpayer's income tax return if the RIC or DRP stock to which the election relates is a noncovered security. *Prop Treas Reg § 1.1012-1(e)(9)(ii)*.

(n114)Footnote 42. *Prop Treas Reg § 1.1012-1(e)(9)(i)*.

(n115)Footnote 43. *Prop Treas Reg § 1.1012-1(e)(9)(i)*. If, for example, a taxpayer holds shares of two different RICs in the same account, the broker may be notified to use average cost to determine basis in the shares of one of the RICs and a different method of determining the basis of shares in the other RIC. *Prop Treas Reg § 1.1012-1(e)(10)(iv)*, Example 2.

(n116)Footnote 44. A taxpayer may use the average cost method for RIC or DRP stock in one account and a different basis determination method for identical stock in a different account, even if both accounts are held with the same broker. *Prop Treas Reg § 1.1012-1(e)(10)(i)*; *Prop Treas Reg § 1.1012-1(e)(10)(iv)*, Example 1. This contrasts with the current rule that an election to use average cost for RIC or DRP stock in one account applies as well to all other accounts in which identical stock is held, a rule the proposed regulations would continue to apply, however, to RIC or DRP shares sold or otherwise disposed of before January 1, 2012. *Prop Treas Reg § 1.1012-1(e)(10)(ii)*.

(n117)Footnote 45. See *Prop Treas Reg § 1.1012-1(e)(2)(ii)*. If the taxpayer does not validly elect a method for determining the basis of RIC or DRP stock held in a brokerage or other custodial account before selling such stock from the account, basis will be determined using the broker's default method. *Prop Treas Reg § 1.1012-1(e)(2)(i)*. Accordingly, if in the above example Broker B uses first-in, first-out as its default method, and does not receive notification to use average cost or another method for determining the basis of the transferred RIC or DRP shares, the basis of those shares will be determined under Broker B's first-in, first-out default method and not under the average cost method that the taxpayer elected when the shares were held by Broker A. Note that while, in the absence of taxpayer instructions to the contrary, brokers must use the first-in, first-out method as their default method for purposes of determining the basis of most customer securities, in the case of stock for which the average cost method of determining basis is permissible (viz, RIC or DRP stock), brokers may choose any permissible method as the default method, including average cost. See *IRC § 6045(g)(2)(B)(i)(I)* and *(II)*; *Prop Treas Reg § 1.1012-1(c)(1)*.

(n118)Footnote 46. Suppose, for example, that on March 1, 2014, a taxpayer transfers inherited stock in a RIC to a brokerage account in which the taxpayer also holds shares in the same RIC that were purchased in the account on or after January 1, 2012. Since inherited stock is not "acquired through a transaction in the account in which such security is held," *IRC § 6045(g)(3)(A)(i)*, the inherited RIC shares are noncovered securities that are deemed held in a separate account from the purchased RIC shares which are covered securities. See *Prop Treas Reg § 1.1012-1(e)(10)(iv)*, Example 5.

(n119)Footnote 47. Recall that the procedure for electing the average cost method is different depending on whether the RIC or DRP shares are noncovered securities (election made with tax return) or covered securities (election made by notifying broker). See *Prop Treas Reg §§ 1.1012-1(e)(9)(i)* and *(ii)*; n 43, *supra*.

(n120)Footnote 48. See *Prop Treas Reg § 1.1012-1(e)(10)(iv)*, Example 4.

(n121)Footnote 49. *IRC § 1012(c)(2)(B)*; *Prop Treas Reg § 1.1012-1(e)(11)*. The single account election may be made at any time. *Prop Treas Reg § 1.1012-1(e)(11)(iv)*. Once made, the single account election applies to all identical stock the taxpayer later acquires in the same account that is a covered security. *Prop Treas Reg § 1.1012-1(e)(11)(iii)*. However, if identical stock that is a noncovered security (for example, inherited stock) is subsequently transferred into the account, it will be treated as held in a separate account unless the RIC, DRP or broker makes another single account election to treat such stock as a covered security. See *Prop Treas Reg §§ 1.1012-1(e)(11)(iii)* and *1.1012-1(e)(11)(vi)*, Example 4.

(n122)Footnote 50. *Prop Treas Reg § 1.1012-1(e)(11)(i)*. The taxpayer must be notified by the RIC, DRP or broker making the single account election that the election has been made and that, as a consequence, all identical RIC or DRP stock in the account will be treated as covered securities regardless of when acquired. *Prop Treas Reg § 1.1012-1(e)(11)(v)*. The taxpayer has the right to receive a copy of the books and records maintained by the RIC, DRP or broker which reflect that a single account election has been made with respect to his account. *Prop Treas Reg § 1.1012-1(e)(11)(iv)*.

(n123)Footnote 51. *Prop Treas Reg § 1.1012-1(e)(11)(iv)*. The books and records must reflect the date of the election; the taxpayer's name, account number, and taxpayer identification number, the stock subject to the election, and the taxpayer's basis in the stock.

(n124)Footnote 52. *Prop Treas Reg §§ 1.1012-1(e)(11)(ii) and (iv).*

(n125)Footnote 53. *Prop Treas Reg §§ 1.1012-1(e)(11)(i) and (ii).* Stock for which accurate basis information is unavailable may not be included in the single account election and must be treated as held in a separate account. *Prop Treas Reg § 1.1012-1(e)(11)(ii).*

(n126)Footnote 54. *Prop Treas Reg § 1.1012-1(e)(9)(iii).*

(n127)Footnote 55. *Prop Treas Reg § 1.1012-1(e)(9)(iv).*

(n128)Footnote 56. *Treas Reg § 1.1012-1(e)(3)(i).*

(n129)Footnote 57. *Treas Reg § 1.1012-1(e)(3)(ii).*

(n130)Footnote 58. *Treas Reg § 1.1012-1(e)(4)(i).*

(n131)Footnote 59. *Treas Reg § 1.1012-1(e)(2).*

(n132)Footnote 60. The Explanation given in the preface to the proposed regulations states that elimination of the double category method resulted from public comments that the method was "not widely used" and could create "problems ... when shares are transferred between accounts that use different methods." See Dept of the Treasury, "Basis Reporting by Securities Brokers and Basis Determination for Stock; Proposed Rules," *supra*, 74 *Fed Reg* at 67016.

(n133)Footnote 61. *Prop Treas Reg § 1.1012-1(e)(7)(iii).*

(n134)Footnote 62. See *Prop Treas Reg § 1.1012-1(e)(10)(i)*. However, the taxpayer must apply *IRC § 1091* and the associated regulations (dealing with wash sales of substantially identical securities (see § 2.07[3] *infra*)) in computing average basis regardless of whether the stock or other security disposed of and the stock acquired are in the same account or in different accounts. By contrast, in applying the basis reporting rules imposed on brokers by the 2008 amendments to *IRC § 6045(g)*, the wash sale provisions need not be taken into account by the broker unless the transactions occur in the same account with respect to identical securities. *IRC § 6045(g)(2)(B)(ii).*

(n135)Footnote 63. *Treas Reg § 1.1012-1(e)(4)(ii).*

(n136)Footnote 64. *Prop Treas Reg § 1.1012-1(e)(7)(ii).*

(n137)Footnote 65. *Id.*

(n138)Footnote 66. *Prop Treas Reg § 1.1012-1(e)(10)(ii).*

(n139)Footnote 67. *Prop Treas Reg § 1.1012-1(e)(4).*

(n140)Footnote 68. *Prop Treas Reg § 1.1012-1(e)(7)(vi)*, Example 1.

(n141)Footnote 69. *Prop Treas Reg § 1.1012-1(e)(10)(iii).*

(n142)Footnote 70. *IRC § 1012(c)(2)(A).*

(n143)Footnote 71. See § 1.04[7][b][i], *supra*.

(n144)Footnote 72. *Prop Treas Reg § 1.1012-1(e)(11)(i).*

(n145)Footnote 73. *Prop Treas Reg § 1.1012-1(e)(7)(ii).*

(n146)Footnote 74. See *Prop Treas Reg* §§ 1.1012-1(e)(9)(iii) and *Prop Treas Reg* § 1.1012-1(e)(9)(v), Example.

(n147)Footnote 75. See *Prop Treas Reg* § 1.1012-1(e)(9)(i)(average basis election may be made "at any time," effective for sales occurring after notification of the broker or other agent); Dept of the Treasury, "Basis Reporting by Securities Brokers and Basis Determination for Stock; Proposed Rules," *supra*, 74 *Fed Reg* at 67017 ("The proposed regulations do not limit the number of times or frequency a taxpayer may change basis determination methods.")

(n148)Footnote 76. *Prop Treas Reg* § 1.1012-1(e)(7)(v).

(n149)Footnote 77. See *Prop Treas Reg* § 1.1012-1(e)(7)(vi), Example 3.

(n150)Footnote 1. Sales executed on behalf of certain customers, notably corporations and tax-exempt organizations, are exempt from the information reporting requirements. *Treas Reg* § 1.6045-1(c)(3).

(n151)Footnote 2. *IRC* § 6045(b). The customer statement may be a copy of the Form 1099-B prepared by the broker for the Internal Revenue Service. *Treas Reg* § 1.6045-1(k).

(n152)Footnote 3. Div B of Pub L No 110-343, 122 *Stat* 3765 (2008). Div B of Pub L No 110-343, 122 *Stat* 3765 (2008). Div B of Pub L No 110-343, 122 *Stat* 3765 (2008).

(n153)Footnote 4. See *IRC* § 6045(g). The Treasury Department and Internal Revenue Service have published proposed regulations that interpret the new statutory provisions. See Dept of the Treasury, "Basis Reporting by Securities Brokers and Basis Determination for Stock; Proposed Rules," 74 *Fed Reg* 67010 *et seq* (Dec 17, 2009).

(n154)Footnote 5. *IRC* § 6045(g)(3)(C)(i).

(n155)Footnote 6. *IRC* § 6045(g)(3)(C)(i) and (ii). These two exceptions are specially treated because, unlike other corporate stock, their adjusted basis may be determined under the average cost method described in § 1.04[7][c], *supra*.

(n156)Footnote 7. *IRC* §§ 6045(g)(3)(C)(iii). Certain transactions involving options for which information reporting has not previously been required will become subject to reporting requirements and be regarded as "covered securities" with respect to transactions entered into on or after January 1, 2013. See *IRC* § 6045(h).

(n157)Footnote 8. *Prop Treas Reg* § 1.6045-1(d)(6). Alternatively, a broker may, but is not required to, take commissions into account in determining gross proceeds, provided the treatment chosen is consistent with the manner in which the broker keeps its books. *Treas Reg* § 1.6045-1(d)(5); *Prop Treas Reg* § 1.6045-1(d)(5); *Prop Treas Reg* § 1.6045-1(d)(6)(i) and (ii).

(n158)Footnote 9. *Prop Treas Reg* § 1.6045-1(d)(6)(v).

(n159)Footnote 10. *Prop Treas Reg* § 1.6045-1(d)(6)(i). Issuers are required by *IRC* § 6045B to file an "issuer return" with the Internal Revenue Service in the event they take an organizational action that affects the basis of their securities, including information as to the quantitative effect of the action on basis expressed either as an adjustment per share or as a percentage of old basis. *Prop Treas Reg* § 1.6045B-1(a)(1) The issuer must also provide "issuer statements" with the same information to each holder of record of the affected security (or the holder's nominee, if any). *Prop Treas Reg* § 1.6045B-1(b)(1). The return is required within 45 days of the date of the organizational action (or, if earlier, January 15 of the year following the year in which the action is taken) and statements must be furnished to holders or their nominees by January 15 of the year following the year of the organizational action. *Prop Treas Reg* §§ 1.6045B-1(a)(2) and 1.6045B-1(b)(2). Alternatively, an issuer may satisfy both the issuer return and issuer statement requirements by posting the required information by the due date of the issuer return in an area of its primary public Web site dedicated to this purpose and keeping the information accessible to the public. *Prop Treas Reg* §§

1.6045B-1(a)(3) and 1.6045B-1(b)(4).

(n160)Footnote 11. *Prop Treas Reg § 1.6045-1(d)(6)(i)*. Thus, the proposed regulations provide that a broker need not apply the wash sale rules under *IRC § 1091* in determining the adjusted basis of the securities sold unless all of the transactions triggering the application of the wash sale rules occur in the same account, and the identical security is traded in all such transactions. (see *Prop Treas Reg § 1.6045-1(d)(6)(iii)*, discussed in the Examples below).

(n161)Footnote 12. The proposed regulations not only permit a broker voluntarily to take into account outside information from the customer or third parties in calculating adjusted basis, they protect the broker from penalties in the event such information proves to be incorrect so long as the broker neither knows nor has reason to know that the information is incorrect. *Prop Treas Reg § 1.6045(d)(2)(iv)(B)*. The proposed regulations also make clear that when a customer maintains two or more accounts with the same broker, the broker is only required to take into account information derived from the account in which the sale transaction takes place, although in accordance with the rule stated above outside information from the customer's other accounts may be taken into account at the broker's option. *Prop Treas Reg § 1.6045(d)(2)(iv)(B)*.

(n162)Footnote 13. See *IRC § 6045(g)(2)(B)(ii)* (for purposes of information reporting, broker should determine adjusted basis of securities sold without regard to section 1091 unless the transactions "occur in the same account with respect to identical securities"). Requiring that the securities be "identical" is more restrictive than the terms of *IRC § 1091* itself, which only requires that the securities be "substantially identical." See *IRC § 1091(a)*. See also *Prop Treas Reg § 1.6045-1(d)(7)(ii)*.

(n163)Footnote 14. Given that the adjusted basis and holding period reported by brokers on Form 1099-B may not reflect transactions, elections or events that affect basis but occur outside the account in which the customer's securities are sold, it is clear that their customers cannot rely exclusively on those statements in reporting gain or loss from the sale of securities on their own tax returns. The preface to the proposed regulations warns that "The instructions to the tax return will inform taxpayers of their duty to verify the information reported by brokers and to adjust the reported information when necessary to reflect the taxpayer's current information." Dept of the Treasury, "Basis Reporting by Securities Brokers and Basis Determination for Stock; Proposed Rules," 74 *Fed Reg* 67010, 67014 (Dec 17, 2009) .

(n164)Footnote 15. See *Prop Treas Reg § 1.6045-1(d)(6)(iii)*; *Prop Treas Reg § 1.6045(d)(2)(iv)(B)*. G must also report the \$100 loss disallowed on the March 1 transaction in its Form 1099-B for the July 1, 2011 sale.

(n165)Footnote 16. *Prop Treas Reg § 1.6045-1(d)(6)(iii)*; *Prop Treas Reg § 1.6045-1(d)(6)(vi)*, Example 4.

(n166)Footnote 17. *Prop Treas Reg § 1.6045-1(d)(6)(iii)*. As in Example 2, G would be required to show both the recalculated basis of the repurchased C Company stock and the loss disallowed by *IRC § 1091* on the March 1 sale of the original C Company stock on the Form 1099-B filed with respect to the July 1 sale.

(n167)Footnote 18. *Prop Treas Reg § 1.6045-1(d)(6)(iii)*; *Prop Treas Reg § 1.6045-1(d)(6)(vi)*, Example 3.

(n168)Footnote 19. "Noncovered securities" are defined in the proposed regulations as securities that are not "covered securities." *Prop Treas Reg § 1.6045-1(a)(16)*.

(n169)Footnote 20. *Treas Reg § 1.6045-1(d)(3)* lists several categories of "exempt recipients," including corporations, tax-exempt organizations and individual retirement plans, the sales transactions of which need not be reported by brokers under *IRC § 6045*.

(n170)Footnote 21. *Prop Treas Reg § 1.6045-1(d)(2)(iii)*.

(n171)Footnote 22. *Id.* See also *Prop Treas Reg § 1.6045-1(d)(2)(vi)*, Example 1.

(n172)Footnote 23. See *IRC* §§ 6721 and 6722, and in particular *IRC* § 6722(b)(2).

(n173)Footnote 24. *Prop Treas Reg* § 1.6045-1(d)(2)(iii).

(n174)Footnote 25. The obligation to supply a transfer statement is imposed by a new provision, *IRC* § 6045A, which leaves to the Treasury and Internal Revenue Service the task of filling in the necessary details, such as defining the persons (in addition to brokers) who are subject to the obligation to provide transfer statements and prescribing the contents of such statements. See *Prop Treas Reg* § 1.6045A-1. The proposed regulations designate brokers, professional custodians and issuers of securities, and their agents, as "applicable persons" subject to an obligation to provide transfer statements in connection with transfers of covered securities on behalf of others, but specifically exclude from that category the beneficial owner of the transferred securities, any governmental unit with respect to escheated securities, and any person that acts solely as a clearing organization with respect to the transfer. *Prop Treas Reg* § 1.6045A-1(a)(3). The proposed regulations also clarify that the 15 day period allowed to "applicable persons" in which to provide the required transfer statement begins after the date of settlement for the transfer. *Prop Treas Reg* § 1.6045A-1(a)(5). Finally, while the transfer statement must generally be in writing, the transferor and the receiving broker are allowed to agree upon a different format or method of conveying the required information (*e.g.*, electronic data transfer) prior to the transfer of the securities. *Prop Treas Reg* § 1.6045A-1(a)(2). If the transfer occurs between accounts at the same entity or affiliated entities, a transfer statement is deemed to have been furnished and received when the necessary information is incorporated into the records for the recipient account. *Prop Treas Reg* § 1.6045A-1(a)(2).

(n175)Footnote 26. *Prop Treas Reg* § 1.6045A-1(b)(1)(vii). The transferor may take information from issuer statements into account in calculating basis if it chooses to do so, but the transfer statement must then include the identifying number of the last issuer statement taken into account to indicate that the organizational action identified and all relevant prior organizational actions reported by the issuer are reflected on the transfer statement; in addition, the transfer statement must also describe any other organizational actions reflected on the transfer statement that were not derived from an issuer statement. *Id.*

(n176)Footnote 27. If the transferor acquired the securities on behalf of a customer that was an exempt recipient at the time of the acquisition but subsequently lost its exempt recipient status, the transferor may treat such securities as noncovered securities as long as the transferor indicates that they are noncovered securities on the transfer statement. *Prop Treas Reg* § 1.6045A-1(b)(2).

(n177)Footnote 28. *Prop Treas Reg* § 1.6045A-1(b)(1). Whether covered or noncovered securities are transferred, a transfer statement must include: the date the statement is furnished; the name, address and telephone number of the person furnishing the statement; the name, address and telephone number of the broker receiving custody of the securities; the name, address, telephone number, taxpayer identification number and account number of the beneficial owner(s) of the security before and (if different) after the transfer; the quantity of shares or units transferred, the Committee on Uniform Security Identification Procedures (CUSIP) number (or other security identifier number), the security symbol (if applicable), the lot numbers (if applicable), and the classification (such as stock or debt) of the securities transferred; the date the transfer was initiated, and the settlement date of the transfer. Moreover, as is the case with brokers that file information returns with respect to sales of noncovered securities, a transferor having knowledge of the adjusted basis or holding period of transferred noncovered securities may voluntarily include such information in its transfer statement and receive comparable protection from penalties for incorrect information so as long as the transfer statement indicates that the transferred securities are noncovered securities. Compare *Prop Treas Reg* § 1.6045A-1(b)(2) and *Prop Treas Reg* § 1.6045-1(d)(2)(iii).

(n178)Footnote 29. *Prop Treas Reg* § 1.6045-1(d)(2)(v). Similarly, a broker must file a corrected Form 1099-B if it does not receive a complete issuer statement under *IRC* § 6045B until after it has filed Form 1099-B with respect to a sale of covered securities. The corrected return must be filed within 30 days after the complete issuer statement is received by the broker. *Prop Treas Reg* § 1.6045-1(d)(2)(v).

(n179)Footnote 30. *Prop Treas Reg § 1.6045A-1(b)(3)(i)*. Note that this provision does not apply to securities transferred from a decedent or decedent's estate to a customer account in satisfaction of a cash legacy. *Prop Treas Reg § 1.6045A-1(b)(3)(iii)*. The proposed regulations treat this as a standard non-sale transfer, though for income tax purposes the estate may be taxable on any appreciation in the value of the securities between the date of death and date of distribution of the securities. See *Treas Reg § 1.661(a)-2(f)*; § 1.02[1], n. 12, *supra*.

(n180)Footnote 31. *Prop Treas Reg § 1.6045A-1(b)(3)(ii)*.

(n181)Footnote 32. *Prop Treas Reg § 1.6045A-1(b)(3)(ii)*.

(n182)Footnote 33. *Prop Treas Reg § 1.6045A-1(b)(4)(i)*. The transferred securities need not be identified as a gift if the transfer is between persons for whom gift-related basis adjustments are inapplicable or to a transfer between accounts that share at least one common owner. *Prop Treas Reg § 1.6045A-1(b)(4)(i)*.

(n183)Footnote 34. *Prop Treas Reg § 1.6045A-1(b)(4)(ii)*.

(n184)Footnote 35. See Chapter 10 for a description of a short sale of securities and the substantive tax treatment of such sales.

(n185)Footnote 36. *IRC § 6045(g)(5)*; *Prop Treas Reg § 1.6045-1(c)(2)(xi)*. The return is to be made without regard to the constructive sale rule in *IRC § 1259* (see § 10.02[2], *infra*) and, if the short sale remains open, without regard to *IRC § 1233(h)* (short sale of property that becomes substantially worthless). *Prop Treas Reg § 1.6045-1(c)(2)(xi)*.

(n186)Footnote 37. See *Prop Treas Reg §§ 1.6045-1(c)(2)(xi)(A)* and *(B)*. As noted above, corporate stock will generally be a "covered security" if purchased on or after January 1, 2011. See text at n 5, *supra*.

(n187)Footnote 38. See Rev Rul 2004-15, 2004-1 CB 515 ; § 10.02[1], n 5, *infra*.

(n188)Footnote 39. *Prop Treas Reg § 1.6045-1(c)(2)(xi)(C)*.

(n189)Footnote 40. When filing the information return, the second broker is entitled to rely on the information contained in the original broker's statement, including the date and proceeds from the short sale, unless such information is known to be incorrect. *Prop Treas Reg § 1.6045-1(c)(2)(xi)(C)*.

(n190)Footnote 41. See *Prop Treas Reg § 1.6045-1(c)(4)*, Example 11.



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Taxation of Securities Transactions

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CHAPTER 1 Gains and Losses From the Disposition of Property

1-1 Taxation of Securities Transactions § 1.05

§ 1.05 The Elements of Gain or Loss--Recognition

After computing the gain or loss realized, the final step requires a determination of the portion of the gain or loss which must be recognized. *IRC Section 1001(c)* calls for recognition of the entire amount of gain or loss realized unless nonrecognition is specifically mandated by the Code.ⁿ¹

An interesting question is whether *IRC Section 1033*, permitting elective nonrecognition of gain from involuntary conversions of property, can apply to forced sales of stock. The authorities are in agreement that it cannot.ⁿ²

Recognition of gain automatically requires its inclusion in gross income, since, in the first instance, all realized gains are includable under *IRC Section 61(a)*. While recognition of loss is necessary before a loss deduction can be claimed under *IRC Section 165*, the mere fact that a loss is recognized under *IRC Section 1001(c)* does not itself insure deductibility. Thus, unless a loss deduction is initially permitted by *IRC Section 165*, the question of loss recognition is unimportant.

[1] The Loss Deduction.

The Code provides that "there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise."ⁿ¹ The broad allowance provision is limited, in the case of individuals, to three situations:

- (1) losses incurred in a trade or business,ⁿ²
- (2) losses incurred in a transaction entered into for profit,ⁿ³ and
- (3) certain casualty losses.ⁿ⁴

It is well settled that mere investment in stocks or other securities, no matter how extensive, does not constitute the conduct of a trade or business.ⁿ⁵ However, as a general rule, the purchase of securities is a transaction entered into for profit,ⁿ⁶ and it matters not whether the profit sought is income in the form of interest or dividends, or gain to be realized on a resale of the property. Normally, then, a loss realized on an actual investment in securities will qualify for deduction under *IRC Section 165(c)(2)*,ⁿ⁷ subject possibly to the limitations imposed on the deduction of capital

losses.ⁿ⁸ Technical compliance with the requirements of the Internal Revenue Code will not ensure deductibility of a loss, however, if the transaction giving rise to the loss does not have economic substance.ⁿ⁹

In *New Phoenix Sunrise Corp and Subs v Commr*,ⁿ¹⁰ the Tax Court invoked the economic substance doctrine to disregard a series of transactions culminating in the taxpayer claiming a \$10 million capital loss on the sale of publicly traded stock that had been purchased a few days before for approximately \$150,000. Following a tax strategy known as "BLISS," (Basis Leveraged Investment Swap Spread), the taxpayer had purchased offsetting long and short foreign currency option contracts, contributed the contracts to a newly formed partnership, claimed a \$10 million basis in the partnership by taking into account the amount paid for the long option without deducting the contingent liability assumed by the partnership on the short contract, had the partnership acquire publicly traded stock worth a fraction of his outside basis (\$150,000) and then distribute the stock to him in liquidation, and immediately sold the stock at approximately the same price the partnership had paid for it, claiming a substantial "loss" equal to the difference between his \$10 million inflated basis in the partnership and the sales price (\$150,000) of the stock.ⁿ¹¹ The Tax Court's conclusion that the transactions giving rise to the \$10 million loss had been a sham without economic substance rested primarily on the following factors:

(1) The taxpayer did not suffer an economic loss equal to the claimed tax loss of \$10 million. Its net investment in foreign currency option contracts it later contributed to a newly formed partnership totaled only \$131,500, the difference between premiums paid and premiums received on the long and short arms of the swap. Although the partnership paid about \$150,000 for the publicly traded stock it later distributed to the taxpayer, almost the entire amount was recovered when taxpayer immediately sold the stock. Thus, "the [\$10 million] loss claimed as a result of the stepped-up basis in the ... [stock] was purely fictional."

(2) The taxpayer had no realistic possibility of earning a profit on the foreign currency swap. The bank theoretically responsible for making a payment to the taxpayer on the long arm of the swap in the event the foreign currency's "spot rate" on the date designated in the contract was within a specified range, called a "sweet spot," was also the calculation agent that determined what the spot rate would be. The spot rate is actually a range of market rates made up of various prices at which market makers offer to buy or sell the currency, and on any given day would typically be significantly wider than the extremely narrow "sweet spot," defined in the taxpayer's contract. Therefore, the bank could (and, assuming it acted rationally, would) legally avoid the taxpayer's sweet spot simply by designating as the spot rate for the designated day a legitimate market rate outside the sweet spot's narrow range.ⁿ¹²

(3) The use of a partnership in the transactions served no business purpose but rather highlighted the transaction's sole purpose of tax avoidance. The partnership was used only for tax reasons; to give the taxpayer a step-up in basis for stock distributed from the partnership by exploiting the "loophole" the designers of taxpayer's strategy thought had been created by *Helmer v Commr*.ⁿ¹³ "Absent the benefit of the claimed tax loss, there was nothing but a cash flow that was negative for all relevant periods--the 'hallmark[] of an economic sham ... ' "ⁿ¹⁴

Since the Tax Court ruled that the transactions in *New Phoenix* should be disregarded because they lacked economic substance, it followed that fees paid by the taxpayer to the promoter of the tax shelter were likewise not deductible.ⁿ¹⁵ Moreover, the legal opinion letter received by the taxpayer affirming the validity of the transactions for tax purposes did not in this instance protect the taxpayer from valuation misstatement and negligence penaltiesⁿ¹⁶ because the lawyer issuing the opinion was not acting as an independent professional advisor but as a self-interested promoter of the tax shelter.ⁿ¹⁷ In addition, the Internal Revenue Service had put all taxpayers on notice well before the taxpayer entered into the transactions at issue that it considered the rationale of tax shelters such as the one entered into by the taxpayer to be erroneous and intended to challenge them.ⁿ¹⁸

[a] Tax Treatment of Losses Incurred in a Fraudulent Investment Scheme.

Rev Rul 2009-9,ⁿ¹⁹ provides an extensive analysis of the tax consequences of losses suffered by investors in financial swindles such as Ponzi schemes.ⁿ²⁰ The ruling considered a taxpayer, an individual, who opened an investment account with B, a swindler who held himself out to the public as an investment advisor and securities broker. The taxpayer contributed \$100x to the account in Year 1 and gave B a power of attorney enabling B to purchase and sell securities on the taxpayer's behalf. Over the next 8 years, B periodically issued account statements to the taxpayer reporting purchases and sales of securities purportedly made in the taxpayer's investment account, as well as purported income from interest, dividends and capital gains of \$10x per year in Years 2 through 7. The taxpayer reported the income on his tax returns, made an additional cash contribution of \$20x in Year 3, and received a distribution from B of \$30x in Year 7. The taxpayer learned in Year 8 that B's purported investment advisory and brokerage activity was in fact a fraudulent arrangement and that B had only a small fraction of the funds reported on the account statements issued to the taxpayer and other investors. B had been operating a classic "Ponzi" scheme by taking money from investors and converting most of it to his own use, maintaining the credibility of the scheme by occasionally making payments of purported income or principal to investors who requested them using funds provided by other investors to do so.

The Service ruled that the taxpayer could deduct as a theft loss, in the year the theft was discovered, not only the money the taxpayer gave B to invest (\$100x plus \$20x) but the fictitious income the taxpayer reported in Years 2-7 (a total of \$60x), reduced by the funds returned to the taxpayer (\$30x) and by any claim for reimbursement for which the taxpayer had a reasonable prospect of recovery. The loss is deductible as an ordinary rather than a capital loss, and since it was incurred in connection with a transaction entered into for profit, the deduction is not subject to the limitations ordinarily imposed on personal casualty losses, on miscellaneous itemized deductions, and on total itemized deductions. Moreover, if the deduction for the theft loss in the year of discovery exceeds the taxpayer's net income (before the deduction), the theft loss creates a net operating loss that may be carried back to as many as 5 preceding taxable years.

Each of these points bears further elaboration.

(1) Theft loss. A "theft" for tax purposes is not limited to robberies and burglaries; "the word 'theft' is not ... a technical word of art with a narrowly defined meaning but is, on the contrary, a word of general and broad connotation, intended to cover and covering any criminal appropriation of another's property to the use of the taker, particularly including theft by swindling, false pretenses, and any other form of guile ... [W]hether a loss from theft occurs ... depends upon the law of the jurisdiction where it was sustained ..."ⁿ²¹ The Service's conclusion that the loss sustained by the taxpayer in *Rev Rul 2009-9* was a "theft loss," based on the unstated but undoubtedly justified assumption that B's activities constituted criminal appropriations of taxpayer's funds under the laws of the jurisdiction in which they occurred, came well within existing law as expressed in *Bromberg* and similar cases and rulings.ⁿ²²

The term "theft" is not infinitely elastic, however, and not every securities law violation will be encompassed by it. In *Bellis v Commr*,ⁿ²³ an investor claimed a theft loss on the worthlessness of stock he had acquired from a seller who had not obtained a permit to sell the securities as required by state law. The seller was strictly liable for criminal sanctions as well as civil liability for failing to obtain the required permit. The Tax Court held that violation of the law did not make taxpayer's loss a "theft" loss for tax purposes since the offense did not require that the wrongdoer have a specific intent to fraudulently acquire the taxpayer's money or property, nor could the Tax Court find that any such intent was actually present in the case before it. Similarly, when a taxpayer purchased securities on the open market in reliance upon fraudulent statements made by directors and officers of the corporation that issued the securities, a subsequent loss of value or worthlessness of the securities was not a "theft loss" under state law (nor, therefore, for federal income tax purposes) because the perpetrators of the fraud neither intended to nor had actually taken any cash or other property from the taxpayer.ⁿ²⁴

Further, the courts have not been sympathetic with "theft loss" claims made by taxpayers who invested money in tax shelters and were disappointed when the IRS and the courts held that the expected tax benefits were illusory.ⁿ²⁵ Even in tax shelter cases, however, a taxpayer may be allowed a theft loss deduction if the promoter misrepresented the facts regarding the tax shelter and in reliance on those misrepresentations the taxpayer made an investment she would not otherwise have made.

"In allowing a deduction for 'theft' losses Congress did not distinguish between losses sustained by the naive or greedy from those suffered by others. Indeed gullibility or cupidity of the victim is often the crucial factor that enables the swindler to succeed in his fraud The point is that [the investors] bargained for a transaction in which there would be real purchases of bonds or notes, so that they would be entitled to argue for their claimed tax benefit on the basis of a record involving real bonds or notes. Thus, instead of getting what they now refer to as a "quality facade," they obtained from [the promoter] what they quite properly characterize as a thoroughly useless "fake, counterfeit facade." And they paid their money for this "fake, counterfeit facade" only because they were taken in by [the promoter's] false representations. We hold that they were the victims of a swindle, and are entitled, as the statute is now written, to a deduction in respect of the moneys that they paid out in reliance upon [the promoter's] false representations."ⁿ²⁶

(2) Fictitious Income. In contrast to the well established basis for the Service's ruling that loss of money in a Ponzi scheme is a theft loss, the Service's conclusion that the fictitious income the taxpayer had reported in prior years was part of the loss was unprecedented and indeed the Service cited no authority for it. Normally, the remedy for having mistakenly reported income, even when the mistake was caused by the fraudulent activity of another, is to file an amended return or claim for refund recalculating the tax due for the year(s) without the amount that was erroneously included in income.ⁿ²⁷

However, because of the length of time the Ponzi scheme continued, the taxpayer in *Rev Rul 2009-9* found that some of the years in which fictitious income had been reported were closed by the statute of limitations by the time the scheme was discovered. The Service rejected the taxpayer's arguments that those years should be effectively re-opened under the claim of right statuteⁿ²⁸ or the mitigation provisions,ⁿ²⁹ apparently deciding that allowing a theft loss deduction for the mistakenly reported income would be less incongruous with the intent and language of the Code. Given that neither the fictitious income reported nor the taxes erroneously paid by the taxpayer were appropriated by B, however, the Service's decision to include the fictitious income in the taxpayer's theft loss, however generous, seems questionable.ⁿ³⁰

(3) Tax Consequences of Treating a Loss as a Theft Loss. The advantages to the taxpayer of treating a loss as a theft loss, though noncontroversial, are worth reviewing because of their significance not only for money lost in Ponzi schemes but in cases where an individual taxpayer holds real but worthless or nearly worthless stock or securities and there is at least a possibility of showing that the taxpayer's loss was due to someone's fraud. Such a showing will:

- First, change the character of the loss from a capital loss, deductible only from capital gains and up to \$3,000 of ordinary income per year,ⁿ³¹ into a fully deductible loss that is not subject to the capital loss limitations. Ordinarily, losses resulting from the worthlessness of securities owned by an individual as an investment are treated as losses from the sale or exchange of a capital asset incurred on the last day of the year in which they become worthless.ⁿ³² In the case of loans made to individuals other than in the course of the taxpayer's trade or business, worthlessness results in the loss being treated as

a short-term capital loss incurred during the year.ⁿ³³ However, if the taxpayer can show that the stock or security was acquired, or the loan made, because of misrepresentations or other fraud committed by the seller (or borrower), the loss becomes one incurred as a result of theft and not by reason of the sale or exchange of a capital asset.ⁿ³⁴

- Second, allow the taxpayer to carry back the loss as a net "operating loss," to the extent it exceeds other taxable income, to preceding taxable years, thereby obtaining immediate tax relief rather than having to wait until future years to carry over the excess loss. The key provision here is *IRC Section 172 (d)(4)(C)*, which treats casualty and theft losses as attributable to a trade or business, whether or not such losses were actually sustained in a trade or business. That in turn allows a noncorporate taxpayer to include the theft loss in a net operating loss (NOL), and exempts the loss from the normal limitation that nonbusiness losses of noncorporate taxpayers are deductible only to the extent of nonbusiness income.ⁿ³⁵ As a general rule, an NOL may be carried back 2 years and carried forward 20, but the carryback period is increased to 3 years to the extent the NOL is attributable to a casualty or theft.ⁿ³⁶ Furthermore, if the NOL arises in a taxable year beginning or ending in 2008, and is incurred by an "eligible small business"ⁿ³⁷ that "business" may elect either a 3, 4 or 5-year carryback period.ⁿ³⁸ The Service ruled that a taxpayer who suffers a loss in a Ponzi scheme would be treated as a "business" (a sole proprietorship) for purposes of this temporary provision and, if the gross receipts test were met, the taxpayer could make the election to carry the theft loss back for as many as 5 taxable years.

- Third, avoid a number of limitations to which itemized deductions for individuals are normally subject. As Rev Rul 2009-9 points out, none of those limitations apply to a theft loss connected with a Ponzi scheme or other fraudulently-induced investment. Thus, neither the \$500 deductible with respect to personal casualty losses (including theft losses) (\$100 for taxable years beginning after December 31, 2009),ⁿ³⁹ nor the limitation that only net personal casualty losses in excess of 10 percent of adjusted gross income are deductible,ⁿ⁴⁰ are applicable to a theft loss incurred in connection with a transaction entered into for profit within the meaning of *IRC Section 165(c)(2)*. Further, all casualty losses, not just those associated with transactions entered into for profit, are exempt from the 2 percent of adjusted gross income floor on miscellaneous itemized deductions,ⁿ⁴¹ and the overall limit on itemized deductions imposed by *IRC Section 68*.

(4) Reasonable Chance of Recovery. Although *IRC Section 165(e)* provides that a theft loss is deductible in the taxable year in which the taxpayer discovers the loss, if there exists in that year a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss for which reimbursement may be received is considered sustained (or will be recognized) until the taxable year in which it can be ascertained with reasonable certainty whether or not reimbursement will be received.ⁿ⁴² This puts the taxpayer with a theft loss and some possibility of recovery of the loss at hazard with respect to the amount that may deducted and, more importantly, the appropriate year in which the deduction can be taken.ⁿ⁴³

More often, and not surprisingly, taxpayers tend to be pessimistic about their prospects of recovery when determining the proper year in which to claim a deduction for their losses.ⁿ⁴⁴ Equally unsurprising, the Internal Revenue Service will often challenge the deduction of the full amount of the loss in the year of discovery if the taxpayer is actively pursuing a claim for recovery in litigation.ⁿ⁴⁵ As might also be expected, notwithstanding courts' continuing insistence that the reasonableness of the prospect of recovery must be judged with foresight (as of the end of the year in which the loss was claimed) rather than hindsight, the results of the taxpayer's recovery litigation will often influence the outcome

of the Service's challenge.ⁿ⁴⁶

The Service took a welcome step towards resolving this dilemma for taxpayers, at least those that are victims of Ponzi schemes, by giving them the option of following a procedure that protects against audit adjustments challenging the year in which their theft losses are properly deductible.ⁿ⁴⁷

Rev Proc 2009-20 applies to a "qualified loss" incurred by a "qualified investor." As defined in *Rev Proc 2009-20*, these terms require that:

- (a) The taxpayer's loss must have been suffered as the result of a "specified fraudulent arrangement." This is "an arrangement in which a party (the lead figure) receives cash or property from investors; purports to earn income for the investors; reports income amounts to the investors that are partially or wholly fictitious; makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement; and appropriates some or all of the investors' cash or property."ⁿ⁴⁸ specified fraudulent arrangement (SFA) must involve the commission of fraud, embezzlement, or a similar state or federal crime that is considered "theft" for federal income tax purposes.ⁿ⁴⁹
- (b) There must have been federal or state action taken against the lead figure in the SFA (or one of the lead figures, if more than one) in which (a) a lead figure was charged in a state or federal indictment or information (not withdrawn or dismissed) with the commission of fraud, embezzlement or a similar crime, or (b) a lead figure was the subject of a state or federal complaint (not withdrawn or dismissed) alleging such a crime, and either (i) the complaint alleged an admission of the crime by such figure or the execution of an affidavit by such figure admitting the crime or (ii) a receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen.ⁿ⁵⁰ The "discovery year" with respect to any qualified investor, i.e., the year in which the qualified loss must be deducted, is the taxable year of the investor in which the indictment, information, or complaint was filed.ⁿ⁵¹
- (c) The taxpayer must be a US person as defined in *IRC Section 7701(a)(30)* who generally qualifies to deduct the theft loss under *IRC Section 165* and *Treasury Regulation Section 1.165-8*.
- (d) The taxpayer must have transferred cash or property to an SFA.ⁿ⁵²
- (e) The taxpayer must not have had actual knowledge of the fraudulent nature of the SFA prior to it becoming known to the general public.ⁿ⁵³
- (f) The SFA in which the taxpayer incurred the theft loss must not have been a tax shelter within the meaning of *IRC Section 6662(d)(2)(C)(ii)*.ⁿ⁵⁴

If these requirements are satisfied, the revenue procedure will apply to a theft loss deduction that is equal to the taxpayer's "qualified investment" after making the adjustments required by *Rev Proc 2009-20*, Section 5.02 (as discussed below). The taxpayer's "qualified investment" in an SFA is:

- (i) The total amount of cash, or the basis of property, invested in the SFA in all years; plus
- (ii) The total amount of net income with respect to the SFA that, consistent with information received from the SFA, the qualified investor included in income for federal tax purposes for all taxable years prior to the "discovery year," including taxable years for which a refund is barred by the statute of limitations; less

(iii) The total amount of cash or property that the qualified investor withdrew in all years from the SFA (whether as income or principal).ⁿ⁵⁵

The taxpayer must make both of the following adjustments to "qualified investment" in calculating the "theft loss" deduction to become entitled to the benefits of the revenue procedure.

(1) As a concession to the IRS for not challenging the year of the deduction (whether or not the taxpayer has claims on which there is a reasonable prospect of recovery of all or part of the loss), the taxpayer must reduce the otherwise allowable deduction by multiplying the "qualified investment" in the SFA by (a) 95 percent, if the taxpayer is not pursuing any potential third-party recovery, or (b) 75 percent, if the taxpayer is pursuing or intends to pursue any potential third party recovery.ⁿ⁵⁶ "Potential third-party recovery" means all actual or potential claims for recovery of a qualified loss, as of the last day of the discovery year, against any person other than a member of the SFA's responsible group, the issuer of an insurance policy covering the qualified loss or a guarantor under a similar contractual arrangement, or the Securities Investor Protection Corporation (SIPC) or similar entity.ⁿ⁵⁷ Thus, a taxpayer pursuing a valid and collectible claim against the leading figure or other member of the responsible group is entitled to claim a deduction equal to 95 percent of qualified investment, regardless of the size of the claim or the probability of a recovery.ⁿ⁵⁸

(2) The taxpayer must deduct from the qualified investment as reduced above (1) any actual recoveries made in the discovery year and (2) any potential recoveries under insurance policies in the name of the qualified investor, contractual arrangements other than insurance that guaranteed or otherwise protected against loss of the qualified investment, and any amounts payable by the SIPC as advances for customer claims under *15 USC Section 78fff-3(a)* (the Securities Investor Protection Act of 1970) or by a similar entity under a similar provision.

Finally, a taxpayer wishing to rely on *Rev Proc 2009-20* must mark " *Revenue Procedure 2009-20* " at the top of Form 4684, Casualties and Thefts, which is filed as part of the taxpayer's return for the discovery year, and complete and sign a statement, prescribed in Appendix A to *Rev Proc 2009-20* , to be attached to the taxpayer's timely filed (including extensions) federal income tax return for the discovery year. In executing the statement, the taxpayer agrees--

- (1) Not to deduct in the discovery year any amount of the theft loss in excess of the deduction permitted by Section 5 of *Rev Proc 2009-20* ;
- (2) Not to file returns or amended returns to exclude or recharacterize income reported with respect to the investment arrangement in taxable years preceding the discovery year;
- (3) Not to apply the alternative computation in *IRC Section 1341* with respect to the theft loss deduction allowed by *Rev Proc 2009-20* ;
- (4) Not to apply the doctrine of equitable recoupment or the mitigation provisions in *IRC Sections 1311-1314* with respect to income from the investment arrangement that was reported in taxable years that are otherwise barred by the period of limitations on filing a claim for refund under *IRC Section 6511*.

A taxpayer eligible to utilize the safe harbor provided by *Rev Proc 2009-20* but who chooses not to do so "is subject to all of the generally applicable provisions governing the deductibility of losses under § 165."ⁿ⁵⁹ As a practical matter, this means that the taxpayer, if audited, will have to "establish that no claim for reimbursement of any portion of the loss exists with respect to which there is a reasonable prospect of recovery in the taxable year in which the taxpayer claims the loss."ⁿ⁶⁰ The taxpayer can still rely, however, on all the legal interpretations of the Code made by the

Service in *Rev Rul 2009-9*, including the ruling that allows a victim of a Ponzi scheme to claim as part of the theft loss any fictitious income reported to him as part of the scheme and included in gross income on his federal income tax return(s) for prior years, including closed years.ⁿ⁶¹

[2] Installment Sales.

[a] The Installment Method of Accounting. *IRC Section 453(a)* provides for automatic installment reporting of gain by a cash method or an accrual method taxpayerⁿ¹ (unless the taxpayer elects otherwise)ⁿ² whenever at least one payment is to be received after the close of the taxable year in which the disposition occurs.ⁿ³ (However, any ordinary income produced by the depreciation recapture provisions of *IRC Sections 1245* and *1250* must be recognized in the year of sale.)ⁿ⁴ Sales on revolving credit plans and sales of stock or securities that are traded on an established securities market cannot qualify for installment reporting.ⁿ⁵

Installment reporting is also not available for dealer dispositions.ⁿ⁶ A dealer disposition is defined as any disposition of personal property by a person who regularly sells personal property on the installment plan or any disposition of real property held by the taxpayer for sale to customers in the ordinary course of business.ⁿ⁷ A dealer disposition does not include a disposition on the installment plan of property used or produced in the trade or business of farming as defined in *IRC Section 2032A(e)(4)* or *2032(A)(e)(5)*.ⁿ⁸ If the taxpayer so elects, it also does not include a disposition in the ordinary course of the taxpayer's trade or business to an individual of (1) a timeshare right to use, or a timeshare ownership interest in, residential real property for not more than six weeks a year, or a right to use specified campgrounds for recreational purposes, or (2) any residential lot, but only if the taxpayer or a related person is not to make any improvements to the lot.ⁿ⁹ The election will not apply if the installment obligation is guaranteed by a person other than an individual.

Carrying charges or interest with respect to the excepted dispositions that are added on the books of the seller to the established cash selling price are included in the total contract price of the property. If not so treated, any payments received are first applied against such carrying charges and interest.ⁿ¹⁰

If a taxpayer makes an election with respect to a disposition of a timeshare or residential lot, the taxpayer's tax liability for any year in which payments are received is increased by interest charged on the tax deferred as a result of the installment method.ⁿ¹¹ The amount of interest is determined on the tax for the taxable year attributable to the payments received during the year on the installment obligation, for the period beginning with the date of sale and ending on the date payment is received, by using the applicable federal rate under *IRC Section 1274* (without regard to *IRC Section 1274(d)(2)*) in effect at the time of the sale compounded semiannually.ⁿ¹² The tax attributable to receipt of the payment is determined without regard to the interest charge. No interest is computed for any payment received in the year of disposition of the property from which the installment obligation arises.

The crucial factor in the operation of the installment method can be found in *IRC Section 453(f)(3)*, which provides that "the term 'payment' does not include the receipt of evidences of indebtedness of the person acquiring the property (whether or not payment of such indebtedness is guaranteed by another person)."ⁿ¹³

The installment method effectively defers the inclusion in income of gain from the sale until the year of actual receipt of payment. The gain which must be reported in such year is that proportion of the payment received which the gross profit to be realized bears to the total contract price.ⁿ¹⁴ This may be illustrated as follows:

Example:

Assume a taxpayer sells property having a basis of \$5,000 for \$10,000, the buyer paying \$2,000 in the year of sale and agreeing to pay the balance in two equal installments, the first due one year from the date of sale, and the other one year later. The gross profit to be realized from the transaction is \$5,000 (\$10,000 selling price less \$5,000 basis). The total contract price here equals the selling price of

\$10,000¹⁵ making the gain ratio 50 percent (\$5,000 gain/\$10,000 contract price). Therefore, unless the taxpayer elects otherwise, in the year of sale, \$1,000 of the \$2,000 payment will be includable in gross income. As installments are received, the taxpayer will include one half of each payment in his income for the year of receipt. When the consideration is fully paid, the taxpayer will have reported the total gain realized on the transaction, and excluded an amount equal to his basis.

A reduction in the selling price in a year subsequent to the year of sale requires a corresponding reduction in the amount of income to be reported in the future. The reduction is effected by adjusting the percentage of profit to be reported on the remaining installments. This is determined by (1) recomputing total gross profit using the adjusted sales price, (2) subtracting the profit previously reported, and (3) spreading the remainder evenly over the remaining installments.¹⁶ If the reduction is greater than the unreported income, a loss is allowed in the year of reduction. By way of illustration:

Example 1:

Taxpayer sold property with a basis of \$10,000 for \$20,000 under an arrangement calling for the payment of \$5,000 in the year of sale and \$3,000 in each of the succeeding five years. After \$8,000 had been paid, the buyer and seller agreed to reduce the total price to \$18,000 and the remaining installments to \$2,500 each. The profit anticipated originally was \$10,000; the reduction changed that figure to \$8,000. The installments paid prior to the adjustment produced reportable gain of \$4,000, leaving a balance of \$4,000 to be reported as the remaining installments were received.

Example 2:

Assume the same facts as in Example 1, except that the reduction in price is to \$16,000 and that it takes place after \$17,000 has been received by the seller. The reduction results in a loss of \$1,000.

Two important limitations on the use of the installment method can be found in *IRC Section 453A* governing the treatment of installment obligations arising from a disposition of property used in the taxpayer's trade or business or property held for the production of rental income, if the sales price of the property exceeds \$150,000.¹⁷ Installment obligations arising from the disposition of property used in the trade or business of farming (as defined in *IRC Section 2032A(e)(4)* or *2032A(e)(5)*) are not subject to these rules. An exception is also provided for installment obligations arising out of the disposition of certain timeshares and residential lots, but the interest provisions of *IRC Section 453(l)(3)* will apply.

The first consequence of the *IRC Section 453A(c)* rules is the imposition of an interest charge on the deferred tax liability with respect to the obligation.¹⁸ If an installment obligation is outstanding at the close of any taxable year, and the face amount of all such obligations that arose during, and are outstanding at, the close of the taxable year exceeds \$5 million, the taxpayer's tax liability for the year is increased in an amount equal to the product of the applicable percentage of the deferred tax liability with respect to such obligation multiplied by the underpayment rate in effect under *IRC Section 6621(a)(2)* for the month within which the taxable year ends. The deferred tax liability is the amount of gain that has not been recognized with respect to the obligation as of the close of the taxable year multiplied by the maximum rate of tax in effect under *IRC Section 1* (noncorporate taxpayers), or *IRC Section 11* (corporate taxpayers). (If the gain to be recognized will be long-term capital gain, the maximum rate is the capital gain rate under *IRC Section 1(h)* (noncorporate taxpayers) or *IRC Section 1201* (corporate taxpayers)). The applicable percentage is determined by dividing the aggregate face amount of nondealer property installment obligations outstanding at the close of the taxable year in excess of \$5 million by the aggregate face amount of such obligations. The Treasury is authorized to prescribe such regulations as may be necessary to carry out the purposes of the interest charge rule including regulations that address the treatment of contingent payments, short taxable years, and pass-through entities.

The second consequence is the pledging rule of *IRC Section 453A(d)*. If any installment obligation arising from the disposition of property is pledged as direct security for the payment of principal or interest on any indebtedness, the net proceeds of the secured indebtedness (gross loan proceeds less the direct expenses of obtaining the loan) are treated as a

payment received on the installment obligation as of the later of the time the indebtedness is secured or the proceeds of the indebtedness are received by the taxpayer. Gain is recognized in an amount equal to the product of the net loan proceeds and the gross profit ratio applicable to the installment obligation.ⁿ¹⁹

Receipt of payments on the obligation subsequent to the pledge generally will not result in the recognition of additional gain, except to the extent that the gain that would otherwise be recognized on account of the payments exceeds the gain recognized as a result of the pledge. The rule relating to the nonrecognition of gain from subsequent payments applies whether or not such payments are used to pay any portion of the secured debt. The total amount of gain that can be recognized on an obligation as a result of the pledge rule and actual payments cannot exceed the total gain from the installment sale.

It has long been the rule that a transfer of property for like-kind property and cash payments in the future can qualify both for nonrecognition treatment for that portion of the gain attributable to the like-kind property and for installment reporting with respect to the cash payments.ⁿ²⁰ (The gain eligible for installment reporting is the total gain realized on the transaction less the portion eligible for nonrecognition.) Under *IRC Section 453(f)(6)* the value of the nonrecognition propertyⁿ²¹ is excluded from the total contract price and the payments received. The taxpayer's basis in the property transferred will first be allocated to the like-kind property received (but not in excess of its fair market value) and any remaining basis will be used to determine the gross profit ratio. The result is evidenced by the following example:

Example:

A taxpayer exchanges property with a basis of \$400,000 for like-kind property worth \$200,000 and an installment obligation of \$800,000, \$100,000 of which is payable in the taxable year of sale with the balance payable in the succeeding taxable year. Application of *IRC Section 453(f)(6)* limits the contract price to the amount of the installment obligation of \$800,000, which produces a gross profit of \$600,000 (\$800,000 contract price less \$200,000 of basis remaining after allocating \$200,000 to the like-kind property) and a gross profit ratio of 75 percent to be applied solely to the actual cash payments received. This creates a reportable gain of \$75,000 in the year of sale and \$525,000 in the succeeding year.

Suppose that a corporation sells its assets on an installment basis as part of a plan of liquidation and then distributes the installment obligation to the shareholders. Absent a special provision, the installment obligation would have to be taken into account as part of the amount realized by the shareholders on the liquidation. However, *IRC Section 453(h)* allows the shareholders to defer the reporting of the gain attributable to the installment obligation until payments on it are received, if the corporation acquired the obligation in a sale or exchange during the 12-month period beginning on the date of adoption of the plan of liquidation and the liquidation is completed during the period.ⁿ²² If liquidation distributions are received by a shareholder in more than one taxable year, the shareholder must, upon completion of the liquidation, redetermine the shareholder's gain from the liquidation by allocating the shareholder's basis in the stock of the corporation over all payments received by the shareholder.ⁿ²³

The regulations require that the installment obligation be a qualifying installment obligation; an evidence of indebtedness that is payable on demand or readily tradable cannot be a qualifying installment obligation.ⁿ²⁴ As a general rule, the nature of the assets sold by, and the tax consequences to, the selling corporation do not affect whether an installment obligation is a qualifying installment obligation.ⁿ²⁵ Excepted from this last stated rule is any installment obligation derived from a transaction where the obligor and shareholder are related persons, from the sale of inventory, or from certain tax avoidance transactions.

The shareholder receiving the qualified installment obligation must be a qualifying shareholder, defined as a shareholder subject to *IRC Section 331* with respect to the liquidating distribution.ⁿ²⁶ Thus, a creditor that receives a distribution from a liquidating corporation, in exchange for the creditor's claim, is not a qualifying shareholder.

Generally, a qualifying shareholder treats a qualifying installment obligation, for all purposes of the Code, as if the obligation is received by the shareholder from the person issuing the obligation in exchange for all of the shareholder's stock in the liquidating corporation.ⁿ²⁷ In order to test whether there is any original issue discount, the shareholder treats the obligation as newly issued on the date of distribution with an issue price equal to the sum of the adjusted issue price on the date of distribution and the amount of any qualified stated interest that has accrued prior to the distribution but is not payable until after the distribution.ⁿ²⁸ If the installment obligation is a variable rate debt instrument, the shareholder uses the equivalent fixed rate debt instrument constructed for the qualifying installment obligation as of the date the obligation was issued to the liquidating corporation to determine the accruals of original issue discount, if any, and interest on the obligation.ⁿ²⁹

All amounts distributed or treated as distributed to the shareholder incident to the liquidation, including cash, the issue price of qualifying installment obligations, and the fair market value of other property (including obligations that are not qualifying installment obligations) are considered as having been received by the shareholder as the selling price for the shareholder's stock in the liquidating corporation.ⁿ³⁰ An election not to report on the installment method an installment obligation received in the liquidation applies to all distributions received in the liquidation.

If, in the course, of a liquidation a shareholder assumes secured or unsecured liabilities of the liquidating corporation, or receives property from the corporation subject to liabilities (including any tax liabilities incurred by the corporation on the distribution), the liabilities do not reduce the amounts received in computing the selling price, but are added to the shareholder's basis in the stock of the liquidating corporation.ⁿ³¹ The additions to basis do not affect the shareholder's holding period for the stock.

The rule of *IRC Section 453(h)* does not extend to installment obligations received by the corporation on the sale of its inventory assets unless the sale is in the form of a bulk sale.ⁿ³² Nor can gain be deferred when the installment obligation is derived from the sale of depreciable property by the corporation to the distributee shareholder's spouse, to a trust in which the shareholder or his spouse is a beneficiary (unless the beneficiary's interest is a remote contingent interest as defined in *IRC Section 318(a)(3)(B)(i)*), or to a controlled entity.ⁿ³³ The following are controlled entities for this purpose: a corporation or partnership that is 50 percent owned by the distributee, his spouse, or both; two corporations that are members of the same controlled group; a corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital interest or profits interest in the partnership; an S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation; and an S corporation and a C corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation.ⁿ³⁴ In addition, if the corporation's assets are sold to a related party in a transaction not of the type described in the preceding sentence, and the purchaser then disposes of the assets, the related party disposition rules described below will apply to the shareholder who received the related party's obligation as a liquidating distribution.ⁿ³⁵ Finally, an installment obligation acquired by a liquidating corporation attributable to the sale of "covered property" is not a qualifying obligation if the corporation is formed or availed of for a principal purpose of avoiding *IRC Section 453(b)(2)* (relating to dealer dispositions and certain other dispositions of personal property), *IRC Section 453(i)* (relating to sales of property subject to recapture), or *IRC Section 453(k)* (relating to dispositions under a revolving credit plan or securities traded on an established securities market) through the use of a party bearing a relationship, either directly or indirectly, described in *IRC Section 267(b)* to any shareholder of the corporation.ⁿ³⁶

A significant expansion of the availability of installment reporting can be found in the enactment of *IRC Section 453(j)* which mandates the adoption of regulations "providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained."

According to those regulations, a contingent payment sale must be reported on the installment method unless the taxpayer elects to report all of the gain in accordance with the taxpayer's normal method of accounting.ⁿ³⁷ A contingent

payment sale is defined as one in which the aggregate selling price cannot be determined by the close of the taxable year in which the sale occurs. Excluded from the scope of contingent payment sales are any transactions with respect to which the installment obligation represents, under applicable principles of tax law, a retained interest in the property that is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation, or similar transactions, regardless of the existence of a stated maximum selling price or a fixed payment term.

For sales in which there is a stated maximum selling price, the portion of each payment reportable as income will be computed on the basis of a gross profit ratio determined by reference to the stated maximum selling price. A contingent payment sale is treated as having a stated maximum selling price if, under the terms of the agreement, the maximum amount of sale proceeds receivable by the taxpayer can be determined as of the end of the year in which the sale occurs.ⁿ³⁸ The stated maximum selling price is determined by assuming that all of the contingencies contemplated by the agreement are met or otherwise resolved in a manner that will maximize the selling price and accelerate payment to the earliest dates permitted under the agreement.ⁿ³⁹

If the contingent price sale agreement contains an adequate amount of stated interest, and such stated interest is payable in addition to the amounts otherwise payable under the agreement, the stated interest is not part of the contingent selling price.ⁿ⁴⁰ If there is unstated interest, the amount of unstated interest determined under *IRC Section 483* or *IRC Section 1274* is deducted from the initially determined stated maximum selling price and the reduced price used to determine the gross profit ratio and the amount of includable gain. For each year after the year of sale, the stated maximum selling price must be recomputed, taking into account all events that have occurred and assuming that all amounts that may become payable under the agreement will be paid on the earliest dates permitted under the agreement.

Example:

Assume that a taxpayer sells stock with a basis of \$250,000 to a buyer who agrees to pay a fixed percentage of the gross sales, but not more than \$200,000, in each of the next five years. Assume further that the contract provides for an adequate amount of stated interest that is paid in addition to the contingent payments. Since the largest price that can be paid to the seller during the term of the contract is \$1 million (five payments of \$200,000), the amount of income to be returned is determined by using that figure as the total contract price. This produces a potential gain of \$750,000 (\$1 million less \$250,000 basis) and a gross profit ratio of 75 percent to be applied to each payment.

The stated maximum selling price, as initially determined, is treated as the selling price unless and until the maximum amount is reduced pursuant to the terms of the agreement, by subsequent amendment, or by a payment recharacterization where there is unstated interest. When the maximum amount is subsequently reduced, the gross profit ratio will be recomputed with respect to payments received in or after the taxable year in which the reduction event occurs.ⁿ⁴¹ If there is more income to be earned for the transaction even with the price reduced, the taxpayer will report reduced income with respect to each installment payment received in the taxable year of adjustment and succeeding taxable years. If the reduction in the maximum selling price yields a total recomputed income that is less than the amount of income reported from installment payments received in previous taxable years, the excess of the earlier reported income over the total recomputed income is deductible as a loss in the adjustment year.

The transaction may be structured in such a way that the selling price is indefinite and no maximum can be determined. In such case, if the price is payable over a fixed period of time, the seller's basis in the property is recoverable ratably over the fixed period.ⁿ⁴² In making the allocation, it is not relevant whether the buyer is required to pay adequate stated interest. However, if the terms of the agreement incorporate an arithmetic component that is not identical for all taxable years, basis must be allocated among the taxable years to accord with that component, unless, taking into account all of the payment terms of the agreement, it is inappropriate to presume that payments under the contract are likely to accord with the variable component. If, in any taxable year, no payment is received or the amount of the payment (exclusive of interest) is less than the basis allocated to that taxable year, no loss deduction will be allowed unless the year is the final payment year or the obligation is determined to be worthless. When the loss is not allowed, the unrecovered portion of

the basis allocated to the taxable year is carried forward to the next succeeding taxable year.

Example 1:

A sells property to B for 10 percent of the property's gross yield for each of the next five years. A's basis in the property is \$10 million. If A receives payments (exclusive of interest) as shown in the following table, he will allocate basis and report gain as follows:

Year	Payment	Basis Recovered	Gain
1	\$2,600,000	\$2,000,000	\$600,000
2	\$3,000,000	\$2,000,000	\$1,000,000
3	\$2,800,000	\$2,000,000	\$800,000
4	\$3,600,000	\$2,000,000	\$1,600,000
5	\$4,200,000	\$2,000,000	\$2,200,000

The \$10 million basis was allocated equally to the five-year period during which payments were to be received because there was no way to determine a stated maximum selling price.

If the payment in year 1 had been only \$1,800,000 and the installment obligation was not found to be worthless, no loss would be allowed and the \$200,000 in unrecovered basis would be carried to year 2 to produce a gain in that year of \$800,000.

Example 2:

C owns all of the stock of X Corporation. He sells the stock, having a basis of \$200,000, to D, who agrees to make four payments based on the net profits of X as follows: 40 percent of the net profits in year 1, 30 percent in year 2, 20 percent in year 3, and 10 percent in year 4. C's basis is allocated to each of the four years as follows: \$80,000 to year 1, \$60,000 to year 2, \$40,000 to year 3, and \$20,000 to year 4.

Example 3:

Assume the same facts as in Example 2, except that the agreement calls for the following fixed installment payments: no payment in year 1, \$200,000 in year 2, \$400,000 in year 3, \$600,000 in year 4, and \$800,000 in year 5. Because of the fixed payment schedule, it is inappropriate to presume that the payments accord with the variable component. Thus, C will be required to allocate \$40,000 of basis to each of the five taxable years.

If there is neither a stated maximum selling price nor a fixed period, the transaction will be scrutinized to see if a sale has realistically occurred, or whether, in economic effect, the payments received are in the nature of rent or royalty income.⁴³ If the arrangement is found to qualify as a sale, the taxpayer's basis is recovered in equal annual installments over a period of 15 years commencing with the date of sale. However, if no payment is received during the taxable year or the payment is less than the allocated basis, no deduction is allowed unless the obligation has become worthless. The unrecovered basis is reallocated in level amounts over the balance of the 15-year term. Any basis not recovered at the end of the 15th year is carried forward from year to year until recovered or until the payment obligation is found to be worthless.

The rules for recovery of basis in contingent sales focus on the payment terms of the contingent selling price agreement. However, there are instances in which failure to take account of the nature or productivity of the property sold may be expected to result in distortion of the taxpayer's income over time (eg, when the property is depreciable property normally eligible for depreciation on the income forecast method, or is depletable property normally eligible for cost

depletion in which total future production must be estimated, and payments under the agreement are based upon receipts or units produced by or from the property). In such case, the taxpayer's basis may be recovered by using an income forecast method.ⁿ⁴⁴

The normal basis recovery rules could prove inadequate in a given case. If the taxpayer can demonstrate that application of the normal rules will substantially and inappropriately defer recovery of basis, an alternative method of basis recovery can be used.ⁿ⁴⁵ The Service can employ an alternative method if the usual rules will accelerate the recovery of basis.ⁿ⁴⁶

Interest payable by the purchaser does not form part of the selling price. However, if the imputed interest provisions of *IRC Section 483* or the original issue discount rules of *IRC Section 1274* become applicable, the total contract price for the purposes of computing gross profit becomes the stated selling price reduced by the amount of unstated interest.ⁿ⁴⁷

What constitutes a payment? Clearly, the delivery of cash by the purchaser to the seller is not the only manner in which a payment can be made. Thus, payment has been found where a purchaser cancelled a debt due it by the seller,ⁿ⁴⁸ where promissory notes of a party other than the purchaser were delivered to the seller,ⁿ⁴⁹ where the purchaser paid the seller's legal expenses--the parties considering such expenses part of the selling price,ⁿ⁵⁰ as well as where a dividend declared on stock was applied against the purchase price of the stock,ⁿ⁵¹ and where 80 percent of the purchase price was paid to an irrevocable trust from which the seller was entitled to receive all of the income and up to 20 percent of the corpus annually.ⁿ⁵² On the other hand, an assumption of the seller's liabilities does not constitute a paymentⁿ⁵³ unless the indebtedness assumed exceeds the basis of the property sold.ⁿ⁵⁴

In the normal installment sale, the advantage of deferred income reporting is offset by the uncertainty of payment by the purchaser at the time specified in the installment obligation. The detriment of possible default could be eliminated if a sale made in the installment mode to a family member, who resold the property shortly thereafter for cash, could qualify as an installment sale with gain recognized only when payments are received by the initial seller. Generally, there would be little or no gain on the resale, since the selling price would approximate, if not equal, the related party's basis (the price fixed in the installment sale contract).

The described scheme met with a measure of success under the statutory framework that existed before the Installment Sales Revision Act of 1980. The critical inquiry was whether the seller directly or indirectly controlled the proceeds or possessed the economic benefit therefrom.ⁿ⁵⁵ Thus, a sale to an independent trustee of a trust for the benefit of the seller's family passed muster,ⁿ⁵⁶ while one to the seller's son who was obligated to resell, invest the proceeds, and hold the reinvestment in escrow, did not.ⁿ⁵⁷

Under *IRC Section 453(e)*, added by the 1980 amendment, a disposition by a related installment buyer will trigger the recognition of gain by the initial seller, based on his gross profit ratio, to the extent the amount realized on the second disposition exceeds actual payments made under the installment sale (whether made before the second disposition or thereafter, but in the same taxable year).ⁿ⁵⁸ Once an initial seller is required to accelerate the recognition of gain by reason of a second disposition,ⁿ⁵⁹ subsequent payments received by the initial seller are recovered tax-free until they equal the amount realized on the resale.ⁿ⁶⁰

For these purposes, a related person means "a person whose stock would be attributed under section 318(a) ... to the person first disposing of the property, or ... a person who bears a relationship described in section 267(b) to the person first disposing of the property."ⁿ⁶¹ Thus, an installment sale is a contender for *IRC Section 453(e)* treatment if made, for example, to the spouse or to a child, grandchild, sibling or parent of the initial seller, to a corporation in which the initial seller owns, directly or indirectly, 50 percent or more in value of the stock, to a partnership in which the seller is a partner, or to an estate or trust under which the seller is a beneficiary. A sale to an aunt or uncle would not be affected by *IRC Section 453(e)*; they are not part of a taxpayer's "family" as defined by either *IRC Section 318(a)(1)*, or *IRC Section 267(c)(4)*. Presumably, the ability to defer recognition of gain on an installment sale to an aunt or uncle, or to

any other collateral relative other than a sibling, followed by a resale, will continue to be determined under the control or enjoyment test developed by the courts.ⁿ⁶²

A special period of limitations is imposed in the case of property other than marketable securities. (A marketable security is one for which, as of the date of disposition, there was a market on an established securities market or otherwise.)ⁿ⁶³ For such property the resale rule applies only if the second disposition occurs within two years of the initial installment sale.ⁿ⁶⁴ The running of the two-year period is suspended for any period during which the related party's risk of loss with respect to the property is substantially diminished by the holding of a "put" with respect to such property (or similar property), the holding by another person of a right to acquire the property, a short sale or other transaction.ⁿ⁶⁵ For marketable securities, the resale rule applies without time limit for dispositions made before the installment obligation is satisfied.

There are several exceptions to the application of the foregoing rules. A reacquisition of stock by the issuing corporation in a nonliquidating sale is not treated as a first disposition.ⁿ⁶⁶ Further, there is no acceleration of gain when the second disposition results from a compulsory or involuntary conversion provided the first disposition occurred before the threat or imminence of the conversion.ⁿ⁶⁷ Also excepted is any transfer made after the death of the initial seller or the related buyer.ⁿ⁶⁸ Finally, there will be no triggering of gain if it is established to the satisfaction of the Service that none of the dispositions had as one of its principal purposes the avoidance of federal income taxes.ⁿ⁶⁹

IRC Section 453(g) prescribes a special rule for installment sales of depreciable property by the seller to a trust in which the seller or his spouse is a beneficiary (unless the beneficiary's interest is a remote contingent interest as defined in *IRC Section 318(a)(3)(B)(i)*), or to a controlled entity as described above.ⁿ⁷⁰ Here, installment treatment is denied and all payments to be received are treated as received in the year of sale (effectively placing the seller on the accrual method), unless it is established to the satisfaction of the Service that the sale did not have as one of its principal purposes the avoidance of federal income taxes. The term "payments to be received" includes the aggregate amount of all payments that are not contingent, and the fair market value of any payments that are contingent as to amount.ⁿ⁷¹ In the case of payments that are contingent as to amount, but as to which a fair market value cannot be reasonably ascertained, the basis of the property sold is recovered ratably, and the purchaser cannot increase the basis of any property acquired in the sale by any amount before such time as the seller includes the amount in income.

[b] Disposition of Installment Obligations. If the taxpayer sells or otherwise disposes of the installment obligation received by him, or if the obligation is satisfied at other than its face value, gain or loss is recognized in the year of disposition or satisfaction.ⁿ⁷² If the disposition takes the form of a sale or exchange, the amount of gain or loss is the difference between the amount realized on the disposition and the basis of the obligation (face value of the obligation less the total amount of income which would have been received had the obligation been satisfied in full by the obligor).ⁿ⁷³

Example:

Assume that the taxpayer sells stock having a basis of \$4,000 for \$10,000, of which \$2,000 is payable in cash at the time of sale with the balance payable in equal annual installments (with sufficient interest to avoid invoking *IRC Section 483*). Eight months after the sale, and before receipt of any installment payments, the notes representing the future installments are sold for \$6,000. The gain on the disposition of the installment obligation is determined as follows:

(1) *Determining the basis of the obligation*

Selling price of stock	\$10,000
Basis of stock	4,000
Gross profit	\$6,000
Proportion of each payment includable in income (\$6,000 gross profit/\$10,000 total contract price)	60%

Face value of notes	\$8,000
Total income which would have been returnable had notes been satisfied in full (60% of \$8,000)	4,800
Basis of obligation	\$3,200
(2) <i>Computing the gain from the disposition</i>	
Amount realized	\$6,000
Basis of the obligation	3,200
Gain realized on the disposition	\$2,800

The gain or loss will be considered as resulting from the sale or exchange of the property with respect to which the obligation was originally received.ⁿ⁷⁴ Thus, the character of the gain will depend solely on whether the underlying asset was a capital asset and the holding period computed solely by reference to the length of time the original property was held.ⁿ⁷⁵

If the disposition is not a sale or exchange, gain is measured by the difference between the fair market value of the obligation and its basis. At issue may be the question whether the transaction should be governed by *IRC Section 453B(a)(1)* (sale or exchange of installment obligations), or *IRC Section 453B(a)(2)* (other disposition of installment obligations). This would be important if the value of the obligation and the amount realized on its disposition were not the same.ⁿ⁷⁶

A number of actual dispositions are excepted from the provisions of *IRC Section 453B*. The disposition of an obligation at death does not trigger immediate gain.ⁿ⁷⁷ Rather, the income which would have been returned by the decedent is considered income in respect of a decedent, includable by the person succeeding to the right to collect the obligation.ⁿ⁷⁸

Outright transfers of installment obligations between spouses or incident to a divorce are not gain-producing dispositions if the transfer comes within the terms of *IRC Section 1041*; the same tax treatment that would have applied to the transferor had the obligation not been transferred applies to the transferee.ⁿ⁷⁹ Gain is recognized if the transfer is in trust.ⁿ⁸⁰

The disposition of installment obligations as part of the complete liquidation of a subsidiary by a parent is exempt from the general rule of *IRC Section 453B*, provided the basis of the property acquired by the parent is determined by reference to the basis in the hands of the subsidiary.ⁿ⁸¹ If the parent uses the provisions of *IRC Section 338* to obtain a stepped-up basis for the acquired property,ⁿ⁸² gain must then be recognized.

In general, *IRC Section 453B* does not require the recognition of gain or loss by an S corporation that distributes an installment obligation in complete liquidation if receipt of the obligation is nontaxable pursuant to *IRC Section 453(h)*. However, this does not exempt the corporation from any gain imposed by Subchapter S.ⁿ⁸³

The regulations provide a further exception for dispositions which are part of transactions afforded nonrecognition treatment by some provision of the Code.ⁿ⁸⁴ However, the provision must be viewed with caution, for its language is decidedly broader than its application. For example, if a transfer to a corporation is sheltered from taxation by *IRC Section 351*, a disposition of an installment obligation in connection therewith should fall under the nonrecognition umbrella. Generally it will, but, if the debtor is also the transferee corporation and the holder of the obligation exchanges it for stock in the corporation, the Service considers the disposition to be a taxable event.ⁿ⁸⁵ The rationale given for this result is that the exchange of the obligation for the stock works a satisfaction of the obligation at other than face value.

A gift of an installment obligation is a disposition that produces gain for the donor,ⁿ⁸⁶ as is a conveyance of an installment obligation to an irrevocable trust.ⁿ⁸⁷ However, no gain will result upon the transfer of an installment obligation to a trust if the taxpayer retains the right to revoke the trust and revest the corpus in himself.ⁿ⁸⁸

The cancellation of an installment obligation is a disposition on which the seller will recognize gain equal to the difference between the fair market value of the obligation and its basis.ⁿ⁸⁹ On the other hand, a surrender of an installment obligation for one containing identical terms is not a gain-producing disposition, but merely a change in the type of security.ⁿ⁹⁰

Finally, the transfer of an installment obligation to a life insurance company is subject to its own special rule and exception. In general, the transfer will require recognition of gain notwithstanding any provision of the Code granting nonrecognition to transfers to such companies.ⁿ⁹¹ The exception comes into play if the life insurance company elects to treat the remaining gain as investment income as payments are received.ⁿ⁹²

FOOTNOTES:

(n1)Footnote 1. See, eg, *IRC §§ 351, 354, 1036* (exchanges of stock for stock in the same corporation, § 8.07[2], *infra*) and 1037 (exchanges of certain Government obligations, § 8.07[3], *infra*).

(n2)Footnote 2. *American Natural Gas Co v US*, 279 F2d 220 (Ct Cl 1960); *Rev Rul 69-550*, 1969-2 CB 161; *Rev Rul 58-11*, 1958-1 CB 273; *Rev Rul 55-717*, 1955-2 CB 298; *Ltr Rul 8722083*.

(n3)Footnote 1. *IRC § 165(a)*. The loss must arise as the result of a closed and completed transaction. *Treas Reg § 1.165-1(b)*. Compare *Rev Rul 74-276*, 1974-1 CB 54, with *Rev Rul 72-1*, 1972-1 CB 52.

(n4)Footnote 2. The trade or business need not be a legal business. *Tharp v Commr*, *TC Memo 1972-10* (taxpayer in the business of making usurious loans).

(n5)Footnote 3. The profit motive must be a motive, but need not be the dominant motive, for entering into a transaction. *Wehrly v US*, 808 F2d 1311 (9th Cir 1986).

(n6)Footnote 4. *IRC § 165(c)*. No such provision is required in the case of a corporation since it is presumed to be engaged in a trade or business.

(n7)Footnote 5. *Higgins v Commr*, 312 US 212 (1941).

(n8)Footnote 6. *Weir v Commr*, 109 F2d 996 (3d Cir 1940). Libin, "Transactions Entered Into For Profit,' 'Regular Trade or Business,' and/or 'Investment': Some Distinctions and Differences," *NYU 27th Inst on Fed Tax* 1209 (1969). The question whether a transaction is entered into for profit is apparently one of intention, so that loss deductions have been disallowed where the taxpayer knew that the stock could never yield profit. *Dresser v US*, 55 F2d 499 (Ct Cl 1932), *cert denied* 287 US 635 (1932); *Paine v Commr*, 102 F2d 110 (1st Cir 1939).

(n9)Footnote 7. No loss was allowed in *Grey v Commr*, *TC Memo 1974-2*, *affd in an unpublished opinion* (5th Cir 1974), when it was found that the taxpayer's alleged ownership of the stock in question was a mere facade to conceal the identity of the true owner.

The loss must result from an identifiable transaction. A mere decline in the value of property does not suffice. See, eg, *Snyder v US*, 83 AFTR2d 99-397 (Fed Cir 1999).

(n10)Footnote 8. See Ch 2.

(n11)Footnote 9. See *Rose v Commr*, 868 F2d 851, 853 (6th Cir 1989): "This court will not inquire into whether a

transaction's primary objective was for the production of income or to make a profit, until it determines that the transaction is bona fide and not a sham ... The proper standard in determining if a transaction is a sham is whether the transaction has any practicable economic effects other than the creation of income tax losses ... A taxpayer's subjective business purpose and the transaction's objective economic substance may be relevant to this inquiry." For a fuller discussion of the economic substance doctrine, see § 1.02A, *supra* .

(n12)Footnote 10. 132 TC 161 (2009) .

(n13)Footnote 11. BLISS and similar investment strategies relied on a Tax Court Memorandum decision, *Helmer v Commissioner*, TC Memo 1975-160 , for the proposition that the potential liability created by the writer of an option contract, because of its contingent nature, could not be taken into account in calculating either the amount realized on a contribution of the contract to the partnership or deducted from the taxpayer's basis in its partnership interest. The IRS alerted taxpayers that tax shelters relying on *Helmer*, such as the one acquired by the taxpayer in *New Phoenix*, would be challenged by the Service, and that the liability represented by the short contract should reduce the taxpayer's outside basis in the partnership under IRC § 752. See Notice 2000-44, 2002-2 CB 255 . This position was ultimately adopted in *Treas Reg* § 1.752-6(b)(2), which became effective retroactively after the taxpayer in *New Phoenix* executed its BLISS transaction. The Tax Court in *New Phoenix* found it unnecessary to decide whether *Helmer v Commr* was good law prior to adoption of the amended IRC § 752 regulations because, under the sham transaction doctrine, even if BLISS technically complied with the tax law, such technical compliance is irrelevant to deductibility of the loss if the underlying transaction is devoid of economic reality. See also *Jade Trading, LLC v US*, 80 Fed Cl 11 (2007) .

BLISS produced anything but for its promoters and those who paid them to employ the strategy. In *New Phoenix*, the taxpayer not only failed to obtain the tax benefit it sought, it was also denied a deduction for the substantial promoter's fees it paid and, additionally, was required to pay a 40 percent valuation misstatement penalty on account of the artificial inflation of its basis in the publicly traded stock. See IRC § 6662(h). The promoter, a nationally known law firm, was driven out of business by liabilities to clients who subscribed to the scheme, while the tax lawyer responsible, who employed the scheme to avoid his own tax liabilities, was also hit with tax deficiencies, interest and 40 percent valuation misstatement penalties. See *Cemco Investors LLC v US*, 515 F3d 749 (7th Cir 2008) .

(n14)Footnote 12. The taxpayer's option contracts with the bank provided that neither party owed a fiduciary duty to the other.

(n15)Footnote 13. TC Memo 1975-160 .

(n16)Footnote 14. *New Phoenix Sunrise Corp and Subs v Commr*, 132 TC 161, 185 (2009) ; quoting *Dow Chem Co v US*, 435 F3d 594, 602 (6th Cir 2006) and *Am Elec Power Co v US*, 326 F3d 737, 742 (6th Cir 2003) . See also *Southgate Master Fund, LLC v US*, 651 F Supp 2d 596 (ND Tex 2009) (partnership disregarded as a sham where only purpose was to create high outside basis for taxpayer, who made an illusory contribution to the partnership of assets over which he continued to have complete control, including the sole right to any appreciation in the assets' value).

(n17)Footnote 15. *Winn-Dixie Stores, Inc & Subs v Commr*, 113 TC 254, 294 (1999) , *affd* 254 F3d 1313 (11th Cir 2001) ; *Brown v Commr*, 85 TC 968, 1000 (1985) , *affd* sub nom *Sochin v Commr*, 843 F2d 351 (9th Cir 1988) . Since the taxpayer in *New Phoenix* was a corporation, it was not subject to IRC § 165(c)'s requirement that deductible losses of individuals are limited to those incurred either in a trade or business or a transaction entered into for profit (or a casualty loss). See *International Trading Co v Commr* 484 F2d 707 (7th Cir 1973) , *reversing* 57 TC 455 (1971) (In *International Trading*, the Tax Court held in a court-reviewed opinion that although there was no express limitation on the deductibility of corporate losses comparable to IRC § 165(c), IRC § 165 should be read to include an implicit requirement that corporate losses, to be deductible, must be incurred in a trade or business. Calling this judicial legislation, the Court of Appeals reversed and allowed the taxpayer corporation to deduct a loss on sale of nonbusiness property used exclusively for the benefit of its shareholders.) Since the corporation in *New Phoenix* did not incur a real loss, however, it was not necessary for the Tax Court to revisit the issue in *International Trading*, *supra*. See *Rose v*

Commr, 868 F2d 851, 853 (6th Cir 1989) . Cf *Silver Brand Clothes, Inc v US*, 404 F Supp 721 (SD WVa 1975) .

(n18)Footnote 16. See *IRC* § 6664(c)(1) ("No penalty shall be imposed under section 6662 * * * with respect to any portion of an underpayment [of tax] if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion."). See also *US v Boyle*, 469 US 241, 251 (1985) ("When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice.")

(n19)Footnote 17. See also *Maguire Partners-Master Invs, LLC v US*, 2009 US Dist LEXIS 8361, 8369 (CD Cal 2009) . Indeed, the attorney who normally provided legal advice to the taxpayer in *New Phoenix* had expressed serious reservations about the validity of the transactions.

(n20)Footnote 18. See Notice 2000-44, 2002-2 CB 255 .

(n21)Footnote 19. 2009-1 CB 735 .

(n22)Footnote 20. The ruling was prompted by widely reported fraudulent investment schemes perpetrated by confessed swindler Bernard Madoff and others that claimed hundreds if not thousands of victims. See Rev Proc 2009-20, 2009-14 IRB 749 , § 2.01, discussed *infra*; Coder and Young, "IRS Issues Guidance on Losses for Madoff Victims," 122 *Tax Notes* 1422 (March 23, 2009).

(n23)Footnote 21. *Edwards v Bromberg*, 232 F2d 107, 110 (5th Cir 1956) .

(n24)Footnote 22. See also *Vietzke v Commr*, 37 TC 504 (1961) , acq 1962-2 CB 6 ; *Monteleone v Commr*, 34 TC 688, (1960) , acq 1960-2 CB 6 ; *First Chicago Corp v Commr*, TC Memo 1995-109 ; *Rev Rul* 71-381, 1971-2 CB 126 .

(n25)Footnote 23. 61 TC 354 (1973) , *aff'd* 540 F2d 448 (9th Cir 1974) .

(n26)Footnote 24. See *Paine v Commissioner*, 63 TC 736 (1975) , *aff'd without published opinion*, 523 F2d 1053 (5th Cir 1975) ; *MTS International, Inc v Commr*, 169 F3d 1018, 1022 (6th Cir 1999) ; *Marr v Commr*, TC Memo 1995-250 ; *Rev Rul* 77-17, 1977-1 CB 44 ; Chief Counsel Advice Memorandum 200811016 (June 22, 2007). See also *IRS Notice* 2004-27, 2004-1 CB 782 (in which the Service notified taxpayers that it intended to disallow theft loss deductions (and possibly impose penalties under *IRC* § 6662) if such deductions were claimed with respect to open market purchases of stock that subsequently declined in value due to a disclosure of accounting fraud or other illegal misconduct by officers or directors of the corporation that issued the stock.)

(n27)Footnote 25. See *Estate of Melcher v Commr*, 476 F2d 398 (9th Cir 1973) ; *Marine v Commr*, 92 TC 958, 978 (1989) , *aff'd without opinion*, 921 F2d 280 (9th Cir 1991) , *cert denied* 502 US 819 (1991) ("Petitioners received exactly what they bargained for--title to a ... building ... and claims to tax deductions greatly exceeding their cash investment"); *Viehweg v Commr*, 90 TC 1248 (1988) ; *West v Commr*, 88 TC 152 (1987) ; *McCullough v Commr*, TC Memo 1990-653 .

(n28)Footnote 26. See *Nichols v Commr*, 43 TC 842, 886 (1965) , *nonacq* 1970-2 CB xvii and *Rev Rul* 70-333, 1970-1 CB 38 . On the other hand, a theft loss may not be allowed, even if misrepresentations were made, if the taxpayer's conduct demonstrated a "complete indifference to the economic realities" of the transaction (including indifference to the reality of the misrepresented facts). See *Doyle v Commr*, TC Memo 1989-465 . The taxpayer, in other words, must demonstrate actual reliance on false statements to establish a theft loss.

(n29)Footnote 27. See, eg, *Harlan v US*, 160 Ct Cl 209 (1963) (corporation in receivership may recover taxes paid on fraudulently inflated income reported by former owners and managers to allow them to pay dividends on Class A stock and thereby prevent Class A shareholders from obtaining voting control.)

(n30)Footnote 28. See *IRC § 1341* which applies when a taxpayer is required to return an amount that was included in income in a prior year because it appeared that the taxpayer had an unrestricted right to it. The Service found *IRC § 1341* inapplicable because the taxpayer was not required to restore the fictitious income he reported.)

(n31)Footnote 29. *IRC §§ 1311-1314* provides that under enumerated circumstances either the taxpayer or the Service may effectively re-open a closed year to prevent the other party from maintaining inconsistent positions in the open and closed years. The Service concluded that its position allowing the taxpayer a theft loss for the fictitious income in the year of discovery was not inconsistent with its position that the fictitious income was properly reported in the prior years the taxpayer sought to re-open.

(n32)Footnote 30. Legislative relief, perhaps giving taxpayers an extended or unlimited right to recover prior years' taxes on income erroneously overstated due to another's fraud (analogous to the Service's unlimited right to recover understatements of income due to taxpayer fraud, see *IRC § 6501(c)(1)* and (2)), would seem a preferable solution. Whether or not Congress acts, however, it is unlikely that it would change *Rev Rul 2009-9* retroactively. Cf Section 1261 of Title I of Division B of the American Recovery and Reinvestment Act of 2009, Pub L No 111-5, 123 Stat 115 (2009) (making legislative findings that *IRS Notice 2008-83, 2008-2 CB 905*, was "not authorize[d]" and "inconsistent with the congressional intent" yet still refusing to overrule the Notice retroactively "as taxpayers should generally be able to rely on guidance issued by the Secretary of the Treasury." *Notice 2008-83*, issued during the "financial meltdown" of 2008, had declared that banks undergoing an "ownership change" would not be subject to the disallowance of built-in losses under *IRC § 382(h)* with respect to losses on their loans or bad debts.)

(n33)Footnote 31. See *IRC § 1211(b)*, discussed in § 2.06[2][b].

(n34)Footnote 32. *IRC § 165(g)(1)*.

(n35)Footnote 33. *IRC § 166(d)*.

(n36)Footnote 34. See *First Chicago Corp v Commr, TC Memo 1995-109*, where the taxpayer was able not only to transform a capital into an ordinary loss in this fashion, but to accelerate recognition of the loss in doing so.

(n37)Footnote 35. *IRC § 172(d)(4)*.

(n38)Footnote 36. *IRC § 172(b)(1)(F)*.

(n39)Footnote 37. An "eligible small business" for purposes of this provision means any corporation, partnership or sole proprietorship with average annual gross receipts, calculated using a 3 year moving average for all prior years in which it has been in existence, of \$15 million or less. See *IRC §§ 172(b)(1)(H)(iv), 172(b)(1)(F)(iii), and 448(c)*.

(n40)Footnote 38. *IRC § 172(b)(1)(H)*.

(n41)Footnote 39. *IRC § 165(h)(1)*.

(n42)Footnote 40. *IRC § 165(h)(2)*.

(n43)Footnote 41. *IRC § 67*.

(n44)Footnote 42. See *Treas Reg §§ 1.165-8(a)(2)* and *1.165-1(d)(2)*. This longstanding regulation, of undoubted validity, is merely a corollary of the general principle that before any loss may be claimed as a deduction, it must be evidenced by a closed and completed transaction. *US v White Dental Co, 274 US 398, 401 (1927)*; *Boehm v Commr, 326 US 287, 291 (1945)*. "One of the essential inquiries under the 'closed transaction' concept has been whether, in the year the deduction is sought, there existed a substantial possibility that the alleged losses could be recouped by actions against responsible third parties or otherwise." *Ramsay Scarlett and Company, Inc v Commr, 61 TC 795, 807 (1974)*.

(n45)Footnote 43. An example of this dilemma can be found in *Estate of Scofield v Commr*, 266 F2d 154 (6th Cir 1959) , reversing 25 TC 774 (1956) , in which the Tax Court held that the taxpayer had unreasonably delayed claiming an embezzlement loss, first discovered in 1935, until claims against the embezzlers and various third parties were finally resolved, for the most part unsuccessfully, in 1948. At that point the taxpayer was barred from claiming the loss because the year in which the Tax Court thought it should have been claimed, 1935, was by then barred by the statute of limitations. The Court of Appeals for the Sixth Circuit reversed the Tax Court, however, holding that "the only fair test is foresight, not hindsight," and finding the Tax Court's decision had been "clearly erroneous" because the Court of Appeals believed it was made mostly with the benefit of the latter. *Estate of Scofield v Commr*, 266 F2d at 163 .

(n46)Footnote 44. Taxpayers that deduct the entire theft loss in the year of discovery must take any subsequent recovery of the loss into income under the tax benefit rule, to the extent the earlier loss deduction reduced the taxpayer's income tax. See *IRC § 111*; *Treas Reg § 1.165-1(d)(2)(iii)*; *Rev Rul 2009-9* .

(n47)Footnote 45. The Service now apparently agrees with the Court of Appeals in *Estate of Scofield v Commr*, 266 F2d at 159 that "Normally where a taxpayer is in good faith willing to go to the trouble and expense of instituting suit to recoup a...loss, there is as a matter of fact sufficient chance of at least part recovery to justify that taxpayer in deferring a claim of a loss deduction ... until the litigation in question is concluded." But compare *Parmelee Transp Co v US*, 173 Ct Cl 139, 154 (1965) : "The mere existence of a 'possible' claim or pending litigation will not alone warrant postponing loss recognition ... Where the stakes are ... high, a suit may be '100 percent justified' even though the probability of recovery is miniscule ... Analyzing the rule in percentage terms, we would consider a 40 to 50 percent chance of recovery as being 'reasonable.' A lawsuit might well be justified by a 10 percent chance."

(n48)Footnote 46. See, eg, *Vincentini v Commr*, TC Memo 2008-271 .

(n49)Footnote 47. See *Rev Proc 2009-20* , § 5. In addition, the procedure will protect a taxpayer who follows it from audit adjustments challenging the classification of a loss incurred by a victim of a Ponzi scheme as a "theft loss," or challenging the methodology prescribed in the procedure for calculating the amount of the loss. *Rev Proc 2009-20* , § 5. The revenue procedure does not purport to protect the taxpayer from challenges to the factual foundation for the deduction: i.e., whether the taxpayer actually suffered a loss, or the amounts the taxpayer invested or recovered in the fraudulent scheme.

(n50)Footnote 48. *Rev Proc 2009-20* , § 4.01.

(n51)Footnote 49. *Rev Proc 2009-20* , § 4.02(1).

(n52)Footnote 50. *Rev Proc 2009-20* , § 4.02(2).

(n53)Footnote 51. *Rev Proc 2009-20* , § 4.04.

(n54)Footnote 52. *Rev Proc 2009-20* , § 4.03(4). This does not include cash or property transferred by the taxpayer to a fund or other entity (separate from the investor for federal income tax purposes) which invested in the SFA, although the fund or entity itself may be entitled to a deduction that is within the scope of the revenue procedure. *Rev Proc 2009-20* , § 4.04(4).

(n55)Footnote 53. *Rev Proc 2009-20* , § 4.03(2).

(n56)Footnote 54. *Rev Proc 2009-20* , § 4.03(3).

(n57)Footnote 55. *Rev Proc 2009-20* , § 4.06(1). The revenue procedure specifically provides that "qualified investment" does not include any of the following: (1) amounts borrowed from the "responsible group" to the extent the borrowed amounts were not repaid by the time the theft was discovered; (2) fees paid to the "responsible group" that were deducted for federal income tax purposes; (3) amounts reported to the qualified investor by the SFA as taxable

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income that were not included the investor's gross income; or (4) cash or property that the qualified investor invested in a fund or entity which used the cash or property to invest in the SFA. The "responsible group" with respect to an SFA consists of (a) the individual(s) who conducted the SFA, (b) any investment vehicle or other entity that conducted the SFA, including employees, officers or directors, (c) a liquidation, receivership, bankruptcy or similar estate established to recover assets for the benefit of investors and creditors of the SFA, and (d) parties that are subject to claims brought on behalf of such estates. *Rev Proc 2009-20* , § 4.05.

(n58)Footnote 56. *Rev Proc 2009-20* , § 5.02(1).

(n59)Footnote 57. *Rev Proc 2009-20* , §§ 4.10, 4.08 and 4.09.

(n60)Footnote 58. A qualified investor may have income or become entitled to an additional deduction in a year subsequent to the discovery year depending on the actual amount of the loss eventually recovered. *Rev Proc 2009-20* , § 5.03. Although the Service does not say so expressly, presumably the taxpayer will eventually be allowed to recover the 5 percent or 25 percent reduction in the theft loss deduction made pursuant to *Rev Proc 2009-20* , § 5.02(1) by claiming a deduction for that amount in the earliest taxable year in which it becomes clear that no further recoveries will be made (eg, all claims are either abandoned, settled, or otherwise concluded), and the actual loss sustained is greater than the 95 percent or 75 percent claimed in the discovery year pursuant to the revenue procedure. Nothing in *Rev Proc 2009-20* (including the representations the taxpayer is required to make in a statement attached to the return filed for the discovery year (see *Rev Proc 2009-20* , § 6.02, discussed *infra*)) is inconsistent with claiming such an additional deduction in a year subsequent to the discovery year.

(n61)Footnote 59. *Rev Proc 2009-20* , § 8.01.

(n62)Footnote 60. *Id.*

(n63)Footnote 61. *Rev Proc 2009-20* , § 8.02.

(n64)Footnote 1. Installment reporting of losses is not permitted. *Martin v Commr*, 61 F2d 942 (2d Cir 1932) .

A partnership can use the installment method even though one of the partners has a basis in the property greater than the partner's share of the amount realized. That partner will report the entire loss in the year of sale. *Rev Rul 79-92*, 1979-1 CB 180 .

Because of the gain deferral, no bad debt deduction is allowed if the buyer defaults on the installment obligation. *Lombard v Commr*, TC Memo 1994-154 .

(n65)Footnote 2. *IRC § 453(d)(1)*. The election must be made on or before the due date (including extensions) for the filing of the return for the taxable year in which the disposition occurs. *IRC § 453(d)(2)*; *Bolton v Commr*, 92 TC 303 (1989) . The filing of a return reporting all of the gain from the transaction in the year of sale is an effective election out of the installment method. *Temp Reg § 15A.453-1(d)(3)(i)*. Once made, the election can be revoked only with consent. *IRC § 453(d)(3)*.

Permission to revoke an election not to use the installment method was approved in *Ltr Rul 9345027* . The taxpayer's tax return preparer did not realize that the sale was an installment sale, and the revocation was not motivated by a tax avoidance purpose.

The Service will not allow a taxpayer to make a late election out of the installment method if the failure to elect within the prescribed period was due to a change of mind or change of law. See, eg, *Ltr Rul 9413019* . The Service may do so, however, if, after considering all of the relevant facts, a taxpayer's intention to timely elect out of the installment method is thwarted by a mistake and the taxpayer makes a timely effort to correct the mistake. *Rev Rul 90-46*, 1990-1 CB 107 .

See also *Ltr Rul 9218012*, *Ltr Rul 9213003* and *Ltr Rul 9118013*. A late election out of the installment method has been allowed where the delay was due to the failure of a tax return preparer to complete the return on time after assurances that it would be ready by the due date. *Ltr Rul 9145015*.

Effect of election. The Tax Court has concluded that the essence of the election-out procedure requires the taxpayer to report the full amount of the income from an installment sale on the return for the year of sale. *Estate of Wilkinson v Commr, TC Memo 1993-463*.

A cash basis taxpayer electing not to use the installment method will treat as an amount realized in the taxable year of sale the fair market value of the installment obligation. For an accrual method taxpayer eligible to use the installment method, the total amount payable under the obligation is an amount realized in the year of sale. *Temp Reg § 15A.453-1(d)(2)(ii)(A)*.

(n66)Footnote 3. *IRC § 453(b)(1)*.

The Service has ruled that a nonresident alien, who sold property to an unrelated foreign taxpayer and then became a US citizen, does not have to include in income payments received after the seller became a citizen; the taxpayer is deemed to have elected not to report the sale on the installment method. *Ltr Rul 8708002*. The exclusion from income does not extend to interest income received after the taxpayer becomes a resident alien or citizen. *Ltr Rul 9412008*.

(n67)Footnote 4. *IRC § 453(i)*.

(n68)Footnote 5. *IRC § 453(k)(1), (2)(A)*; *Rev Rul 93-84, 1993-2 CB 225*. Regulations can prescribe the extent to which sales of property (other than stock or securities) of a kind regularly traded on an established market will not qualify for the installment method. *IRC § 453(k)(2)(B)*.

See *PLR 9306001* and *PLR 9306003* for examples of the application of *IRC § 453(k)(2)(A)* to stock that is not traded on an established market but is convertible into stock that is.

The prohibition of *IRC § 453(k)(2)(A)* does not extend to unregistered shares of a publicly traded corporation. The shares are restricted from sale on the public market. See, eg, *Ltr Rul 9803022*.

The Service can provide for the application of this rule for transactions in which the rule otherwise would be avoided through the use of related parties, pass-through entities, or intermediaries.

(n69)Footnote 6. *IRC § 453(b)(2)*.

(n70)Footnote 7. *IRC § 453(l)(1)*.

(n71)Footnote 8. *IRC § 453(l)(2)(A)*.

(n72)Footnote 9. *IRC § 453(l)(2)(B)*.

(n73)Footnote 10. *IRC § 453(l)(2)(C)*.

(n74)Footnote 11. *IRC § 453(l)(3)(A)*.

(n75)Footnote 12. *IRC § 453(l)(3)(B)*. The interest is treated as interest for purposes of any interest deduction allowable to the taxpayer for the taxable year. *IRC § 453(l)(3)(C)*.

(n76)Footnote 13. One exception to the general rule regarding evidences of indebtedness is to be found in *IRC § 453(f)(4)* and (5), which treats readily tradable registered or coupon bonds and debt instruments payable on demand as

something other than evidences of indebtedness issued by a purchaser, making the receipt of such instruments a payment. An instrument is deemed to be readily tradable if steps necessary to create a market for it are taken at the time of issuance (or later, if taken pursuant to an expressed or implied agreement or understanding that existed at the time of issuance). *Treas Reg § 15a.453-1(e)(4)(A)*.

An obligation that is not readily tradable but is convertible into publicly traded stock is deemed to be traded on an established securities market if it can be converted without a substantial discount. A substantial discount exists if the stock or obligation into which the installment obligation is convertible is less than 80 percent of the value of the original obligation (determined by taking into account all relevant factors). A substantial discount also exists if the conversion privilege cannot be exercised within a period of one year from the date the obligation is issued. *Treas Reg § 15a.453-1(e)(5)*.

The determination of whether an instrument is payable on demand is a question of state law. *Champy v Commr, TC Memo 1994-355*.

An installment note secured by a standby letter of credit, even one that is collateralized with cash, is not a payment. *Treas Reg § 15a.453-1(b)(5), Ex (7)*.

(n77)Footnote 14. *IRC § 453(c)*. In determining total contract price, that portion of the consideration received in the form of notes or other evidences of indebtedness is taken into account at face value and not fair market value. *Mason v US, 365 F Supp 670 (ND Ill 1973), affd 513 F2d 25 (7th Cir 1975)*.

(n78)Footnote 15. The selling price and contract price will normally be the same. One exception is the sale of mortgaged property, where the total contract price will include the amount of the mortgage only to the extent that it exceeds the basis for the property. *Treas Reg § 1.453-4(c)*.

(n79)Footnote 16. *Jerpe v Commr, 45 BTA 199 (1941), acq 1942-1 CB 9; Rev Rul 72-570, 1972-2 CB 241*. The modification is not considered to be a disposition of an installment obligation.

(n80)Footnote 17. All sales or exchanges that are part of the same transaction or a series of related transactions are treated as one sale or exchange. *IRC § 453A(b)(5)*.

(n81)Footnote 18. Hanna & Olchyk, "Interest Under Section 453A(c): Is It or Isn't It?" *56 Tax Notes 1345 (1992)*.

(n82)Footnote 19. A payment is treated as directly secured by an interest in an installment obligation to the extent an arrangement allows the taxpayer to satisfy all or a portion of the indebtedness with the installment obligation.

(n83)Footnote 20. *Rev Rul 65-155, 1965-1 CB 356*.

(n84)Footnote 21. The provision covers like-kind exchanges (*IRC § 1031*), exchanges of certain insurance policies (*IRC § 1035*), exchanges of stock in the same corporation (*IRC § 1036*, discussed in § 8.07[2]), exchanges of US obligations (*IRC § 1037*, see § 8.07[3]), and to reorganization exchanges governed by *IRC § 356(a)* to the extent the transaction is not treated as a dividend (see § 8.03[1][c][ii]).

(n85)Footnote 22. For this purpose, installment obligations received by an 80-percent controlled subsidiary on the sale of its assets as part of a complete liquidation are treated as acquired by the controlling shareholder. *IRC § 453(h)(1)(E)*.

(n86)Footnote 23. *IRC § 453(h)(2)*.

(n87)Footnote 24. *Treas Reg § 1.453-11(c)(1)*.

(n88)Footnote 25. *Treas Reg § 1.453-11(c)(2)*.

(n89)Footnote 26. *Treas Reg § 1.453-11(b)*.

(n90)Footnote 27. *Treas Reg § 1.453-11(a)(2)(i)*. There is a specific exception for transactions described in *IRC § 453(h)(1)(C)*, where the obligor and the shareholder are related persons.

(n91)Footnote 28. *Treas Reg § 1.453-11(a)(2)(ii)(A)*. The adjusted issue price of the obligation is determined under *Treas Reg § 1.1275-1(b)*. The term "qualified stated interest" is defined in *Treas Reg § 1.1273-1(c)*. Both provisions are discussed in § 17.02A[1].

If the installment obligation is a debt instrument that has unstated interest under *IRC § 483*, the adjusted issue price of the obligation is determined under *Reg §§ 1.446-2(c)* and *(d)*. *IRC § 483* is the subject of § 2.07[1][a].

(n92)Footnote 29. *Treas Reg § 1.453-11(a)(2)(ii)(B)*. See § 17.02A[2][d] for a discussion of variable rate debt instruments.

(n93)Footnote 30. *Treas Reg § 1.453-11(a)(3)*.

(n94)Footnote 31. *Treas Reg § 1.453-11(a)(4)*.

(n95)Footnote 32. *IRC § 453(h)(1)(B)*.

(n96)Footnote 33. *IRC §§ 453(h)(1)(C), 1239(b)*.

(n97)Footnote 34. *IRC § 1239(c)(1)*.

(n98)Footnote 35. *IRC § 453(h)(1)(D)*.

(n99)Footnote 36. *Reg § 1.453-11(c)(5)*.

(n100)Footnote 37. *Treas Reg § 15a.453-1(c)(1)*.

An installment sale calling for payment in foreign currency is a contingent payment sale. Basis is recovered in the same manner as if the agreement provided for payment in United States dollars. *Treas Reg § 15a.453-1(c)(5)*.

An attempt to use the contingent payment sale regulations to secure a tax advantage failed in *ACM Partnership v Commr*, 157 F3d 231 (3d Cir 1998), cert denied, 526 US 1017 (1999) when the transaction was found to lack economic substance. See discussion at § 1.02A[2], *supra*.

The Tax Court initially followed *ACM Partnership* in *Saba Partnership v Commr*, TC Memo 1999-359, but the Court of Appeals for the District of Columbia remanded the case to the Tax Court with instructions to determine whether the tax losses sought by the taxpayer-partners should be disallowed on the ground that the partnerships in *Saba*, like the partnership in *ASA Investerings Partnership v Commr*, 201 F3d 505 (DC Cir 2000), were shams incapable of generating deductible tax losses. *Saba Partnership v Commr*, 273 F3d 1135 (DC Cir 2001). On remand, the Tax Court held that there was no meaningful distinction between the partnerships involved in *Saba* and the one determined to be a sham in *ASA*. The court further held that the partnerships were not organized or operated for a nontax business purpose. *Saba Partnership v Commr* (Supplemental Memorandum Opinion), TC Memo 2003-31.

(n101)Footnote 38. *Treas Reg § 15a.453-1(c)(2)(i)*.

(n102)Footnote 39. A prepayment provision in an otherwise contingent selling price transaction is not a contingency as contemplated by the regulations. Leon H. *Perlin, Inc v Commr*, TC Memo 1993-79.

(n103)Footnote 40. *Treas Reg § 15a.453-1(c)(2)(ii)*.

(n104)Footnote 41. *Treas Reg § 15a.453-1(c)(2)(i)*.

(n105)Footnote 42. *Treas Reg § 15a.453-1(c)(3)(i)*.

(n106)Footnote 43. *Treas Reg § 15a.453-1(c)(4)*.

(n107)Footnote 44. *Treas Reg § 15a.453-1(c)(6)(i)*.

(n108)Footnote 45. *Treas Reg § 15a.453-1(c)(7)(ii)*. The taxpayer must show that the alternative method is a reasonable method of ratably recovering basis, and that, under the method, it is reasonable to conclude that over time the taxpayer will recover basis at a rate twice as fast as the rate at which basis would have been recovered under the otherwise applicable normal basis recovery rule.

An example of the use of an alternative method of basis recovery can be found in *Ltr Rul 9647035*, where 85 percent of the total reasonably expected to be received over a six-year period (including the year of sale) was received as a cash payment on the closing date. The Service concluded that the normal basis recovery rules would substantially and inappropriately defer recovery of basis and, therefore, permitted the taxpayer to allocate 85 percent of the total basis to the year of sale. The remaining basis would be recovered ratably over each year of the five-year contingent payment period. See also *PLR 200036014*, *PLR 199949041* and *PLR 9811039*.

(n109)Footnote 46. *Treas Reg § 15a.453-1(c)(7)(iii)*.

(n110)Footnote 47. *Treas Reg § 1.453-1(b)(2)*; *Temp Reg § 15A.453-1(b)(2)(iii)*; *Robinson v Commr*, 439 F2d 767 (8th Cir 1971). See § 2.07[1][a], *infra*, for a discussion of the operation of *IRC § 483*, and § 17.02[4][c][i], *infra*, for a discussion of *IRC § 1274*.

(n111)Footnote 48. *Riss v Commr*, 368 F2d 965 (10th Cir 1966); *Rev Rul 76-398*, 1976-2 CB 130; *Rev Rul 71-515*, 1971-2 CB 222.

(n112)Footnote 49. *Freeman v Commr*, 303 F2d 580 (8th Cir 1962), *affg* 36 TC 779 (1961).

(n113)Footnote 50. *Wagegro Corp v Commr*, 38 BTA 1225 (1938), *acq* 1939-1 CB 36; *Rev Rul 76-109*, 1976-1 CB 125; *Rev Rul 73-555*, 1973-2 CB 159.

(n114)Footnote 51. *Funsten v Commr*, 44 BTA 1166 (1941), *acq* 1941-2 CB 5. Prior to the sale the purchasers were assured that substantial dividends would be paid in the year of sale and that these dividends would serve as the down payment.

(n115)Footnote 52. *Rev Rul 71-352*, 1971-2 CB 221.

(n116)Footnote 53. *Rev Rul 76-483*, 1976-2 CB 131; *Rev Rul 71-543*, 1971-2 CB 223.

(n117)Footnote 54. *Amsler v Commr*, 39 TC 458 (1962). Where mortgaged property is sold, payment arises only to the extent that the amount assumed exceeds the basis of the property. *Treas Reg § 1.453-4(c)*.

An issue that arose in connection with the former 30 percent year-of-sale maximum was whether the purchaser's payment of any assumed liabilities in the year of sale was to be considered a part of the payments made to the seller in that year. The Tax Court was of the opinion that a payment resulted. *Irwin v Commr*, 45 TC 544 (1966), *revd* 390 F2d 91 (5th Cir 1968); *Horneff v Commr*, 50 TC 63 (1968), *vacated and remanded* 24 AFTR 2d 69-5593 (3d Cir 1969). The Fifth and Ninth Circuits reached the contrary conclusion. *Irwin v Commr*, 390 F2d 91 (5th Cir 1968); *US v Marshall*, 357 F2d 294 (9th Cir 1966). The Internal Revenue took the same position, but held that it did not extend to

situations in which it was evident that the liabilities were incurred for the purpose of avoiding the 30 percent limitation. *Rev Rul 76-109, 1976-1 CB 125* ; *Rev Rul 73-555, 1973-2 CB 159* .

(n118)Footnote 55. The test was developed in *Rushing v Commr, 441 F2d 593 (5th Cir 1971)* .

(n119)Footnote 56. *Rushing v Commr, 441 F2d 593 (5th Cir 1971)* ; *Goodman v Commr, 74 TC 684 (1980)* ; *Roberts v Commr, 71 TC 311 (1978)* ; *affd 643 F2d 654 (9th Cir 1981)* ; *Pityo v Commr, 70 TC 225 (1978)* .

In *Nye v US, 407 F Supp 1345 (MDNC 1975)* , a wife sold stock to her husband who immediately resold the shares. The wife's election of the installment method was upheld over the argument that the husband was merely the wife's agent. The court found an independent purpose in the husband's need to use the proceeds to finance one of his own investments.

(n120)Footnote 57. *Lustgarten v Commr, 71 TC 303 (1978)* , *affd per curiam 639 F2d 1208 (5th Cir 1981)* ; see also *Rev Rul 73-536, 1973-2 CB 158* ; *Rev Rul 73-451, 1973-2 CB 158* ; *Rev Rul 73-157, 1973-1 CB 213* . A sale by a husband to his wife failed to qualify when the court found that the transaction served no purpose other than tax avoidance. *Wrenn v Commr, 67 TC 576 (1976)* .

X, a stock corporation was merged into Y, a mutual savings and loan association. The shareholders of X received cash and certificates of deposit with varying maturity dates. The certificates were subject to restrictions on withdrawal and could not be redeemed prior to the maturity dates. The Service held, in a technical advice, that the transaction did not qualify for installment reporting. The purchase of the certificates of deposit by Y was substantially equivalent to the creation of an escrow for the benefit of the X shareholders. *Ltr Rul 8622002* .

(n121)Footnote 58. *IRC § 453(e)(1), (3)*. The period for assessing a deficiency in tax with respect to a first disposition (to the extent attributable to a resale) does not expire until two years after the date that the initial seller furnishes a notice that the resale has occurred. *IRC § 453(e)(8)*.

The liquidation of a related corporation that purchased stock of another corporation from the taxpayer has the effect of a second disposition for purposes of *IRC § 453(e)*. *Shelton v Commr, 105 TC 114 (1995)* .

(n122)Footnote 59. No matter what the form of disposition any portion of the amount realized attributable to improvements made by the related party is not taken into account. S Rep No 96-1000, 96th Cong, 2d Sess 15 (1980).

(n123)Footnote 60. *IRC § 453(e)(5)*.

(n124)Footnote 61. *IRC § 453(f)(1)*. The option attribution rule of *IRC § 318(a)(4)* is not applicable.

(n125)Footnote 62. The legislative history indicates that the presence of statutory rules will not prevent the Internal Revenue Service from asserting the proper tax treatment of any transaction that is a sham. S Rep No. 96-1000, 96th Cong, 2d Sess 15, 17 (1980).

(n126)Footnote 63. *IRC § 453(f)(2)*.

(n127)Footnote 64. *IRC § 453(e)(2)(A)*.

(n128)Footnote 65. *IRC § 453(e)(2)(B)*. For this purpose a typical close corporation's shareholders' agreement is not to be taken into account. In addition, the holding of an option is not to be considered to have the effect of a substantially diminished risk of loss of the option purchase price is to be determined with reference to the fair market value of the property at the time the option is exercised. S Rep No 96-1000, 96th Cong, 2d Sess 15 (1980).

A cash sale of all of the assets of a corporation whose stock had been sold by the taxpayer to a related corporate

purchaser substantially diminished the purchaser's risk of loss of the stock and suspended the running of the two-year period in *Shelton v Commr*, 105 TC 114 (1995) . The amount received on the sale of the assets was approximately twice as much as the amount due on the installment sale.

(n129)Footnote 66. *IRC § 453(e)(6)(A)*. This recognizes the fact that gain from the sale of a corporation's treasury stock is nontaxable, so that the corporation's basis in the stock is irrelevant. S Rep No 96-1000, 96th Cong, 2d Sess 15 (1980).

(n130)Footnote 67. *IRC § 453(e)(6)(B)*.

(n131)Footnote 68. *IRC § 453(e)(6)(C)*. Generally, it is intended that this exception will apply after the death of either spouse when the spouses hold their interests in the installment obligation or the purchased property as community property or as equal undivided joint interests. S Rep No 96-1000, 96th Cong, 2d Sess 15, 16 (1980).

(n132)Footnote 69. *IRC § 453(e)(7)*. According to Congress, the exception should not apply if the resale terms would permit significant deferral of recognition of gain from the first sale when proceeds from the resale are collected sooner. S Rep No 96-1000, 96th Cong, 2d Sess 15 (1980).

The Tax Court treats the issue as analogous to the exception provided by *IRC § 306(b)(4)* for the disposition or redemption of Section 306 stock. *Tecumseh Corrugated Box Co v Commr*, 94 TC 360 (1990) , *affd* 932 F2d 526 (6th Cir 1991) . See Ch 7.

(n133)Footnote 70. *IRC § 1239(b)*. Indirect ownership is determined under the attribution rules of *IRC §§ 267, 1239(c)(2)*.

IRC § 453(g) also applies to a transaction between two or more partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital or profits interests. *IRC § 453(g)(3)*.

According to the legislative history, the special rule will not apply in the case of a sale between husband and wife if at the time of the installment sale, they are legally separated, or if the installment sale occurs pursuant to a settlement in a proceeding which culminates in a decree of divorce or separate maintenance. In addition, the rule will be inapplicable if no significant tax deferral benefits will be derived from the sale. S Rep No 96-1000, 96th Cong, 2d Sess 15, 17 (1980).

(n134)Footnote 71. *IRC § 453(f)(8)*.

(n135)Footnote 72. *IRC § 453B(a)*. See generally Emory, "Disposition of Installment Obligations: Income Deferral, 'Thou Art Lost and Gone Forever,' " 54 *Iowa L Rev* 945 (1969).

IRC § 453B(a) does not preclude a bad debt deduction under *IRC § 166*, if the debt becomes worthless. *American Offshore, Inc v Commr*, 97 TC 579 (1991) .

The substitution of a new obligor on an installment obligation and an increase in the interest rate thereon is not a satisfaction or disposition of the obligation within the meaning of *IRC § 453B(a)*. *Rev Rul 82-122, 1982-1 CB 80* . The same holds true where the terms of the installment note were modified to defer payment dates and increase the rate of interest. *Rev Rul 68-419, 1968-2 CB 196* .

A substantial increase in the face amount of a note in exchange for the waiver of a right to convert the note into stock of the obligor materially alters the rights of the obligee and constitutes a disposition of the obligation. *Rev Rul 82-188, 1982-2 CB 90* . See also *Ltr Rul 9238005* , where a change in form of the collateral securing the note from stock of a corporation into cash and cash equivalents was held not to be a disposition of the note but, rather, a payment on the note.

A corporation transferred property to a related corporation in return for an installment note. Sometime later, the transferor was liquidated into the transferee and the note extinguished. Although the documents relating to the transfer characterized the transaction as a sale, the Tax Court found that it was a contribution to the capital of an undercapitalized corporation. Thus, the extinguishment of the debt was not a disposition of an installment obligation that produced gain. *LDS, Inc v Commr, TC Memo 1986-293* .

(n136)Footnote 73. *IRC § 453B(a)*.

(n137)Footnote 74. *IRC § 453B(a)*.

(n138)Footnote 75. *Rogers Estate v Commr, 143 F2d 695 (2d Cir 1944)* , *cert denied 323 US 780* .

(n139)Footnote 76. See, eg, *Dessauer v Commr, 449 F2d 562 (8th Cir 1971)* .

(n140)Footnote 77. *IRC § 453B(c)*.

(n141)Footnote 78. *IRC § 691(a)(4)*.

(n142)Footnote 79. *IRC § 453B(g)*.

(n143)Footnote 80. *IRC § 453B(g)*.

(n144)Footnote 81. *IRC § 453B(d)(1)*.

(n145)Footnote 82. See Ch 6.

(n146)Footnote 83. *IRC § 453B(h)*.

(n147)Footnote 84. *Treas Reg § 1.453-9(c)(2)*.

(n148)Footnote 85. *Rev Rul 73-423, 1973-2 CB 161* ; cf *Rev Rul 72-264, 1972-1 CB 131* .

(n149)Footnote 86. *Rev Rul 79-371, 1979-2 CB 294* . The basis of the obligation in the hands of the donee will be increased by the amount of such gain. If the fair market value and the face value of the obligation are equal, there is no room for an adjustment for gift taxes paid with respect to the gift.

(n150)Footnote 87. *Legg v Commr, 57 TC 164 (1972)* , *affd per curiam 469 F2d 1179 (9th Cir 1974)* ; *Rev Rul 76-530, 1976-2 CB 132* .

(n151)Footnote 88. *Rev Rul 76-100, 1976-1 CB 123* ; *Rev Rul 74-613, 1974-2 CB 153* .

(n152)Footnote 89. *IRC § 453B(f)(1)*. If the obligor and obligee are related persons as defined in *IRC § 453(f)(1)*, the fair market value of the obligation cannot be treated as being less than its face value. *IRC § 453B(f)(2)*.

If an installment obligation is transmitted by bequest, devise or inheritance to the obligor or is canceled by a decedent's personal representative, the cancellation will be treated as a transfer by the estate. *IRC § 691(a)(5)(A)*. In the absence of some act of cancellation under local law, the disposition will be deemed to have occurred when the administration of the estate is concluded. If the obligation is held by someone other than the decedent, say a trust, the cancellation will be treated as a transfer by that person immediately after the death of the decedent.

Promissory notes given as part of an installment sale provided for their cancellation if the obligee died before all of the payments were made. The seller's life expectancy at the time of sale exceeded the 20-year payment period, but death

ensued shortly after the transaction. A majority of the Tax Court, in *Estate of Frane v Commr*, 98 TC 341 (1992) , held that the installment obligations were canceled within the meaning of *IRC § 453B(f)*. In so doing, the court rejected the taxpayer's argument that the contingency of death rendered the total price to be paid for the stock contingent, to the end that the seller's death did not work a cancellation of the obligations but rather served to fix the ultimate purchase price. The court also held that the income was reportable on the decedent's final return. The Eighth Circuit agreed that *IRC § 453B(f)* applied to the cancellation, but treated the income as income in respect of a decedent under *§ 691(a)(5)*. The appellate opinion can be found at 998 F2d 567 (8th Cir 1993) .

An open question is whether a cancellation of indebtedness that is treated as a purchase price adjustment under *IRC § 108(e)(5)* is a transaction that requires recognition of gain by the holder of the obligation.

If an installment obligation becomes unenforceable, it will be treated as if it were canceled. *IRC §§ 453B(f)(1), 691(a)(5)(C)*.

An installment obligation provided that all sums due on the note were automatically cancelled at the holder's death. The cancellation produces gain for the estate of the decedent; the gain is treated as income in respect of a decedent. *Rev Rul 86-72, 1986-1 CB 253* .

(n153)Footnote 90. *Rev Rul 74-157, 1974-1 CB 115* .

A liquidating corporation set up several liquidating trusts to distribute corporate assets. Assets transferred to the trust included two installment notes. To minimize the risk of default, the note obligors proposed to modify the terms of the notes to allow payments on the notes with property equal in value to the cash payments required. The former corporate shareholders also proposed allowing the note holders to surrender the notes in exchange for new notes, with the exception that the principal amount and security would be apportioned among separate notes issued, and the maturity dates extended. The Service held, in *Ltr Rul 9819043* , that the rights of the note holders would not be materially altered, resulting in the conclusion that there would not be a disposition of an installment obligation.

(n154)Footnote 91. *IRC § 453B(e)(1)*.

(n155)Footnote 92. *IRC § 453B(e)(2)*.



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CHAPTER 2 Capital Gains and Losses

1-2 Taxation of Securities Transactions 2.syn

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CHAPTER 2 Capital Gains and Losses

1-2 Taxation of Securities Transactions § 2.01

§ 2.01 Introduction

The preceding chapter was concerned with the manner in which gains and losses from the sale or other disposition of property are ascertained. Once that task is completed, the relevant inquiry turns to the character of such gain.

Congress long considered a certain type of gain, long-term capital gain, worthy of special treatment. Taxation of such gain at rates different from those imposed on ordinary income or other manner of gain commenced with passage of the Revenue Act of 1921.ⁿ¹ The purpose of the legislation was to stimulate sales of capital assets which Congress found seriously retarded by the fact that gains accruing over a period of years were taxed in a lump sum in the year of disposition.ⁿ² Although avoidance of the effects of bunched income continues to be one of the arguments advanced for the continued lower rates for capital gains,ⁿ³ it is by no means the sole reason given to justify such treatment.ⁿ⁴

FOOTNOTES:

(n1)Footnote 1. Ch 136, § 206, 42 Stat 232-233.

(n2)Footnote 2. HR Rep No 350, 67th Cong, 1st Sess 10-11 (1921).

(n3)Footnote 3. The report of the House Ways and Means Committee accompanying the Tax Reform Act of 1969, Pub L No 91-172, specifically cites this reason. HR Rep No 91-413 (Pt 1), 91st Cong, 1st Sess 144 (1969).

(n4)Footnote 4. A rather complete list of the arguments for and against capital gains can be found in Blum, "A Handy Summary of the Capital Gains Arguments," 35 Taxes 247 (1957).



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CHAPTER 2 Capital Gains and Losses

1-2 Taxation of Securities Transactions § 2.02

§ 2.02 The Elements of Capital Gain or Loss

In determining the amount of gain or loss realized upon a taxable disposition of property, no consideration need be given to the form of the transaction, the nature of the asset disposed of, or the length of time the asset was held by the taxpayer. Once the transaction is found to be one in which gain or loss is realized, the only questions, aside from that of recognition of gain, revolve around the amount realized and basis. When the inquiry shifts from the determination of the amount of gain or loss to one concerning the character of that gain or loss, the statutory definition of capital gains and losses makes necessary a consideration of the nature of the transaction (whether a sale or exchange, or some other form of disposition), the nature of the asset involved in the transaction (whether capital or noncapital), and the period for which the asset was held by the taxpayer (whether long-term or short-term). A discussion of each of these requirements follows.



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CHAPTER 2 Capital Gains and Losses

1-2 Taxation of Securities Transactions § 2.03

§ 2.03 The Sale or Exchange Requirement

The first requisite of capital gains and losses is that the transaction from which they arise be a sale or exchange. Unless the particular disposition can be so characterized, any gain or loss realized thereon will be taxed at ordinary income rates.ⁿ¹ The problem attending this ingredient of the statutory definition is that while the Code specifically prescribes sale or exchange treatment for certain dispositions which might not otherwise be considered such, the Code does not provide a definition of sale or exchange. The role of classifying transactions has therefore been relegated to the courts, and it is to judicial decision that we must look to determine the content of the term "sale or exchange."

[1] When Is a Disposition a Sale or Exchange.

In deciding that an amount received from an insurance company as compensation for a loss did not derive from the sale or exchange of the destroyed property, the Supreme Court remarked: "[T]he language in the Revenue Act ... is to be given its ordinary meaning, and the words 'sale' and 'exchange' are not to be read any differently."ⁿ¹

Ordinarily, a sale implies a transfer of property for a monetary consideration; and exchange differs only in that the consideration received takes the form of a reciprocal transfer of property other than money. But merely casting the transaction in a sale or exchange mold will not suffice. The form of the transaction must reflect its substance, and if that is not a sale or exchange, capital gains treatment will not be available. Application of this principle is well illustrated by the Tax Court's decision in *Hilton v. Commissioner*.ⁿ² The taxpayer, holder of a \$175,000 note with a low basis, sought to convert the ordinary income which would result from collection in the normal course into capital gain by selling the note to a bank for \$175,000. However, the bank was not permitted by law to lend more than \$100,000. The taxpayer and the bank attempted to circumvent the restriction by arranging for the debtor, a corporation controlled by the taxpayer, to pay \$75,000 to the bank immediately after the purchase. The taxpayer characterized the transaction as a sale of a capital asset for \$175,000. The Commissioner determined that the supposed sale was no more than payment of the note by the debtor, so that any gain realized was ordinary income. The Tax Court found a middle ground--a sale to the extent of \$100,000, with the additional \$75,000 being payment of the note by the debtor to the original holder.

The Tax Court originally held that a gratuitous transfer or surrender of shares to the issuing corporation was not a sale or exchange, and allowed the surrendering shareholder an ordinary loss deduction.ⁿ³ The court reversed its position in *Frantz v. Commissioner*,ⁿ⁴ and disallowed the loss on the ground that it was not authorized by any provision of the Code. Instead, it treated the transaction as a contribution to capital that increased the basis of the taxpayer's remaining

stock. The Sixth Circuit disagreed with that view in *Fink v. Commissioner*,ⁿ⁵ and adopted a fragmented approach rather than a unitary approach to stock ownership to hold that the taxpayers suffered a reduction in their proportionate ownership rights, and, thus, an immediately deductible loss. (The fragmented approach treats every share of stock as a separate investment.) The Supreme Court reversed, and determined that the rule governing contributions to capital applied.ⁿ⁶ It is important to note that *Fink* involved dominant shareholders who did not lose control by reason of the surrender.ⁿ⁷ The Court expressly reserved opinion as to whether a surrender that causes the shareholder to lose control is immediately deductible.ⁿ⁸

Can there be a sale without any shift of risk to the buyer? This was the issue presented to the Supreme Court in *Commissioner v. Brown*,ⁿ⁹ where stock in a closely held corporation was sold to a tax-exempt organization for \$1,300,000, payable within ten years out of the earnings of the company's assets. The agreement between the parties further provided that immediately after transfer the corporation would be liquidated and its assets leased to a new corporation formed and wholly owned by the attorneys for the sellers. The stipulated rental was equal to 80 percent of the new enterprise's operating profit; the payment by the charity to the sellers was fixed at 90 percent of that amount. The purchaser did not have to pay any interest, nor was it obliged to make any payments except from the rental income. If the payments failed to total \$250,000 over any two consecutive years, the sellers could declare the balance due and foreclose on the mortgages securing the assets.

The Commissioner first argued that the transaction (a "boot-strap" sale) lacked economic substance and therefore was a sham.ⁿ¹⁰ He abandoned this contention after the Tax Court found that there had been considerable good faith bargaining at arm's length, and switched his attack to a claim that the transaction did not have the substance of a sale for capital gain purposes because the entire risk of the transaction remained on the sellers.

The Court rejected risk shifting as an essential element of a sale and went on to hold that the transaction in question was a sale. Support for this was found in the basic definition of sale and in the reasonableness of the purchase price in light of the earnings and net worth of the corporation.ⁿ¹¹

With the general principles in mind, we turn to a consideration of some specific situations in which the sale or exchange issue has been posed. Once again, the focus will be on those situations having relevance to the taxation of securities transactions.

[a] Transfers in Satisfaction of a Claim.

[i] From the Standpoint of the Transferor or Debtor. We have previously seen that a transfer of property in satisfaction of a claim against the transferor is a disposition in which gain or loss is realized. We did not, however, determine whether that taxable disposition constitutes an exchange, and that now becomes the relevant inquiry.

In *Kenan v. Commissioner*,ⁿ¹² the Second Circuit placed the "exchange" label on a transfer of appreciated property by a trust to a beneficiary in satisfaction of a fixed obligation due the latter under the terms of the trust indenture. The decision seems, in part, to be based upon equitable considerations. The taxpayer (here the trust) would certainly have been entitled to claim capital gains treatment if it had sold the property and then delivered the proceeds to the beneficiary. The court thought it "extraordinary that the exercise by the trustees of the option to deliver to the legatee securities, rather than cash, should be thought to result in an increased deficiency of enormous proportions."ⁿ¹³

In *Kenan*, the distribution was a mere distribution in kind, i.e., the property transferred did not secure the obligation satisfied. Such dispositions will almost always satisfy the sale and exchange requirement of *IRC Section 1222*.ⁿ¹⁴ But does the same rule obtain when the property transferred secures the debt? The answer to this question depends on the answers to two others: (1) the nature of the transfer, and (2) the nature of the taxpayer's liability.

If the encumbered property is sold as part of a proceeding by the creditor to foreclose his lien, the transfer has

consistently been held to constitute a sale or exchange by the debtor, and hence, the realization by him of capital gain or loss.ⁿ¹⁵ In this regard, whether the debtor be personally liable on the debt or not is unimportant; the result is the same in either case.ⁿ¹⁶

Once the nature of the transfer shifts from involuntary to voluntary, the issue of personal as opposed to nonpersonal liability becomes important. If the obligor is personally liable, then his voluntary transfer of property in discharge of his obligation will be found to be a sale or exchange.ⁿ¹⁷ But where there is no personal liability, so that no consideration is received by the debtor in exchange for his transfer, the courts have generally held that the requisite sale or exchange is absent.ⁿ¹⁸ However, if in addition to the discharge of the debt, the taxpayer were to receive some form of consideration, such as cash, the entire transaction would be deemed an exchange producing capital gain or loss.ⁿ¹⁹

[ii] From the Standpoint of the Transferee or Creditor. Suppose a taxpayer holding a \$10,000 debt obligation collects only \$5,000 of the debt from the debtor. Does he treat his \$5,000 as an ordinary loss or as a capital loss? The general rule insofar as the creditor is concerned, is that payment of the debt by his debtor is not a sale or exchange transaction.ⁿ²⁰ The reasoning of the courts is best illustrated by this language of the Tax Court:

"[I]n their day-to-day transactions, neither businessmen nor lawyers would call the settlement of a judgment a sale; we can see no reason to apply a strained interpretation to the transaction before us."ⁿ²¹

The transaction before the Tax Court was the settlement of a judgment by payment of \$21,150 to persons who had purchased it from the original judgment creditor for an amount less than that paid in settlement. The gain was, therefore, ordinary and not capital.

The underlying premise, that payment does not produce a transfer by the creditor, prevents the finding of a sale or exchange even where the creditor receives property rather than cash in satisfaction of the debt.ⁿ²² That the transaction would be a sale or exchange from the standpoint of the debtor is of no moment.

[b] Liquidated Damages and Other Compromise Settlements. A contract for the sale of stock or other property may often contain a provision calling for the payment of liquidated damages by the purchaser if he should default in performing his part of the bargain. If the breach occurs and the stipulated damages are paid, the seller realizes ordinary income and not capital gains, since the damages would be acquired without the consummation of a sale or exchange. Even a later sale of the property will not infuse the prior transaction with the necessary ingredient of sale or exchange.ⁿ²³

This does not mean that every settlement under a contract of sale will be relegated to the status of ordinary income.ⁿ²⁴ The payments received may qualify for capital gains treatment if the settlement itself takes the form of a sale. This was just the situation presented in *McKean v. Commissioner*.ⁿ²⁵ Under the agreement in that case, the taxpayer advanced money to another in return for which he was to receive an interest in certain stock to be acquired by the other person. After the agreement was breached by the other party's failure to deliver the stock to the taxpayer, the latter commenced an action to compel its delivery. The suit was settled by a cash payment to the taxpayer in exchange for his relinquishment of any interest in the stock. The Tax Court held that this settlement constituted a sale for capital gains purposes. The theory underlying the decision is that while the taxpayer might not have had actual or record title to the property, he did have an economic or equitable interest therein. This rendered the lack of actual physical possession of the stock immaterial.

The settlement producing the compromise payment is issue in *Victor E. Gidwitz Family Trust v. Commissioner*.ⁿ²⁶ was not cast as a sale. Nevertheless, the result was capital gains, not ordinary income. In so decreeing, the Tax Court looked at the nature of the lawsuit which ended in the settlement and payment and saw that it was grounded on the inadequacy of the consideration received by the taxpayer in a merger. The compromise represented additional payment for the original exchange of the taxpayer's shares in the merged corporation.

[2] Statutory Specification of Sale or Exchange.

Congress has determined that certain transactions, which would otherwise fail to qualify as capital transactions for lack of a sale or exchange, should not fall outside the ambit of the capital gain and loss provisions solely for that reason. This action is, in part, an attempt to prevent dissimilar tax consequences in economically similar situations.ⁿ¹ For example, absent a statutory provision to the contrary, retirement of a bond at maturity yields ordinary income, while any gain produced by a sale of that same bond would be taxed at preferential capital gains rates (assuming the bond to be a capital asset in the hands of the bondholder). Equality of result has been achieved through legislative fiat. *IRC Section 1271(a)(1)* deems retirement at maturity an exchange. Conversely, the security-holder who suffered a loss when his securities became worthless would have the advantage of an ordinary loss, and, thus, an offset against ordinary income, while one who realized the same quantum of loss through a sale would be forced to treat his loss as a capital loss. Congress has eliminated this disparity by treating the worthless security loss "as a loss from [a] sale or exchange."ⁿ²

The needed ingredient of sale or exchange has been specifically prescribed for transactions other than those just mentioned. Particularly relevant in connection with the taxation of securities transactions are *IRC Section 301* (nondividend distributions exceeding the taxpayer's basis for his stock); *IRC Sections 302 and 303* (distributions in redemption of stock); and *IRC Section 331* (liquidating distributions). Full coverage of these provisions will be found in the discussion of the transactions to which they relate.

[3] Correlation With a Prior Transaction.

A cardinal principle in the administration of the tax laws is that each taxable year is a separate and distinct unit for tax accounting purposes. This would seem to dictate that each transaction be characterized as capital or ordinary solely by reference to the facts which occur in the year of disposition, and, in general, this is the case. However, on occasion, a transaction taking place in one year may be so related to another, which occurred in a prior year, that the same characterization should be applied to both transactions. In such event, the subsequent transaction will take its character from the earlier one.

Application of this doctrine of relation back is well illustrated by the leading case of *Arrowsmith v. Commissioner*.ⁿ¹ In that case, the taxpayers were required to satisfy a judgment against a corporation whose assets they had received upon the liquidation of the corporation in an earlier year. The Supreme Court denied the taxpayer's claim that the payment gave rise to an ordinary loss deduction, the requisite sale or exchange not being present, and held instead that payment of the judgment in this instance produced a capital loss. The decision was grounded on the fact that the taxpayers' liability was imposed solely because they were transferees of the corporate assets, and that had the corporate liability been satisfied prior to liquidation, the amount of the liquidating distribution and, hence, the gain realized therefrom would have been less. Since the gain occasioned by the liquidation was capital,ⁿ² the Court was of the opinion that the loss should be of a similar nature.

Like reasoning has produced like results. Thus, the Fifth Circuit required a taxpayer that had previously charged off notes as worthless, thereby securing an ordinary deduction, to treat gain realized on a later sale of those notes as ordinary income.ⁿ³ The court reasoned that

"To permit the bank to reduce its ordinary income by the amount of the loss in the first instance, thus gaining a maximum tax advantage on that basis, and then permit it to treat the amount later recovered on the notes as capital gain, taxable on a much lower basis than ordinary income, would afford the taxpayer a tax advantage on the transaction not contemplated by the income tax laws."ⁿ⁴

For some reason, application of the relation-back doctrine has generally produced adverse tax consequences for the taxpayer; gains produced by sales are taxed at ordinary income rates, while payments producing losses in nonsale situations become capital losses.ⁿ⁵ The taxpayer's problem is nowise better pointed up than in the case of a "closed"

contingent consideration sale, i.e., one in which a year-of-sale value is placed upon the right to receive future payments. If the amount actually received exceeds the ascribed value, the excess payment produces ordinary income because of the lack of a sale or exchange.ⁿ⁶ A consistent approach would require that an ultimate loss be afforded the same treatment. However, it has been suggested that a capital loss would result on the theory that the original gain was overstated.ⁿ⁷

An interesting application of the *Arrowsmith* doctrine is presented by *Mitchell v. Commissioner*,ⁿ⁸ where a repayment of "insider" profits,ⁿ⁹ commonly deductible as an ordinary and necessary business expense, was held to give rise to a capital loss. The taxpayer had originally sold his employer's stock at a gain; his "insider" transaction was the purchase of new shares at a lesser price pursuant to the exercise of a restricted stock option. The Sixth Circuit recognized that the taxpayer's repayment was made for business purposes. Nevertheless, the court held that the payment had its inception in the original sale of the employer's stock since, without that sale, there would have been no violation of the "insider" rules.

A contrary view was taken by the Tax Court in *Anderson v. Commissioner*,ⁿ¹⁰ where the taxpayer was allowed to claim the repayment of "insider" profits as an ordinary and necessary business expense. The court rejected the notion that the case was governed by *Mitchell* and concluded that the application of *Arrowsmith* should be limited to situations in which the later transaction is so integrally related to the earlier one that the two must be considered as parts of a unified whole. The Seventh Circuit reversed.ⁿ¹¹ It found the 16(b) payments to be integrally related to the original sale by characterizing the payments as an adjustment of the sales price.

During the period between original decision and reversal by the appellate court, the Tax Court was presented with the same issue in *Cummings v. Commissioner*.ⁿ¹² The court relied on its holding in *Anderson* to reach the result that the taxpayer in *Cummings* was entitled to an ordinary loss deduction.

Following the reversal, the Commissioner asked the Tax Court to reconsider and revise its opinion in *Cummings*. The court refused to do so, holding once again that there was no integral relationship between the sale of the stock and the payment to the corporation.ⁿ¹³ Of importance to the court was the fact that the payment was made without any determination that the taxpayer had violated Section 16(b). This led the Tax Court to the conclusion that the taxpayer had undertaken repayment in order to protect his business reputation.ⁿ¹⁴

The Second Circuit reversed and treated the repayment as a long-term capital loss.ⁿ¹⁵ In the opinion of the majority of the court, the nexus between the Section 16(b) repayment and the earlier gain made *Arrowsmith* applicable. In addition, the court believed that the policy underlying the insider profit rule would be defeated if insiders could reap a tax advantage by enjoying the low capital gains rate on realized gains while obtaining a deduction against ordinary income when they surrendered those gains in satisfaction of a Section 16(b) liability.

Judge Smith concurred in result but not in the rationale of the majority opinion. He would have disallowed the ordinary deduction but not have treated the repayment as a long-term capital loss. Instead, he would have added the repayment to the basis of the repurchased shares. Judge Smith believed that the holding of the majority was proper where the Section 16(b) violation was produced by a purchase and then a sale which resulted in the realization of gain, but did not think that such should be the rule where the violation resulted from a sale and then a repurchase at an amount less than the sale proceeds.

FOOTNOTES:

(n1)Footnote 1. *IRC § 1222(1)-(4)*.

(n2)Footnote 1. *Helvering v William Flaccus Oak Leather Co*, 313 US 247, 249 (1941) .

(n3)Footnote 2. 13 TC 623 (1949) , acq 1950-1 CB 3 ; but cf *Beard v Commr*, 4 TC 756 (1945) , acq 1945 CB 1 ,

where the taxpayer, having a choice between two transactions, bona fide elected the one that produced capital gains.

(n4)Footnote 3. *Smith v Commr*, 66 TC 622 (1976) , *revd sub nom Schleppy v Commr*, 601 F2d 196 (5th Cir 1979) ; *Budd Intl Corp v Commr*, 45 BTA 737 (1941) , *nonacq* 1977-2 CB 2 ; *Miller v Commr*, 45 BTA 292 (1941) , *nonacq* 1977-2 CB 2 .

(n5)Footnote 4. 83 TC 162 (1984) , *affd* 784 F2d 119 (2d Cir 1986) , *cert denied* 483 US 1019 .

(n6)Footnote 5. 789 F2d 427 (6th Cir 1986) , *revg* TC Memo 1984-418 .

(n7)Footnote 6. 483 US 89 (1987) . Schockney, "Commissioner v. Fink: The Final Judgment on Section 165(c)(2) Losses for Non Pro Rata Stock Surrenders," 41 Sw LJ 1243 (1988).

(n8)Footnote 7. The taxpayers conceded that their surrender was motivated by a desire to protect their investment or increase the value of their stock. Otherwise, the surrender would have been treated as a gift. 483 US 89, 97 , N 12 (1987).

(n9)Footnote 8. 483 US 89, 99 , N 15 (1987).

(n10)Footnote 9. 380 US 563 (1965) .

(n11)Footnote 10. An example of a sham "boot-strap" transaction can be found in *Kolkey v Commr*, 27 TC 37 (1956) , *affd* 254 F2d 51 (7th Cir 1958) .

(n12)Footnote 11. A reasonable price and, thus, a sale was found to exist in *Boone v US*, 470 F2d 232 (10th Cir 1972) , and in *Allen v Commr*, TC Memo 1975-39 .

In *Kraut v Commr*, 527 F2d 1014 (2d Cir 1975) , *cert denied* 96 S Ct 2171 (1976) , and *Berenson v Commr*, 507 F2d 262 (2d Cir 1974) , the price to be paid by an exempt organization exceeded the fair market value of the stock. In each case, the portion of the purchase price that would have been paid by a non-exempt purchaser was treated as the amount realized on a sale. The excess was not sale-produced and had to be taxed as ordinary income.

(n13)Footnote 12. 114 F2d 217 (2d Cir 1940) .

(n14)Footnote 13. *Id* at 220-221 .

(n15)Footnote 14. Eg, *Simonson v Commr*, TC Memo 1975-12 (transfer of stock in satisfaction of obligation treated as an exchange).

(n16)Footnote 15. *Helvering v Hammel*, 311 US 504, (1941) .

(n17)Footnote 16. *Commr v Abramson*, 124 F2d 416 (2d Cir 1942) ; *Millar v Commr*, TC Memo 1975-113 , *vacated and remanded* 540 F2d 184 (3d Cir 1976) ; *Rev Rul* 74-301, 1974-1 CB 196 . The remand in *Millar* was for the purpose of having the Tax Court determine whether the initial advance was a loan or a gift. This eliminated any need for the Third Circuit to address the taxpayer's argument that no income results from the foreclosure of property securing a nonrecourse obligation when the property has zero value. The appellate court suggested that the lower court treat this issue if it found the original advance to be a debt. On remand, the Tax Court characterized the advance as a nonrecourse loan and then went on to hold that the taxpayer had gain to the extent the extinguished debt exceeded the adjusted basis of the surrendered stock. In the opinion of the Tax Court, the value of the property was not a factor. However, the court went on to say that it believed the stock to have some value, at least to the one who obtained the stock on foreclosure, because he thereby became sole stockholder of a Subchapter S corporation and would be able to deduct losses which were anticipated. The decision on remand is reported at 67 TC 656 (1977) . The Third Circuit affirmed the decision on remand. 577 F2d 212 (3d Cir 1978) , *cert denied* 439 US 1046 (1978) .

(n18)Footnote 17. *Commr v Green*, 126 F2d 70 (3d Cir 1942) .

(n19)Footnote 18. *Polin v Commr*, 114 F2d 174 (3d Cir 1940) ; *Stokes v Commr*, 124 F2d 335 (3d Cir 1941) ; but cf *Lutz & Schramm Co v Commr*, 1 TC 682 (1943) , *nonacq* 1943 CB 35 , where the Commissioner never put in issue the question of capital gains versus ordinary income.

The voluntary transfer of property to a mortgagee by a mortgagor, who was not personally liable and whose adjusted basis in the property exceeded the amount of the debt, was held to be a sale yielding a capital loss in *Rev Rul 78-164*, 1978-1 CB 264 . In the Service's opinion, there was no warrant for a difference in tax treatment based upon the distinction between voluntary and involuntary conveyances.

(n20)Footnote 19. *Blum v Commr*, 133 F2d 447 (2d Cir 1943) .

(n21)Footnote 20. *Fairbanks v US*, 306 US 436 (1939) ; *Hale v Helvering*, 85 F2d 819 (DC Cir 1939) . The Code provides sale and exchange treatment in a number of instances involving creditors. Eg, *IRC* §§ 165(g), 166(d).

(n22)Footnote 21. *Hudson v Commr*, 20 TC 734, 736 (1953) , *affd sub nom Ogilvie v Commr*, 216 F2d 748 (6th Cir 1954) . *Hudson* was cited in *Nahey v Commr*, 111 TC 256 (1998) , involving the settlement of a lawsuit for breach of contract. The Tax Court held that the proceeds constituted ordinary income, not capital gain; the settlement was not a sale or exchange of property because no property or property rights were transferred. *Nahey* was affirmed by the *Seventh Circuit*. 196 F3d 866 (7th Cir 1999) .

(n23)Footnote 22. *Bingham v Commr*, 105 F2d 971 (2d Cir 1939) ; *Elverson Corp v Commr*, 122 F2d 295 (2d Cir 1941) .

(n24)Footnote 23. *Boatman v Commr*, 32 TC 1188 (1959) ; see also *Handelman v Commr*, 509 F2d 1067 (2d Cir 1975) ; *Mittleman v Commr*, 56 TC 171 (1971) , *affd per curiam* 464 F2d 1393 (3d Cir 1972) ; *Smith v Commr*, 50 TC 273 (1968) , *affd per curiam* 418 F2d 573 (9th Cir 1969) ; *Steel v Commr*, TC Memo 2002-113 ; *Rev Rul 74-251*, 1974-1 CB 234 .

(n25)Footnote 24. A settlement in which the taxpayers gave up their rights to the stock interest to which they were entitled under the terms of the breached agreement was the equivalent of a sale or exchange of a capital asset, and taxed accordingly, in *Denison v Commr*, TC Memo 1977-430 .

A taxpayer realized a short-term loss on the sale of certain stock. Gain produced by the settlement of a suit alleging that the loss resulted from a violation of federal securities laws was taxed as short-term capital gain under the *Arrowsmith* doctrine, discussed in § 2.03[3], *infra*. *Rev Rul 79-278*, 1979-2 CB 302 .

(n26)Footnote 25. 6 TC 757 (1946) ,*acq*, 1946-2 CB 4, 1947-1 CB 3 .

(n27)Footnote 26. 61 TC 664 (1974) .

(n28)Footnote 1. Other reasons have produced statutory sales or exchanges. For example, the desirability of predictable results motivated the mechanical exchange criteria for stock redemptions contained in *IRC* § 302(b). HR Rep No 1337, 83d Cong, 2d Sess, 35 (1954).

(n29)Footnote 2. *IRC* § 165(g). The legislative history of the predecessor of this section can be found in HR Rep No 1860, 75th Cong, 3d Sess, 18-19 (1938).

(n30)Footnote 1. 344 US 6 (1952) . A shareholder of a liquidated corporation incurred a loss when required to make a payment on behalf of the corporation in a year subsequent to the liquidation. Applying *Arrowsmith*, the Service held that the shareholder could claim the amount paid as a capital loss, and to the extent the amount was included in

income in a prior year, compute his tax liability for the year of payment under *IRC § 1341* (the "claim of right" provision). *Rev Rul 78-25, 1978-1 CB 270* .

The *Arrowsmith* doctrine was employed in *Rev Rul 79-278, § 2.03[1], supra* , to characterize a settlement recovery in an action based on a violation of federal securities laws as a short-term capital gain. The taxpayer had realized a short-term capital loss on an earlier sale of stock issued by the defendant.

A recovery of losses was treated as long-term capital gain in *Ltr Rul 200724012* . The original losses were long-term losses.

(n31)Footnote 2. *IRC § 331* prescribes capital gains treatment for liquidations.

(n32)Footnote 3. *Merchants Natl Bank v Commr, 199 F2d 657 (5th Cir 1952)* .

(n33)Footnote 4. *Id at 659* .

(n34)Footnote 5. *Kimbell v US, 364 F Supp 1232 (ND Tex 1973)* , *affd 490 F2d 203 (5th Cir 1974)* , *cert denied 419 US 833* (settlement of lawsuit yielded capital loss; original transaction had produced capital gain).

(n35)Footnote 6. *Osenbach v Commr, 198 F2d 235 (4th Cir 1952)* .

(n36)Footnote 7. Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* 11-13 (5th ed 1987).

(n37)Footnote 8. *428 F2d 259 (6th Cir 1970)* , *cert denied 401 US 909* .

(n38)Footnote 9. Securities Exchange Act of 1934, § 16(b), *15 USC § 78p(b)*. A discussion of the "insider" profits rule can be found in 11A *Business Organizations--Securities Regulation*, Gadsby, *Federal Securities Exchange Act of 1934 § 8.02*.

(n39)Footnote 10. *56 TC 1370 (1971)* .

(n40)Footnote 11. *480 F2d 1304 (7th Cir 1973)* .

(n41)Footnote 12. *60 TC 91 (1973)* .

(n42)Footnote 13. *61 TC 1 (1973)* , *nonacq 1978-2 CB 2* . Since the appeal in *Cummings* would be to the Second Circuit, the Tax Court was not required to follow the decision of the Seventh Circuit.

(n43)Footnote 14. A similar conclusion was reached in *Brown v Commr, TC Memo 1973-275* . The Tenth Circuit applied *Arrowsmith* and reversed, finding the motive for repayment to be irrelevant. *529 F2d 609 (10th Cir 1976)* .

(n44)Footnote 15. *Cummings v Commr, 506 F2d 449 (2d Cir 1974)* , *cert denied, 421 US 913* .



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Taxation of Securities Transactions

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CHAPTER 2 Capital Gains and Losses

1-2 Taxation of Securities Transactions § 2.04

§ 2.04 The Capital Asset Requirement

[1] The Statutory Definition.

Unlike the term "sale or exchange" the second member of the capital gain or loss equation, capital asset, is defined in the Code. In the words of *IRC Section 1221(a)*, "the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business)" with certain specified exceptions which include (1) inventory, stock in trade, or property held primarily for sale to customers, and (2) accounts or notes receivable acquired in the ordinary course of business for services or from the sale of inventory or like property.ⁿ¹

The major issue posed by the statutory language centers on the meaning of the word "primarily" in the phrase, "held primarily for sale to customers." Is the word to be given its dictionary meaning, "principally" or "chiefly," or is the content of the term more nearly akin to "substantially"? Prior to 1966, the problem was often presented by so-called dual purpose cases. For example, a taxpayer constructs housing units which he intends to hold for rental purposes. After some length of time, he decides to sell the property and does so in single parcel units. Resolution of the question of capital gains versus ordinary income depends on a determination of the purpose for which the property was held, whether investment or sale to customers. Courts subscribing to the dual purpose doctrineⁿ² were quick to hold that the property could not qualify as a capital asset if one of the essential or substantial purposes, though not the chief purpose, for holding the property was resale to customers. The contrary view was simply that "we find nothing in the statutes as a whole which manifests any intent on the part of Congress to give the word 'primarily' any meaning different from its plain, usual and well-understood meaning."ⁿ³ The Supreme Court finally rejected the dual purpose test, when it held, in *Malat v. Riddell*,ⁿ⁴ that, "as used in § 1221(1), 'primarily' means 'of first importance' or 'principally.'"ⁿ⁵

The importance of *IRC Section 1221(a)(1)* and the *Malat* case in the area of securities transactions is to be found in the difference in treatment afforded dealers and traders. The dealer, since he holds securities for resale to customers, realizes ordinary income on such sales. The trader, even though he may be engaged in the business of buying and selling securities, is insulated from ordinary income treatment since he has no "customers."ⁿ⁶

Two new exclusions relevant to the taxation of securities transactions were added by the Tax Relief Extension Act. The first, *IRC Section 1221(a)(6)*, excludes from capital asset treatment any commodities derivative financial instrument held by a commodities derivatives dealer, unless (a) it is established to the satisfaction of the Service that the instrument has no connection to the activities of the dealer as a dealer, and (b) the instrument is clearly identified in the dealer's

records as having no such connection before the close of the day on which it was acquired, originated, or entered into (or such other time as regulations prescribe).ⁿ⁷

A commodities derivatives dealer is a person who regularly offers to enter into, assume, offset, assign, or terminate positions in commodities derivative financial instruments with customers in the ordinary course of a trade or business.ⁿ⁸ A commodities derivative financial instrument is defined as any contract or financial instrument with respect to commodities, the value or settlement price of which is calculated by or determined by reference to a specified index.ⁿ⁹ Excluded from the definition of commodities derivative financial instrument is (1) any share of stock in a corporation, (2) a beneficial interest in a partnership or trust, (3) a note, bond, debenture, or other evidence of indebtedness, or (4) any Section 1256 contract.ⁿ¹⁰

The second new exclusion, *IRC Section 1221(a)(7)*, relates to any hedging transaction that is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as regulations prescribe).ⁿ¹¹ For this purpose, a hedging transaction is any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily (i) to manage risk of price changes or currency fluctuations with respect to ordinary property that is held or to be held by the taxpayer, (ii) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or (iii) to manage such other risks that may be prescribed in regulations.ⁿ¹² Notwithstanding *IRC Section 1221(a)(7)*, the Service is directed to prescribe regulations to properly characterize any income, gain, expense or loss arising from a transaction that is a hedging transaction that was not identified as such, or that was so identified but is not a hedging transaction.ⁿ¹³

The Service is required to prescribe regulations that are appropriate to carry out the purposes of the new exclusions in the case of transactions involving related parties.ⁿ¹⁴

[2] Judicial Gloss on the Definition of Capital Asset.

Are all assets held by the taxpayer capital assets unless some specific statutory provision excepts them from such classification? The language of *IRC Section 1221(a)*, namely, "'capital asset' means property held by the taxpayer ... but does not include [listed exceptions]" would seem to indicate an affirmative answer to the foregoing question. Furthermore, the regulations lend strong support to this conclusion by stating, "the term 'capital asset' includes all classes of property not specifically excluded by section 1221."ⁿ¹ Notwithstanding statutory and administrative language to the contrary, the courts have on occasion removed the sale or exchange of an asset, on its face a capital asset, from the scope of capital gains on the ground that Congress did not intend preferential treatment for such transactions.ⁿ²

[a] Transactions Related to the Taxpayer's Business Activity--The Corn Products Doctrine. Seemingly apparent capital assets have not been afforded capital status when the reason for the investment in the assets is very closely related to the profit-making operations of the taxpayer. The factual situation is exemplified by the leading case of *Corn Products Refining Co. v. Commissioner*,ⁿ³ wherein the taxpayer, attempting to insure future deliveries at favorable prices, would purchase commodity futures, take delivery of only those contracts it required for its operations, and sell the remainder. The taxpayer claimed that the transactions in futures were separate from its manufacturing operation, that the futures were capital assets, and that therefore any gain or loss derived from their sale should be characterized as capital gain or loss. The Supreme Court held to the contrary, stating:

"Admittedly, petitioner's corn futures do not come within the literal language of the exceptions set out in [Section 1221]. They were not stock in trade, actual inventory, property held for sale to customers or depreciable property used in a trade or business. But the capital-asset provision of [Section 1221] must not be so broadly applied as to defeat rather than further the purpose of Congress. ... Since this section is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly."ⁿ⁴

For many years, lower courts experienced great difficulty with the Supreme Court's decision in *Corn Products* for, while clearly cutting down the definition of capital asset in transactions integrally related to the gain seeking activity of the taxpayer, it did not set down any criteria for distinguishing business connected purchases from purchases that are not. The effect was to make those courts focus their attention on the taxpayer's motive or purpose in purchasing and holding the asset, and then use this as a foundation for the decision as to the character of the asset. The results may be illustrated by reference to cases involving the purchase of stock or other securities by a taxpayer in order to insure a continued supply of supplies or materials needed in the taxpayer's business, where the courts had been fairly uniform in holding that "stock purchased in the ordinary course of business *where the only purpose is to insure a vital source of inventory* is not a capital asset."ⁿ⁵ Where a substantial investment interest was found, the stock remained within the capital asset sphere, even if the more dominant motive in acquiring the stock may have been source-of-supply or business oriented.ⁿ⁶

The motive test employed by courts in determining capital asset status was held to be irrelevant in *Arkansas Best Corp. v. Commissioner*.ⁿ⁷ An asset will be a capital asset unless it is related to one of the exclusions specified in *IRC Section 1221(a)*. *Corn Products* is still good law, but only for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of *IRC Section 1221(a)(1)*.ⁿ⁸

The holding of *Arkansas Best* is not limited to the inventory exception, although the Service advanced such a position in *Federal National Mortgage Association v. Commissioner*.^{n8.1} Federal National Mortgage Association ("FNMA") was established to provide liquidity to the secondary market for home mortgages. Accordingly, FNMA purchased residential mortgages from mortgage lenders using funds derived from indebtedness issued to the public. The principal factor in determining FNMA's profit or loss was the spread between the average net yield of its mortgage portfolio and the average cost of its outstanding debt.

The manner in which FNMA conducted its business subjected it to the risk that interest rates would rise on the money it had to borrow (interest rate risk). This risk arose in part because the duration of FNMA's portfolio exceeded that of its liabilities. Thus, FNMA faced the risk that its spread would erode when it refunded its debt in carrying its low-yield, long-term mortgages (refinancing risk). One of the ways in which FNMA attempted to manage its interest rate risk was through a hedging program. Each hedge had a direct relationship to an anticipated debenture issuance or to debt issued to purchase mortgages that were subject to commitments; FNMA did not hedge every debenture issuance or mortgage commitments in the years in issue. Because interest rates declined in those years, FNMA suffered hedging losses far in excess of hedging gains. The gains were reported as ordinary income and the losses were claimed as ordinary losses.

After finding that the transactions entered into by FNMA were hedges, the Tax Court was called upon to determine the proper tax treatment of the hedging losses under *IRC Section 1221* (i.e., whether the loss was the consequence of the sale or exchange of a capital asset and, therefore, subject to the limitation on the deduction of capital losses provided in *IRC Section 1211(a)*). In more specific terms, FNMA could prevail only if it could show that the property used in the hedges was excepted from capital treatment under one of the exclusions in *IRC Section 1221*.

FNMA made several arguments in favor of ordinary treatment of its hedging transactions even though the hedges did not fit under any literal application of the statutory exceptions to capital asset treatment found in *IRC Section 1221*. It asserted first that such transactions constituted a nonstatutory exception to capital treatment. Second, it argued that the hedging losses were substitutes for interest expense. Next, it contended that the hedging transactions were an integral part of the system by which FNMA purchased and held mortgages. FNMA's final principal argument was that Congress had implicitly codified ordinary treatment for business hedging gains and losses.

The Commissioner's argument was simple. The property used as hedges had to be treated as capital assets in light of *Arkansas Best*. The hedge positions were property and did not come within any of the exceptions of *IRC Section 1221*. Moreover, she argued that *Arkansas Best* stood for the proposition that property that does not literally come within any

statutory exclusion in *IRC Section 1221* can qualify for ordinary treatment only if (1) it is an integral part of the taxpayer's inventory purchase system, and (2) is capable of treatment as a substitute for inventory.

The Tax Court declined to consider any issue other than whether the hedging transactions were an integral part of the system by which FNMA purchased and held mortgages. It recognized that, while the Supreme Court in *Arkansas Best* concluded that *Corn Products* involved the inventory exception, there was nothing in the *Corn Products* opinion that precluded ordinary treatment for gains and losses that were integrally related to other exceptions in *IRC Section 1221*.

The Tax Court determined that the mortgage notes held by FNMA were notes receivable within the meaning of *IRC Section 1221(a)(4)*, and the hedging transactions in connection with their acquisition were substitutes for the mortgage notes. It concluded that to the extent the mortgages fell within the statutory exception to capital asset treatment specified in *IRC Section 1221(a)(4)*, the taxpayer could rely on the general reasoning of *Arkansas Best* to obtain ordinary treatment for the hedges relating to those assets.

In 1994, the Service issued regulations holding that property that is part of a hedging transaction is not a capital asset; the approach taken in the regulations has been codified generally by the adoption of *IRC § 1221(a)(7)*, discussed in the preceding section.

Regulations governing transactions covered by *IRC Section 1221(a)(7)* were issued in 2002.^{n8,2} The regulations also govern the character of gain or loss from a short sale or option that is part of a hedging transaction.ⁿ⁹ The regulations are exclusive, that is, gain or loss on property, a short sale, or an option is ordinary on the grounds that the property, short sale, or option serves a hedging function *only* if it is part of a hedging transaction as defined in the regulations.ⁿ¹⁰

A "hedging transaction" is a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily: (i) to manage risk of price changes or currency fluctuations with respect to ordinary property that is held or to be held by the taxpayer, (ii) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or (iii) to manage such other risks as the Service may prescribe in regulations.ⁿ¹¹ To enter into a hedging transaction, the taxpayer must have risk when all of its operations are considered, that is, there must be risk on a "macro" basis.ⁿ¹² Nonetheless, a hedge of a single asset or liability will be respected if the hedge reduces the risk attributable to the item or items being hedged and if the hedge is reasonably expected to reduce the overall risk of the taxpayer's operations.ⁿ¹³ If a taxpayer hedges particular assets or liabilities, or groups of assets or liabilities, and the hedge is undertaken as part of a program to reduce the overall risk of the taxpayer's operations, the taxpayer need not show that the hedge reduces its overall risk.ⁿ¹⁴

The regulations recognize that a transaction that economically converts a price from a fixed price to a floating price may reduce risk and be a hedging transaction.ⁿ¹⁵ A transaction that economically converts an interest rate from a fixed rate to a floating rate or from a floating rate to a fixed rate manages risk.^{n15.1} In addition, a written option--a written call option with respect to assets held by a taxpayer, or a written put option with respect to assets to be acquired by a taxpayer--may also reduce risk and be a hedging transaction.ⁿ¹⁶ Finally, a transaction that is entered into primarily to counteract or reverse all or part of the risk reduction effected by one or more hedging transactions will be treated as a hedging transaction.ⁿ¹⁷

The fact that a taxpayer frequently enters into and terminates positions is not relevant in determining whether the transactions are hedging transactions.ⁿ¹⁸ For example, a taxpayer hedging the risk associated with an asset or liability may frequently establish and terminate positions that hedge that risk, depending on the extent the taxpayer wants to be hedged. By the same token, if a taxpayer maintains its level of risk exposure by entering into and terminating a large number of transactions in a single day, the transactions may still qualify as hedging transactions.

If a transaction is not a hedging transaction as defined in the Code and regulations, gain or loss from the transaction is

not made ordinary on the grounds that property involved in the transaction is a surrogate for a noncapital asset, that the transaction serves as insurance against a business risk, that the transaction serves a hedging function, or that the transaction serves a similar function or purpose.ⁿ¹⁹

A hedging transaction also includes a transaction that reduces an aggregate risk of interest rate changes, price changes, and/or currency fluctuations only if all of the risk, or all but *de minimis* amount of the risk, is with respect to ordinary property, ordinary obligations, or borrowings.ⁿ²⁰

Except as otherwise determined in published guidance or private letter ruling, the purchase or sale of a debt instrument, an equity security, or an annuity contract is not a hedging transaction even if the transaction limits or reduces the taxpayer's risk with respect to ordinary property, borrowings, or ordinary obligations.ⁿ²¹ In addition, the Commissioner may determine in published guidance that other transactions are not hedging transactions. Furthermore, the Commissioner may, by published guidance, determine that hedging transactions include transactions entered into to manage risks other than interest rate or price changes or currency fluctuations.^{n21.1}

For purposes of the hedging transaction rules, a transaction is entered into in the normal course of a taxpayer's trade or business if it is in furtherance of that trade or business.ⁿ²² This rule applies even if the risk to be managed relates to the expansion of an existing business or the acquisition of a new trade or business.

A taxpayer that enters into a hedging transaction (including recycling an existing hedge) must identify the transaction as a hedging transaction before the close of the day on which the taxpayer enters into the transaction (same-day identification) and must identify what is being hedged not more than 35 days after the hedging transaction (substantially contemporaneous identification).ⁿ²³ The identification must be made on, and retained as part of, the taxpayer's books and records, and must specify the item, items, or aggregate risk that is being hedged.ⁿ²⁴ In addition, the identification of certain hedging transactions must include the following information:

- (1) If the hedging transaction relates to inventory held or to be held by the taxpayer, the identification must specify the type or class of inventory to which the transaction relates. If the hedging transaction relates to specific purchases or sales, the identification must also include the expected dates of the purchase or sales and the amounts to be purchased or sold.ⁿ²⁵
- (2) If the hedging transaction relates to accruals or payments under an issue of existing debt of the taxpayer, the identification must specify the issue, and if the hedge is for less than the full adjusted issue price or full term of the debt, the identification must specify the amount or period to which the hedging relates.ⁿ²⁶
- (3) If the hedging transaction relates to the expected issuance of debt by the taxpayer or to accruals or payments under debt that is expected to be issued by the taxpayer, the identification must specify the following information: the expected date of issuance of the debt; the expected maturity or maturities; the total expected issue price of the issue; and the expected interest provisions. If the hedge is for less than the entire expected issue price of the debt or the full expected term of the debt, the identification must also include the amount or the term being hedged. The identification may indicate a range of dates, terms, and amounts, rather than specific dates, terms, or amounts.ⁿ²⁷ For example, a taxpayer might identify a transaction as hedging the yield on an anticipated issuance of fixed rate debt during the second half of its fiscal year, with the anticipated amount of the debt between \$75 million and \$125 million, and an anticipated term of 20 to 30 years.
- (4) If the hedging transaction relates to assets to be acquired by the taxpayer, the identification must specify the expected date of acquisition and quantity to be acquired.ⁿ²⁸

(5) If a transaction hedges aggregate risk, the identification must include a description of the risk being hedged and of the hedging program under which the hedging transaction was entered.ⁿ²⁹ This requirement may be met by placing in the taxpayer's records a description of the hedging program and by establishing a system under which individual transactions are identified as being entered pursuant to the program.ⁿ³⁰

The presence or absence of an identification must be unambiguous. The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer's books and records indicate that the identification is also being made for tax purposes. The taxpayer may indicate that individual hedging transactions, or a class or classes of hedging transactions, that are identified for financial accounting or regulatory purposes are also being identified as hedging transactions for purposes of the tax regulations.ⁿ³¹

The taxpayer can separately and explicitly make each identification, or, as long as the identification is unambiguous, establish a system under which the identification is indicated by the type of transaction or by the manner in which the transaction is consummated or recorded.ⁿ³² An identification under this system is made at the later of the time that the system is established or the time that the transaction satisfies the terms of the system by being entered into, or by being consummated or recorded, in the designated fashion. These rules can be illustrated by the following examples:

- (1) A taxpayer can make an identification by designating a hedging transaction for (or by placing it in) an account that has been identified as containing only hedges of a specified item (or of specified items or specified aggregate risk).
- (2) A taxpayer can make an identification by including and retaining in its books and records a statement that designates all future transactions in a specified derivative product as hedges of a specified item, items, or risk.
- (3) A taxpayer can make an identification by placing a designated mark on a record of the transaction (eg, trading ticket, purchase order, or trade confirmation) or by using a designated form or a record that contains a designated legend.ⁿ³³

If the taxpayer identifies a transaction as a hedging transaction, the identification is binding with respect to gain, whether or not all of the identification requirements are satisfied.ⁿ³⁴ Thus, gain from that transaction is ordinary income. If the transaction is not in fact a hedging transaction, the character of loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or purpose.ⁿ³⁵ In other words, the taxpayer's identification of the transaction as a hedging transaction does not itself make loss from the transaction ordinary. If the taxpayer identifies a transaction as a hedging transaction, the character of the gain is determined as if the transaction had not been identified as such if (a) the transaction is not a hedging transaction, (b) the identification of the transaction as a hedging transaction was due to inadvertent error, and (c) all of the taxpayer's transactions in all open years are being treated on either original or, if necessary, amended returns, as transactions that are not hedging transactions.ⁿ³⁶

Conversely, the absence of an identification that meets the requirements set forth generally above *is* binding and establishes that a transaction is not a hedging transaction. This means that, as a general rule, the character of gain or loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or purpose.ⁿ³⁷ However, the taxpayer may treat gain or loss from the transaction as ordinary income or loss if: (a) the transaction is in fact a hedging transaction; (b) the failure to identify the transaction was due to inadvertent error; and (c) all of the taxpayer's hedging transactions in all open years are being treated on either original or, if necessary, amended returns as hedging transactions.ⁿ³⁸

If a taxpayer does not make an identification that satisfies the identification requirements of the regulations, but the taxpayer has no reasonable basis for treating the gain as other than a hedging transaction, gain from the transaction is ordinary.ⁿ³⁹ The reasonableness of the taxpayer's failure to identify the transaction is determined by considering the nature of the transaction as well as the taxpayer's treatment of the transaction for financial accounting or other purposes and the taxpayer's identification of similar transactions as hedging transactions.

The method of accounting used for a hedging transaction must clearly reflect the taxpayer's income.ⁿ⁴⁰ To clearly reflect income, the method used must match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged.

A taxpayer is generally permitted to choose a method of accounting for a particular type of hedging transaction that clearly reflects the taxpayer's income from that type of transaction.ⁿ⁴¹ However, there are guidelines for determining whether a taxpayer's method of accounting with respect to certain hedging transactions meets the clear reflection requirement, namely:

(1) The method of accounting for hedges of aggregate risk must comply with the matching requirements described above.ⁿ⁴² Even though a taxpayer may not be able to associate the hedging transaction with any particular item being hedged, the timing of income, deduction, gain, or loss from the hedging transaction must be matched with the aggregate income, deduction, gain, or loss from the items being hedged.ⁿ⁴³ The following method may be appropriate for taking into account income, deduction, gain or loss from hedges of aggregate risk: (a) The hedging transactions are marked to market at regular intervals for which the taxpayer has the necessary data, but no less frequently than quarterly, and (b) the income, deduction, gain, or loss attributable to the realization or periodic marking to market of hedging transactions is taken into account over the period for which the hedging transactions are intended to reduce risk.ⁿ⁴⁴

(2) In the case of a transaction that hedges an item that is marked to market under the taxpayer's method of accounting, marking the hedge to market clearly reflects income.ⁿ⁴⁵

(3) If a hedging transaction hedges purchases of inventory, gain or loss on the hedging transaction may be taken into account in the same period that it would be taken into account if the gain or loss were treated as an element of the cost of inventory.ⁿ⁴⁶ A transaction that hedges sales of inventory may be accounted for by treating the realized gain or loss on the hedging transaction as if it were an element of the sales price of the inventory. If a hedge is associated with a particular purchase or sales transaction, the gain or loss on the hedge may be taken into account when it would be taken into account if it were an element of the cost incurred in, or sales proceeds from, that transaction. As with hedges of aggregate risk, however, a taxpayer may not be able to associate hedges of inventory purchases or sales with particular purchase or sales transactions. In order to match the timing of aggregate income, deduction, gain, or loss from the hedge with the timing of aggregate income, deduction, gain, or loss from the hedged purchases or sales, it may be appropriate for a taxpayer to account for its hedging transactions by marking to market in the way described above for hedges of aggregate risk, except that the gain or loss that is spread to each period is taken into account when it would be if it were an element of cost incurred (purchase hedges), or an element of proceeds from the sales made (sales hedges), during that period.

Simpler, less precise methods maybe used in appropriate cases where the clear reflection requirement is satisfied.ⁿ⁴⁷ For example: (a) Taking into account realized gains and losses on both hedges of inventory purchases and inventory sales when they would be taken into account if the gains and losses were elements of inventory cost in the period realized may clearly reflect income in some situations, but does not clearly reflect income for a taxpayer that uses the last-in, first-out (LIFO) method of accounting for the

inventory; and (b) marking hedging transactions to market with resulting gain or loss taken into account immediately may clearly reflect income even though the inventory that is being hedged is not marked to market, but only if the inventory is not accounted for under either the LIFO method or the lower-of-cost-or-market method and only if items are held in inventory for short periods of time.

(4) Gain or loss from a transaction that hedges a debt instrument issued or to be issued by a taxpayer, or a debt instrument held or to be held by a taxpayer, must be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates. A hedge of an instrument that provides for interest to be paid at a fixed rate or a qualified floating rate, for example, generally is accounted for using constant yield principles. Thus, assuming that a fixed rate or qualified floating rate instrument remains outstanding, hedging gain or loss is taken into account in the same periods in which it would be taken into account if it adjusted the yield of the instrument over the term to which the hedge relates. For example, gain or loss realized on a transaction that hedged an anticipated borrowing for its entire term is accounted for, for clear reflection purposes, as if it decreased or increased the issue price of the debt instrument.ⁿ⁴⁸

(5) If a notional principal contract hedges a debt instrument, the method of accounting prescribed by the regulations for periodic payments described in *Regulations Section 1.446-3(e)* and for nonperiodic payments described in *Regulations Section 1.446-3(f)(2)(iii)* and (v) will clearly reflect the taxpayer's income.ⁿ⁴⁹ The methods described in *Regulations Section 1.446-3(f)(2)(ii)* and (iv), however, generally do not clearly reflect income in that situation.

(6) If a taxpayer hedges an item and disposes of, or terminates its interest in, the item but does not dispose of or terminate the hedge within a reasonable period, the taxpayer must appropriately match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed or terminated item.ⁿ⁵⁰ To meet this requirement, the taxpayer may mark the hedge to market on the date it disposes of the hedged item. If the taxpayer intends to dispose of the hedging transaction within a reasonable period (generally seven days), however, it may be appropriate to match the realized gain or loss on the hedging transaction with the gain or loss on the disposed item. If the taxpayer intends to dispose of the hedging transaction within a reasonable period and the hedging transaction is not actually disposed of within that period, the taxpayer must match the gain or loss on the hedge at the end of the period with the gain or loss on the disposed item.

(7) If a taxpayer enters into a hedging transaction by recycling a hedge of a particular hedged item to serve as a hedge of a different item, the taxpayer must match the built-in gain or loss at the time of the recycling to the gain or loss on the original hedged item, items or aggregate risk.ⁿ⁵¹ Income, deduction, gain, or loss attributable to the period after the recycling must be matched to the new hedged item, items, or aggregate risk according to the general clear reflection of income principles contained in *Regulations Section 1.446-4(b)*, discussed above.

(8) If a taxpayer enters into a hedging transaction to reduce risk with respect to an anticipated asset acquisition, debt issuance, or obligation, and the anticipated transaction is not consummated, any income, deduction, gain, or loss from the hedging transaction is taken into account when realized.ⁿ⁵² A taxpayer consummates a transaction for purposes of the preceding sentence upon the occurrence (within a reasonable interval around the expected time of the anticipated transaction) of either the anticipated transaction or a different but similar transaction for which the hedge serves to reasonably reduce risk.

The accounting regulations impose additional recordkeeping requirements. The books and records maintained by the taxpayer must contain a description of the accounting method used for each type of hedging transaction and the

description must be sufficient to show how the clear reflection requirement is satisfied.ⁿ⁵³ In addition to the identification requirement of *Regulations Section 1.1221-2(e)* described above, the books and records maintained by the taxpayer must contain whatever more specific identification with respect to a transaction that is necessary to verify the method of accounting used by the taxpayer for the transaction.ⁿ⁵⁴ This additional identification may relate to the hedging transaction or to the item, items, or aggregate risk being hedged.

The Service has issued regulations relating to the character and timing of gain or loss when one member of a consolidated group hedges the risk of another member or enters into a hedge with another member. As a general rule, the regulations adopt a single-entity approach to consolidated groups, applying the hedging rules to a member's transactions that hedge the risk of other members of the same consolidated group. In other words, the risk of one member of a consolidated group is treated as the risk of the other members, as if all of the members of the group were divisions of a single corporation.ⁿ⁵⁵ Thus, if any member of the consolidated group enters into a transaction with an unrelated party that hedges the risk of another member of the group, the transaction potentially qualifies as a hedging transaction.ⁿ⁵⁶ Under the general rule, intercompany transactions are not hedging transactions because they are treated as transactions between divisions of a single corporation and therefore do not reduce the risk of the group.ⁿ⁵⁷

A consolidated group can elect separate-entity treatment of its hedges.ⁿ⁵⁸ If the group makes such an election, the following rules apply:

- (1) the risk of one member is not treated as the risk of other members; and
- (2) an intercompany transaction or obligation is a hedging transaction with respect to a member of a consolidated group if, and only if:
 - (a) the position of the member in the intercompany transaction or obligation would qualify as a hedging transaction with respect to that member if it had entered into the transaction with an unrelated party, and
 - (b) the position of the other member (the marking member) in the transaction is marked to market under the marking member's method of accounting.ⁿ⁵⁹

An intercompany transaction or obligation that is a hedging transaction because it meets the requirements set forth in the preceding sentence, is treated as follows:

- (1) neither the hedging transaction nor any intercompany obligation with respect to that transaction is treated as an intercompany transaction or obligation for purposes of *IRC Section 1502* and the regulations thereunder; and
- (2) the character of the marking member's gain or loss from the transaction is ordinary.ⁿ⁶⁰

The separate-entity election must be made in a separate statement that is filed with the group's consolidated return for the taxable year that includes the first date for which the election is to apply.ⁿ⁶¹ The statement must specify that the election is being made and must indicate the date the election is to be effective. The election applies to all transactions entered into after the effective date. The election cannot be revoked without the consent of the Service.

If a member of a consolidated group hedges the risk of another member under the general rule relating to hedging transactions by consolidated group members, the member entering into the hedging transaction with a third party must identify the transaction as a hedging transaction before the close of the day on which the member enters into the transaction.ⁿ⁶² The member must also identify the item, items, or aggregate risk that is being hedged, even if the item, items, or aggregate risk relates primarily or entirely to other members of the group.ⁿ⁶³ If the members of the group use

intercompany transactions or obligations to transfer risk within the group, the latter requirement may be met by identifying the intercompany transactions or obligations as hedges or hedged items, as appropriate. Because identification of intercompany transactions as a hedge serves solely to identify the hedged item, the identification is timely if met within 35 days after entering into the hedging transaction.ⁿ⁶⁴ Thus, if a member transfers risk in an intercompany transaction, it may identify both its position in that transaction and the item, items, or aggregate risk being hedged. The member that hedges risk outside the group may identify both its position with the third party and its position in the intercompany transaction.

If a consolidated group makes the separate entity election, each member of the group must satisfy identification requirements as though it were not a member of a consolidated group.

The regulations also provide rules with respect to the effects of identification and nonidentification. If a group is under the general rule, the rules of *Regulations Section 1.1221-2(g)* apply to a hedging transaction, but not to intercompany transactions.ⁿ⁶⁵ If a group makes a separate-entity election, the rules of *Regulations Section 1.1221-2(g)* are extended to intercompany transactions that are treated as hedging transactions.ⁿ⁶⁶

If a consolidated group is under the general rule, the timing of income, deduction, gain, or loss must be matched with the timing of income, deduction, gain, or loss from the item or items being hedged rather than with an intercompany transaction.ⁿ⁶⁷ If a consolidated group makes a separate-entity election, each member of the group must account for its hedging transactions (including intercompany transactions that are treated as hedging transactions) in a manner that clearly reflects income without regard to the fact that the taxpayer is a member of a consolidated group.ⁿ⁶⁸

[b] Anticipatory Assignment of Income--The "Sale" of Ordinary Income.

[i] Sale of Stock and Right to Dividend. In the absence of a contrary statutory provision, dividends are includable in the taxpayer's gross income as ordinary income.ⁿ⁶⁹ Can the taxpayer convert the character of income from ordinary to capital merely by selling the underlying stock prior to the time fixed for payment of the dividend? The question cannot be answered without first resolving the question of the taxpayer's right to the dividend at the time of sale. If the sale takes place before the time at which the seller becomes entitled to the dividend (usually the record date), the dividend will not constitute ordinary income to the taxpayer even though the amount received is enhanced by a sum equal to the anticipated dividend.ⁿ⁷⁰ On the other hand, once the taxpayer has succeeded to the right to receive the dividend, he cannot avoid its inclusion in gross income, and any attempt to dispose of his right of receipt through a sale of the stock will fail to change this result.ⁿ⁷¹

[ii] Sale of Bonds With Interest Accrued. The sale price of an interest-bearing bond sold between interest dates normally includes the interest accrued since the last payment date. As in the case of a stock sale, the mere fact that a sale of a capital asset has taken place will not permit the portion of the price attributable to interest to be reported as anything other than ordinary income, even where the seller is a cash basis taxpayer.ⁿ⁷² The balance of the price will constitute the amount realized for the purpose of determining gain or loss from the sale.

FOOTNOTES:

(n1)Footnote 1. Prior to the Economic Recovery Tax Act of 1981, noninterest-bearing government bonds issued at a discount and payable at a fixed maturity date not exceeding one year from issuance were also excluded from the category of capital assets. In *Dial v Commr*, 968 F2d 898 (9th Cir 1992), the taxpayer could not rely on that provision for years prior to 1981 because he traded Treasury bill futures contracts and not the underlying obligations.

(n2)Footnote 2. See, eg, *Rollingwood Corp v Commr*, 190 F2d 263 (9th Cir 1953).

(n3)Footnote 3. *Municipal Bond Corp v Commr*, 341 F2d 683 (8th Cir 1965).

(n4)Footnote 4. 383 US 569 (1966).

(n5)Footnote 5. 383 US at 572 (1966) .

The First Circuit has taken the position that even if "primarily" is defined as "of first importance," the word may still invoke a contrast between sales made in the ordinary course of the taxpayer's business and those that are not. *International Shoe Mach Corp v US*, 491 F2d 157 (1st Cir) , *cert denied*, 419 US 834 .

In *Continental Can Co v US*, 422 F2d 405 (Ct Cl 1970) , *cert denied*, 400 US 819 , the Court of Claims held that the taxpayer realized ordinary income by finding that the taxpayer was engaged in a dual business--selling and renting.

(n6)Footnote 6. See Ch 19.

(n7)Footnote 7. The exclusion applies to any instrument held, acquired, or entered into, and any transaction entered into on or after Dec 17, 1999.

(n8)Footnote 8. IRC § 1221(b)(1)(A).

(n9)Footnote 9. IRC § 1221(b)(1)(B). A specified index is any one or more or any combination of (1) a fixed rate, price, or amount, or (2) a variable rate, price, or amount that is based on any current, objectively determinable financial or economic information with respect to commodities that is not within the control of any of the parties to the transaction or instrument and is not unique to any of the parties' circumstances.

(n10)Footnote 10. Section 1256 contracts are the subject of § 9.02[4][e], *infra* .

(n11)Footnote 11. Regulations issued under IRC § 1221(a)(7) are discussed in the next section.

(n12)Footnote 12. IRC § 1221(b)(2)(A).

(n13)Footnote 13. IRC § 1221(b)(2)(B).

(n14)Footnote 14. IRC § 1221(b)(4).

(n15)Footnote 1. Treas Reg § 1.1221-1(a).

(n16)Footnote 2. The Court of Claims is of the opinion that an essential ingredient of a capital asset is its ability to appreciate or depreciate in value. *Michtom v US*, 573 F2d 58 (Ct Cl 1978) . The Second Circuit finds this position difficult to comprehend. *Lorch v Commr*, 605 F2d 657 (2d Cir 1979) , *cert denied*, 444 US 1076 .

(n17)Footnote 3. 350 US 46 (1955) .

(n18)Footnote 4. 350 US at 51-52 .

(n19)Footnote 5. *Electrical Fittings Corp v Commr*, 33 TC 1026, 1031 (1960) (emphasis supplied). See also *Booth Newspapers, Inc v US*, 303 F2d 916 (Ct Cl 1962) ; *Journal Co v US*, 195 F Supp 434 (ED Wis 1961) ; *Smith & Welton, Inc v US*, 164 F Supp 605 (ED Va 1958) ; *Pumi-Blok Co v Commr*, TC Memo 1972-48 .

(n20)Footnote 6. *Midland Distributors, Inc v US*, 481 F2d 730 (5th Cir 1973) ; *Agway, Inc v US*, 524 F2d 1194 (Ct Cl 1975) ; *Dearborn Co v US*, 444 F2d 1145 (Ct Cl 1971) ; *W W Windle Co v Commr*, 65 TC 694 (1976) , *appeal dismissed* 550 F2d 43 (1st Cir 1976) , *cert denied* 431 US 966 ; Rev Rul 78-94, 1978-2 CB 58 .

(n21)Footnote 7. 485 US 212 (1988) . Source-of-supply cases were not the only ones influenced by *Corn Products*. See, eg, *Schlumberger Technology Corp v US*, 443 F2d 1115 (5th Cir 1971) (stock acquired in order to obtain specialized expertise necessary to computerize taxpayer's business and to aid it in finding markets for its business); *Steadman v Commr*, 424 F2d 1 (6th Cir) , *cert denied*, 400 US 869 (purchase of shares by attorney to protect position as

general counsel); *Union Pacific RR v US*, 524 F2d 1343 (Ct Cl 1975) , *cert denied*, 429 US 827 (corporation's holding in other lines not equity invested capital); *Waterman, Largen & Co v US*, 419 F2d 845 (Ct Cl 1969) , *cert denied*, 400 US 869 (commission agent's purchase of supplier's stock in anticipation of grant of exclusive agency); *Irwin v US*, 401 F Supp 547 (ED La 1975) (purchase only to give sufficient interest in corporation to become attorney for corporation); *Grant v US*, 399 F Supp 79 (ED Ark 1975) (stock in tractor company acquired to obtain benefits and privileges for taxpayer's farming business); *Hagan v US*, 221 F Supp 248 (WD Ark 1963) (purchase of customer's stock in return for agreement by customer to purchase exclusively from taxpayer).

(n22)Footnote 8. See *Dial v Commr*, 968 F2d 898 (9th Cir 1992) , denying an ordinary loss on the sale of Treasury bill futures which the taxpayer claimed were part of hedging transactions; the court held that the statutory exception from capital asset status of any obligation of the US did not apply to such futures.

The taxpayer, in *Pike v US*, 88 F3d 54 (1st Cir 1996) , *cert denied*, 117 S Ct 691 , bought large blocks of stock in various banking institutions in the belief that he could establish a major bank holding company in which others would invest. He sold those shares after their value declined and attempted to claim an ordinary loss on the ground that the stock was the raw material with which he was building the holding company and, thus, sufficient to qualify for the inventory exception. The court rejected this theory and limited the taxpayer to capital loss treatment.

An agricultural cooperative that sold petroleum products to farmers was one of the shareholders in a corporation established to operate an oil refinery. The refinery corporation failed and became bankrupt. The cooperative claimed an ordinary loss on its investment in the refinery. The court found that the transaction was not closely related to the cooperative's inventory-purchase system. In so doing, the court rejected the taxpayer's argument that *Arkansas Best Corp v Commr* did not overrule the source of supply cases decided after *Corn Products. Cenex, Inc v US*, 156 F3d 1377 (Fed Cir 1998) , *cert denied*, 525 US 1146 .

(n23)Footnote 8.1. 100 TC 541 (1993) . In *Davis v Commr*, 119 TC 1 (2002) , the Tax Court held that the right to receive future lottery payments was not a capital asset so that a taxpayer who assigned a right to receive a portion of certain future lottery payments in exchange for a lump sum received ordinary income. The Tax Court adhered to this position in *Clopton v Commr*, TC Memo 2004-95 , *Simpson v Commr*, 2003-155, *Johns v Commr*, 2003-140, and *Boehme v Commr*, TC Memo 2003-81 . The court stated in *Clopton* that it did not have to consider what the result would be if the person who bought the right to the lottery prize then sold it to a third party.

The Ninth Circuit agrees that the sale by the lottery winner produces ordinary income. *US v Maginnis*, 356 F3d 1179 (9th Cir 2004) .

(n24)Footnote 8.2. *Treas Reg § 1.1221-2(a)(1)*. The hedging transaction regulations do not apply to gain or loss realized on an *IRC § 988* transaction as defined in *IRC § 988(c)(1)* or to any qualified fund as defined in *IRC § 988(c)(1)(E)(2)* (see § 20.09, *infra*). *Treas Reg § 1.1221-2(a)(4)*. The regulations are effective March 20, 2002. However, the Service will not challenge any transaction entered into on or after Dec 17, 1999, and before March 20, 2002, that satisfies the provisions of the 1994 regulations or of the 2002 regulations.

(n25)Footnote 9. *Treas Reg § 1.1221-2(a)(2)*.

(n26)Footnote 10. *Treas Reg § 1.1221-2(a)(3)*.

(n27)Footnote 11. *Treas Reg § 1.1221-2(b)*. A transaction that is entered into to reduce a taxpayer's risk manages the taxpayer's risk. *Treas Reg § 1.1221-2(d)(1)(i)*.

If a transaction satisfies the definition of a hedging transaction in *IRC § 1221(b)(2)(A)* and *Treas Reg § 1.1221-2(b)*, the taxpayer must account for the transaction using a method of accounting that is permissible under *Treas Reg § 1.116-4*, even if the taxpayer fails to identify the transaction under *Treas Reg §§ 1.1221-2(f)* and *1.446-4(d)(2)*. If a

taxpayer has used a method of accounting for a type of hedging transaction but, under *Treas Reg* § 1.446-4, that method is impermissible for those transactions, the taxpayer must obtain the Commissioner's consent before changing to a permitted method of accounting. *Rev Rul* 2003-127, 2003-2 CB 1245 .

(n28)Footnote 12. *Treas Reg* § 1.1221-2(d)(1)(ii)(A). Whether a transaction reduces a taxpayer's risk is determined based on all of the facts and circumstances surrounding a taxpayer's business. Whether a transaction manages a taxpayer's risk may be determined on a business unit by business unit basis, provided that the business unit is within a single entity or consolidated return group that adopts the single-entity approach. In general, a taxpayer's hedging strategies and policies as reflected in the taxpayer's minutes or other records are evidence of whether particular transactions reduce the taxpayer's risk. *Treas Reg* § 1.1221-2(c)(4)(i).

A taxpayer may hedge all or any portion of its risk for all or any part of the period during which it is exposed to risk. *Treas Reg* § 1.1221-2(d)(7).

A taxpayer may enter into a hedging transaction by using a position that was a hedge of one asset or liability to hedge another asset or liability (recycling). *Treas Reg* § 1.1221-2(d)(2).

(n29)Footnote 13. *Treas Reg* § 1.1221-2(d)(1)(ii)(A).

(n30)Footnote 14. *Treas Reg* § 1.1221-2(d)(1)(ii)(A).

(n31)Footnote 15. *Treas Reg* § 1.1221-2(d)(1)(iv).

(n32)Footnote 15.1. *Treas Reg* § 1.1221-2(d)(2).

(n33)Footnote 16. *Treas Reg* § 1.1221-2(d)(1)(iii).

(n34)Footnote 17. *Treas Reg* § 1.1221-2(d)(3). For example, if a written option is used to reduce or eliminate the risk reduction obtained from another position such as a purchased option, it may be part of a hedging transaction.

(n35)Footnote 18. *Treas Reg* § 1.1221-2(d)(7)(ii).

(n36)Footnote 19. *Treas Reg* § 1.1221-2(a)(3).

(n37)Footnote 20. *Treas Reg* § 1.1221-2(c)(3).

(n38)Footnote 21. *Treas Reg* § 1.1221-2(c)(5)(i).

(N39)Footnote 21.1. *Treas Reg* § 1.1221-2(d)(7).

(n40)Footnote 22. *Treas Reg* § 1.1221-2(c)(1).

(n41)Footnote 23. *Treas Reg* § 1.1221-2(f)(1), (2). Any identification for purposes of the mark-to-market rules for straddles under *IRC* § 1256(e)(2)(C) is also an identification for purposes of the hedging transaction rules. *Treas Reg* § 1.1221-2(f)(6).

If a transaction satisfies the definition of a hedging transaction in *IRC* § 1221(b)(2)(A) and *Treas Reg* § 1.1221-2(b), the taxpayer must account for the transaction using a method of accounting that is permissible under *Treas Reg* § 1.116-4, even if the taxpayer fails to identify the transaction under *Treas Reg* §§ 1.1221-2(f) and 1.446-4(d)(2). *Rev Rul* 2003-127, 2003-52 IRB 1245 .

(n42)Footnote 24. *Treas Reg* § 1.1221-2(f)(2)(i), (4)(i). Identification of an item being hedged generally involves identifying a transaction that creates risk, and the type of risk that the transaction involves. For example, if the taxpayer

is hedging the price risk with respect to its June purchases of corn inventory, the transaction being hedged is the June purchase of corn and the risk is price movements in the market where the taxpayer buys its corn.

(n43)Footnote 25. *Treas Reg § 1.1221-2(f)(3)(ii)*.

(n44)Footnote 26. *Treas Reg § 1.1221-2(f)(3)(iii)(A)*.

(n45)Footnote 27. *Treas Reg § 1.1221-2(f)(3)(iii)(B)*.

(n46)Footnote 28. *Treas Reg § 1.1221-2(f)(3)(i)*.

(n47)Footnote 29. *Treas Reg § 1.1221-2(f)(3)(iv)(A)*.

(n48)Footnote 30. *Treas Reg § 1.1221-2(f)(3)(iv)(B)*. A description of a hedging program must include an identification of the type of risk being hedged, a description of the type of items giving rise to the risk being aggregated, and sufficient additional information to demonstrate that the program is designed to reduce aggregate risk of the type identified. If the program contains controls on speculation (eg, program limits), the description of the hedging program must also explain how the controls are established, communicated, and implemented.

(n49)Footnote 31. *Treas Reg § 1.1221-2(f)(4)(ii)*.

(n50)Footnote 32. *Treas Reg § 1.1221-2(f)(4)(iii)*.

(n51)Footnote 33. *Treas Reg § 1.1221-2(f)(4)(iv)*.

(n52)Footnote 34. *Treas Reg § 1.1221-2(g)(1)(i)*.

(n53)Footnote 35. *Treas Reg § 1.1221-2(g)(1)(i)*.

(n54)Footnote 36. *Treas Reg § 1.1221-2(g)(1)(ii)*.

(n55)Footnote 37. *Treas Reg § 1.1221-2(g)(2)(i)*.

(n56)Footnote 38. *Treas Reg § 1.1221-2(g)(2)(ii)*.

(n57)Footnote 39. *Treas Reg § 1.1221-2(g)(2)(iii)*.

(n58)Footnote 40. *Treas Reg § 1.446-4(b)*. A taxpayer is not required to account for hedging transactions under the rules set forth in the regulations for any trade or business in which the cash receipts and disbursements method of accounting is used or in which *Treas Reg § 1.471-6* is used for inventory valuations, if, for all prior years ending on or after the date of final regulations, the taxpayer met the \$5 million gross receipts test of *IRC § 448(c)* (or would have met that test if the taxpayer were a corporation or partnership). *Treas Reg § 1.446-4(a)(1)*. (Under the \$5 million gross receipts test of *IRC § 448(c)* for any prior year, a partnership's or corporation's average annual gross receipts for the 3-taxable-year period ending with the prior year must not exceed \$5 million.)

The regulations do not apply to: (i) any transactions governed by *IRC § 475* (the mark-to-market rules for dealers in securities) (see § 18.05, *infra*); (ii) any *IRC § 988* hedging transaction if the transaction is integrated under *Treas Reg § 1.988-5* or if other regulations issued under *IRC § 988* govern when gain or loss from the transaction is taken into account; or (iii) the determination of the issuers' yield on an issue of tax-exempt bonds for purposes of the arbitrage restrictions under *Treas Reg § 1.148-4(h)*. *Treas Reg § 1.446-4(a)(2)*.

(n59)Footnote 41. *Treas Reg § 1.446-4(c)*.

(n60)Footnote 42. *Treas Reg § 1.446-4(e)(1)(i)*.

(n61)Footnote 43. *Treas Reg § 1.446-4(e)(1)(i)*.

(n62)Footnote 44. *Treas Reg § 1.446-4(e)(1)(ii)*.

(n63)Footnote 45. *Treas Reg § 1.446-4(e)(2)*.

(n64)Footnote 46. *Treas Reg § 1.446-4(e)(3)(i)*.

(n65)Footnote 47. *Treas Reg § 1.446-4(e)(3)(ii)*.

(n66)Footnote 48. *Treas Reg § 1.446-4(e)(4)*. Gain or loss realized on a transaction that hedges a contingent payment on a contingent payment debt instrument issued for nonpublicly traded property is taken into account when the contingent payment is taken into account under *Treas Reg § 1.1275-4(c)*, as discussed in § 17.02A[2][b]. In

Rev Rul 2002-71, 2002-2 CB 763, the taxpayer issues a ten-year debt instrument that provides for interest to be paid annually at a fixed rate. Contemporaneously, the taxpayer enters into a notional principal contract with a five-year term, that converts the fixed rate payments under the debt instrument into floating rate payments. This permits the taxpayer to receive payments equal to the product of the fixed rate on the debt instrument and a notional amount equal to the principal amount of the debt instrument in exchange for payments by the taxpayer equal to the product of the floating rate and the same notional amount. The taxpayer properly identifies the notional principal contract as a hedging transaction covering the first five years of the debt instrument. The taxpayer terminates the notional principal contract on the last day of the second year and either receives or makes a termination payment.

The situation in *Rev Rul 2002-71* is different from the hedging transaction described in *Treas Reg § 1.446-4(e)(4)* in that it does not hedge the fixed rate borrowing over the entire term of the debt instrument. Instead, the taxpayer's notional principal contract hedges and relates only to the first five years of the debt instrument. Prior to its termination the notional principal contract would have continued to hedge three more years of the debt instrument and the taxpayer would have been required to take into account the remaining income, deduction, gain, or loss over those three years. The termination payment made or received by the taxpayer represents the present value of the extinguished rights and obligations under the notional principal contract for the last three years. To clearly reflect income, the taxpayer must take into account the gain or loss from terminating the notional principal contract over the remaining three-year period.

If the taxpayer retired the debt instrument at the end of the fourth year, the taxpayer would have already taken into account in the third year a portion of the gain or loss resulting from the termination of the notional principal contract. The taxpayer would then take into account in the fourth year the remaining balance of the gain or loss from the terminated hedge.

(n67)Footnote 49. *Treas Reg § 1.446-4(e)(5)*. The accounting rules for notional principal contracts are discussed in § 9A.03, *infra*.

(n68)Footnote 50. *Treas Reg § 1.446-4(e)(6)*.

(n69)Footnote 51. *Treas Reg § 1.446-4(e)(7)*.

(n70)Footnote 52. *Treas Reg § 1.446-4(e)(8)*.

(n71)Footnote 53. *Treas Reg § 1.446-4(d)(1)*.

(n72)Footnote 54. *Treas Reg § 1.446-4(d)(2)*.

(n73)Footnote 55. *Treas Reg* §§ 1.446-4(e)(9), 1.1221-2(e)(1).

(n74)Footnote 56. *Treas Reg* § 1.1221-2(e)(1).

(n75)Footnote 57. *Treas Reg* § 1.1221-2(e)(1).

(n76)Footnote 58. *Treas Reg* § 1.1221-2(e)(2).

(n77)Footnote 59. *Treas Reg* § 1.1221-2(e)(2)(i), (ii). If an intercompany transaction is entered into with a member that does not mark to market, the transaction is subject to the intercompany transaction rules of *IRC* § 1502. This means that the separate-entity election is likely to be made only by a group whose intercompany hedging activity is done with a member that uses a mark-to-market accounting method.

(n78)Footnote 60. *Treas Reg* § 1.1221-2(e)(iii).

(n79)Footnote 61. *Treas Reg* § 1.1221-2(e)(iv).

(n80)Footnote 62. *Treas Reg* § 1.1221-2(f)(1), (5)(i).

(n81)Footnote 63. *Treas Reg* § 1.1221-2(f)(2)(i), (5)(i).

(n82)Footnote 64. *Treas Reg* § 1.1221-2(f)(2)(ii), (5)(i).

(n83)Footnote 65. *Treas Reg* § 1.1221-2(g)(3)(i).

(n84)Footnote 66. *Treas Reg* § 1.1221-2(g)(3)(ii).

(n85)Footnote 67. *Treas Reg* § 1.446-4(e)(9)(i).

(n86)Footnote 68. *Treas Reg* § 1.446-4(e)(9)(ii).

(n87)Footnote 69. *IRC* § 61(a)(7). An example of an express exception to ordinary income treatment is the capital gains dividend paid by a regulated investment company. See Ch 12.

(n88)Footnote 70. *Treas Reg* § 1.61-9(c).

(n89)Footnote 71. *Treas Reg* § 1.61-9(c); *Rhodes' Estate v Commr*, 131 F2d 50 (6th Cir 1942) .

(n90)Footnote 72. *Treas Reg* § 1.61-7(d). As noted below, at § 2.07[1], this is true whether the accrued interest is stated or imputed. See *IRC* §§ 1274 and 483.



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Taxation of Securities Transactions

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CHAPTER 2 Capital Gains and Losses

1-2 Taxation of Securities Transactions § 2.05

§ 2.05 Holding Period

The final element of the capital gain or loss equation, the holding period, plays no part in differentiating capital transactions from those which result in ordinary income or loss. Its sole function lies in determining whether gain or loss, previously found entitled to capital status, is to be denominated long-term or short-term gain or loss.

[1] Measuring the Holding Period of a Capital Asset.

[a] The Mechanics of Measurement. Whether long-term capital gain or loss is realized depends upon the date that the capital asset forming the subject of the requisite sale or exchange was acquired. Long-term gain or loss requires a holding period of more than one year.ⁿ¹ Any lesser holding period produces short-term gain or loss.ⁿ²

Computation of the critical period is not as simple as the definition would have it appear. The first concern is to fix the starting and ending dates of the holding period. While it might seem that holding period of an asset should begin on the date of acquisition, the first day of the period is the day following acquisition. On the other hand, the date of disposition is included within the prescribed period.ⁿ³ Therefore, gain or loss from the sale of capital asset purchased on February 15, 1997 will be long-term only if sold on or after February 16, 1998.

[b] Fixing the Beginning and End of the Period.

Of critical importance in measuring the period for which property has been "held" is the determination of the dates on which the period begins and ends. In a 1935 decision, the Supreme Court set forth the following rule for fixing the opening of the period:

"In common understanding, to hold property is to own it. In order to own or hold one must acquire. The date of acquisition is, then, that from which to compute the duration of ownership or the length of holding."ⁿ⁴

Thus, the measuring process becomes one of ascertaining, first, the date on which ownership of the property was obtained and, then, the date when ownership ceased. Here the concept of ownership is governed by applicable state law so that, normally, the controlling factor will be transfer of title.ⁿ⁵ Ordinarily the transfer of title test will pose no problem, since title will be acquired on the date of purchase and disposed of on the date of sale. But what result obtains

when the date on which the transaction is executed is not the date of actual delivery? It is to this uncommon state of facts that we now turn.

[i] Securities Traded on an Exchange. When securities are traded on an organized exchange, execution of the purchase or sale is accomplished on one day, and payment and delivery on another, some days later.ⁿ⁶ For holding period purposes, the commencement date is the date of execution of the purchase order, and not the date of payment or actual physical acquisition of the securities. Similarly, the period ends with the date of sale rather than with the subsequent delivery date.ⁿ⁷

The result seems consistent with the passage of title test if that concept is not limited solely to transfer of possession. Under exchange rules, execution of the purchase order seals the rights and duties of the buyer and seller, thereby producing as effective a change in ownership as would be accomplished by actual delivery and passage of legal title.

[ii] Escrow Transactions. Further problems are presented when the transaction involves an escrow deposit. Basically, the escrow agreement calls for the delivery of the subject matter of the transaction, or the price to be paid therefore, or both, to a third party, to be held by him until the occurrence of certain specified events. Such an arrangement suggests a number of choices for the pivotal date, namely, the date of delivery to the escrow agent, the date of delivery by him, or perhaps some date falling between the two.

Once again, transfer of title controls, but an oft-found problem in escrow transactions lies in fixing the date when title passes. Illustrative of the difficulty which may be encountered is the transaction in *First American National Bank v. United States*.ⁿ⁸ There, a contract dated September 7, 1956 called for an escrow deposit of all of the subject stock and one-half of the purchase price until January 4, 1957, the date fixed for closing and payment of the balance of the price. The purchaser was given proxies to vote the escrowed stock, the right to receive at the closing any stock dividends accruing on the escrowed stock, and the right to cancel if the corporation's management did any of certain specified things within a set period of time without the purchaser's permission. The Commissioner claimed that the stock was disposed of on September 7, 1956, the date of contract. This would have resulted in a holding period of less than six months. The taxpayers contended that the sale took place in 1957, at the time possession of the stock was transferred from the escrow agent to the purchaser.

The court determined that both legal and equitable title passed on the date of transfer of possession, since prior to that time there had not been the degree of performance of conditions precedent necessary to impose upon the purchaser an unconditional duty to pay. The court read the contract as one that imposed a duty to pay only upon actual delivery, and not a duty to pay a debt in the future for a completed sale. This conclusion rested on the fact that, except for the voting proxy, no incidents of ownership passed to the purchaser until closing. Since the buyer's duty remained conditional until closing, the sellers "held" the stock until that date.

The situation in *First American National Bank* should be distinguished from the completed sale, where a deposit escrow serves the sole function of security for deferred payment of the purchase price. In such a case, neither the escrow nor the deferral of payments to the future affects the unconditional nature of the promise to pay.ⁿ⁹

[2] Holding Period in Specific Situations.ⁿ¹

[a] Property Received From a Decedent. It will be remembered that the basis of property acquired by inheritance, bequest, or devise from a decedent is fixed by reference to the fair market value of the property at death or at the alternate valuation date. What is the first day of the holding period of taxpayer who acquires such property? Two possible acquisition dates are suggested: (1) the date of decedent's death, and (2) the date of actual receipt by the legatee. Prior to 1935, a split of authority existed, the Board of Tax Appealsⁿ² and four Courts of Appealsⁿ³ sustaining the Commissioner's position that the beneficiary's holding period began with the date of distribution, while the First Circuit took the view that his holding period started at the date of decedent's death.ⁿ⁴ The conflict brought a grant of certiorari by the Supreme Court.

In *McFeely v. Commissioner*,ⁿ⁵ a decision to which Justices Brandeis, Stone, and Cardozo dissented, the Court equated the statutory word "held" with "acquired." Having done so, it was a simple step to conclude that the beneficiary's holding period began on the date of death, since, in contemplation of law, one deriving property through devise, bequest, or intestacy acquires such property upon the decedent's death.ⁿ⁶

In *McFeely*, all of the acquired property had been owned by the decedent. Less than six years later, the Court was called upon to decide if the theory underlying the *McFeely* decision should be applied with equal force in the instance where the distributed property had been purchased by the fiduciary and not owned by the decedent at his death. In deciding that the taxpayer's holding period began with the date of purchase, the Court wrote in *Helvering v. Gambrill*:ⁿ⁷

"[P]roperty held by the taxpayer' ... embraces not only full ownership but also any interest whether vested, contingent, or conditional. ... Hence, as in *McFeely v. Commissioner, supra*, we look to the time when the taxpayer first acquired the interest which later ripened into full ownership."

The rationale of *McFeely* and *Helvering v. Gambrill* requires that the holding period of property received upon the distribution of a trust, whether testamentary or inter vivos, be traced back to the time of acquisition by the trust. Indeed, the taxpayer in *Helvering v. Gambrill* actually acquired the property as the result of the termination of a trust rather than the closing of an estate.

It must be kept in mind that the rules announced in *McFeely* and *Helvering v. Gambrill* do not reach every item of property acquired from a decedent, but only those acquired by devise or bequest of the subject property, by satisfaction of a residuary legacy, or by intestacy. Not reached is property distributed to a beneficiary in satisfaction of a pecuniary or fixed-dollar legacy. In such cases, the beneficiary is deemed to acquire the property by purchase from the estate, causing his holding period to commence with the date of distribution. The result is not at odds with *McFeely* or *Helvering v. Gambrill* since the beneficiary acquires no interest--vested, contingent, or conditional--prior to the date on which he accepts the property in satisfaction of his claim.

A special holding period provision, *IRC Section 1223(10)*, creates a long-term holding period where one does not actually exist. Under that subsection, a person acquiring property from a decedent, or to whom property passed from a decedent, is treated as having held the property for more than one year even if the property is sold within one year after the decedent's death.ⁿ⁸ Of course, if the property is retained for more than one year after the decedent's death, the holding period is automatically long-term. The provision was enacted as part of the legislation which changed the due date of estate tax returns from fifteen months after death to nine months after death; it is intended to mitigate the adverse tax consequences which could result if a sale shortly after death was required to raise the funds needed to pay the tax.

[b] Tacking--Acquiring an Added Holding Period.

Under rules prescribed by *IRC Section 1223*, there may be added to the taxpayer's normal holding period the time during which the property was held by another, or, perhaps, the time that the taxpayer held certain other property. In general, the situations calling for tacking are those in which the taxpayer acquires a substituted basis, that is, a basis determined by reference to the basis of the property in the hands of the person from whom it was acquired, or by reference to the basis of property for which it was exchanged.

[i] Property Acquired by Gift. We have seen previously that the donee of a gift of property assumes a basis in the property equal to that of the donor, adjusted for the amount of gift tax paid with respect to the gift.ⁿ⁹ Since the property has "for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of [any other person]"ⁿ¹⁰ the donee is permitted to add the donor's holding period for the property to his own. (Transfers between spouses governed by *IRC Section 1041* are gifts for holding period

purposes.ⁿ¹¹ The fact that basis is increased by the amount of gift tax paid does not destroy the ability to tack, for the statute requires no more than a substituted basis *in part*, and that condition is certainly met.

Suppose, however, the taxpayer receives property which has a time-of-gift value less than the transferor's basis, and therefore must employ fair market value as his basis for determining loss. If the taxpayer does sell at a loss, will his holding period include that of the donor, or will it commence with the taxpayer's acquisition? The issue comes down to one of statutory construction. *IRC Section 1223(2)* calls for tacking when substituted basis provides the basis for "determining gain or loss." The construction question revolves around the word "or." If the Code is to be read as permitting tacking only when the basis involved in the specific computation is a substituted basis, then clearly tacking would not be permitted if value serves as the basis for loss purposes. If, however, the intention of the statute is to prescribe tacking when either the basis for gain or the basis for loss is determined by reference to the basis in the hands of another person, then the taxpayer must add the prior owner's holding period to his. In 1941, the Service opted for the first construction.ⁿ¹² Its theory was simply that since the donee does not use the donor's basis for determining loss, the ability to tack is eliminated. The Government's position has never been challenged in any litigation, and probably never will be, for it works to the benefit of taxpayers by changing into short-term losses those which would be long-term if tacking were required. In 1969,

*Revenue Ruling 69-43*ⁿ¹³ declared the ruling obsolete and no longer determinative with respect to future transactions. However, this declaration has probably not brought any change in Internal Revenue Service position since it is also contained in a subsequent ruling which is not obsolete.ⁿ¹⁴

Holding *IRC Section 1223(2)* inapplicable when the basis employed in a particular transaction is other than a substituted basis is consistent with the normal basis-holding period partnership, that is, a new basis mandates a new holding period with the same date serving as basis valuation date and the date from which ownership is measured. There is, though, one instance in which the two dates do not coincide, and that is when a gift of property is found to have been in contemplation of death. The basis of the property in such case is its fair market value on the decedent's death, assuming the property was still then held by the donee.ⁿ¹⁵ The donee's holding period, on the other hand, begins, not with the decedent's death, but with actual acquisition by him.ⁿ¹⁶

[ii] Property Acquired in a Tax-Free Exchange. Congress has determined, as a matter of policy, that gain or loss realized from certain transactions should not be recognized. The legislative attitude rests in large measure on the notion that the exchange produces a change solely in the form of the investment, and that no tax should be imposed until the occurrence of an event which results in a change in the substance thereof. The interrelation of nonrecognition with basis and holding period may be illustrated by the exchange of common stock for other common stock of the same corporation. *IRC Section 1036* provides that any gain or loss realized on such an exchange shall not be recognized. Consistent with the sense of mere formal change is the requirement that the taxpayer carry over to the new common stock his basis in the old.ⁿ¹⁷ Equally consistent is the addition of the holding period of the property exchanged to the holding period of the property acquired, provided the asset exchanged is a capital asset or a Section 1231 asset.ⁿ¹⁸

Because *IRC Section 1223(1)* allows tacking only when the acquired property assumes a substituted basis, some of the property received in an exchange may take a tacked holding period while other property received in the same exchange may have a holding period which commences with the exchange. For example, if, in the exchange described in the preceding paragraph, the taxpayer receives not only common stock; but also other property which cannot be received without the recognition of gain or loss, the basis of the property exchanged (after adjustment as set forth in *IRC Section 1031(d)*) still furnishes the basis for the property received, but now an allocation is required. The prescribed method of allocation assigns to the recognition property an amount equal to its fair market value at the time of the exchange.ⁿ¹⁹ Thus, since the basis of the other property is determined by reference to fair market value, its holding period must commence with acquisition. The nonrecognition property takes the remainder of the available basis as well as a holding period which includes the time for which the property exchanged was held.

It is also possible to find a single piece of property with a split holding period. Typical of the facts producing this situation are those considered in *Revenue Ruling 62-140*,ⁿ²⁰ where the taxpayer obtained a share of common stock through the exercise of a conversion privilege contained in a debenture issued by the same corporation, accompanied by payment of \$50. The Service held that (1) the surrender of the debenture and the receipt of stock constituted a nonrecognition transaction, and (2) the share of stock had a split holding period. The part attributable to the surrender of the debenture would include the period of ownership of the debenture. The portion attributable to the \$50 payment would have a new holding period. The end of such a split holding period could see the realization of both long-term and short-term gain or loss from the single disposition of a single piece of property.

[iii] Property Acquired Through the Exercise of an Option or Rights. Suppose that a taxpayer acquires an option to purchase stock on January 15, 2000, exercises it on July 30, 2001, and then sells the acquired stock on February 1, 2002. It is easily ascertained that had the stock been acquired other than by the exercise of the option, the gain would be short-term gain, and that had the option been sold on the date of exercise, the gain arising therefrom would be long-term. The question presented is whether the period during which the option was held may be added to the holding period of the stock. Since the Code does not contain any provision specifically permitting tacking when an option is exercised, the right to tack must, of necessity, be founded on the theory that the stock was "acquired" on the date the option was acquired, a theory which the Supreme Court has refused to accept.ⁿ²¹ Thus, as in the case of a normal purchase, the holding period of stock obtained through the exercise of an option commences on the day following acquisition.ⁿ²²

The Code permits one slight exception to the normal rule--when stock or securities are acquired through the exercise of rights issued by the corporation whose stock is acquired. In such case, the holding period of the stock or securities begins with the date on which the rights are exercised.ⁿ²³ The provision, first enacted in 1942, came into the law as a result of congressional reaction to the administrative difficulties inherent in the rule developed by the courts which prescribed (1) tacking to the extent that the stock right element was represented in the new stock, and (2) no tacking as to the portion of the new stock representing the subscription price element.ⁿ²⁴ While it is clear that Congress intended to change the then-obtaining rule, it is not clear whether it intended to provide stock acquired through the exercise of rights with a holding period commencement date different from that of stock acquired through other options.ⁿ²⁵ Nonetheless, that is the mandate of *IRC Section 1223(6)*.

[iv] Qualified Small Business Stock Acquired in a Rollover. *IRC Section 1045* provides for a tax-free rollover of gain from the sale of qualified small business stock if certain conditions are met.ⁿ²⁶ The holding period of the qualified small business stock that was acquired in the rollover transaction includes the period for which the stock sold was held.ⁿ²⁷

[v] Securities Acquired in Satisfaction of a Securities Futures Contract. *IRC Section 1223(15)* provides that, if a security to which a securities future contract (other than a Section 1256 contract) relates is acquired in satisfaction of the contract, the holding period of the security includes the taxpayer's holding period for the contract if the contract was a capital asset in the hands of the taxpayer.

FOOTNOTES:

(n1)Footnote 1. *IRC § 1222(3), (4)*.

(n2)Footnote 2. *IRC § 1222(1), (2)*.

(n3)Footnote 3. *Fogel v Commr, 203 F2d 347 (5th Cir 1953)* ; *Rev Rul 66-97, 1966-1 CB 190* . The running of the period is unaffected by intervening holidays. *Rev Rul 70-598, 1970-2 CB 168* .

(n4)Footnote 4. *McFeely v Commr, 296 US 102, 107 (1935)* .

Where the sale of Treasury securities is subject to competitive bidding to be accepted or rejected by the Secretary of

the Treasury, the date of acquisition is the date that the Secretary indicates acceptance via a news release. Where the sale is subject to subscription and the subscription acts as acceptance of the offer of sale, the acquisition date is the date the subscription is submitted. *Rev Rul 78-5, 1978-1 CB 263* .

(n5)Footnote 5. *Borelli v Commr, TC Memo 1972-178* ; *Rev Rul 59-220, 1959-1 CB 210* ; but see *Bradford v US, 444 F2d 1133 (Ct Cl 1971)* , where the terms of an agreement to sell caused the court to conclude that the benefits and burdens of sale passed prior to the closing of title. This produced short-term gain even though the actual holding period exceeded six months.

(n6)Footnote 6. See, eg, NYSE Rules 64, 66.

(n7)Footnote 7. *Rev Rul 70-598, 1970-2 CB 168* ; but cf *Hendricks v Commr, 423 F2d 485 (4th Cir 1970)* , holding that gain or loss on a short sale is realized when stock is delivered to close the sale, not when the delivered stock was purchased.

(n8)Footnote 8. *209 F Supp 902 (MD Tenn 1962)* . See also *Dyke v Commr, 6 TC 1134 (1946)* , *acq, 1946-2 CB 2* .

In *Fletcher v US, 436 F2d 413 (7th Cir 1971)* , *aff'd, 303 F Supp 583 (ND Ind 1969)* , the issue was the commencement date of the purchaser's holding period. The court found it to be the date of contracting not the date of actual acquisition, since the buyer's obligation to pay was fixed at the time of execution.

(n9)Footnote 9. See, eg, *Field v Commr, TC Memo 1971-225* .

An escrow agreement effectively shifted recognition of gain to a later year even though the only limitation on the seller's receipt of the funds was the passage of time. The First Circuit determined that the arrangement was valid because it was part of a bona fide, arm's-length agreement between buyer and seller, the seller did not receive any present beneficial enjoyment from the funds while they were in escrow, and the escrowee was not the exclusive agent of the seller. The Commissioner sought to support his argument that income was realized in the earlier year on three separate grounds--constructive receipt, economic benefit, and agency. *Reed v Commr, 723 F2d 138 (1st Cir 1983)* .

(n10)Footnote 1. For the sake of clarity, discussion of certain holding period provisions will be left for discussion of the transactions to which they relate.

(n11)Footnote 2. *Dibblee v Commr, 29 BTA 1070 (1934)* , *aff'd, 75 F2d 617 (9th Cir)* , *revd 296 US 102 (1935)* .

(n12)Footnote 3. *Ogle v Helvering, 77 F2d 338 (2d Cir)* , *revd per stipulation to abide by result, 296 US 102 (1935)* ; *McFeely v Commr, 74 F2d 1017 (3d Cir 1934)* , *revd 296 US 102 (1935)* ; *Rand v Helvering, 79 F2d 24 (8th Cir)* , *revd 296 US 102 (1935)* ; *Dibblee v Commr, § 2.05[1], supra* .

(n13)Footnote 4. *First Natl Bank v US, 76 F2d 200 (1st Cir 1935)* , *aff'd, 296 US 102 (1935)* ; *Lee v Commr, 76 F2d 203 (1st Cir 1935)* , *aff'd, 296 US 102 (1935)* . The First Circuit relied on the Supreme Court's decision in *Brewster v Gage, 280 US 327 (1930)* , a basis case, as support for its position.

(n14)Footnote 5. *74 F2d 1017 (3d Cir 1934)* , *revd 296 US 102 (1935)* . The taxpayer in *Wolder v Commr, 58 TC 974 (1972)* , *nonacq, 1978-2 CB 4* , was specifically bequeathed stock as consideration for services rendered to the decedent during her life. Although the stock represented compensation income, the taxpayer was allowed to use the decedent's date of death as the start of his holding period.

(n15)Footnote 6. *Ogle v Helvering, 77 F2d 338 (2d Cir)* , *revd per stipulation to abide by result, 296 US 102 (1935)* ; *McFeely v Commr, 74 F2d 1017 (3d Cir 1934)* , *revd 296 US 102 (1935)* ; *Rand v Helvering, 79 F2d 24 (8th Cir)* , *revd 296 US 102 (1935)* ; *Dibblee v Commr, § 2.05[1], supra* .

(n16)Footnote 7. *313 US 11, at 15, 1941 Trade Cas. (CCH) P56092 (1941)* .

(n17)Footnote 8. The provision has been applied in the case of a sale of stock forming the corpus of a revocable trust includable in the gross estate of the decedent-settlor. *Rev Rul 72-359, 1972-2 CB 478* .

(n18)Footnote 9. § 1.05[3], *supra* .

(n19)Footnote 10. *IRC § 1223(2)*. Tacking has been permitted where the transaction is in part a sale, in part a gift. *Citizen's Natl Bank v US, 417 F2d 675 (5th Cir 1969)* . The Service takes a contrary position. *Ltr Rul 7752001* . See also *Turner v Commr, 49 TC 356 (1968)* , *nonacq 1971-1 CB 3* , *aff'd 410 F2d 752 (6th Cir 1969)* (gift made on condition that donee pay gift tax).

(n20)Footnote 11. *IRC § 1041(b)(1)*.

(n21)Footnote 12. *IT 3453, 1941-1 CB 254*.

(n22)Footnote 13. *1969-1 CB 310* .

(n23)Footnote 14. *Rev Rul 59-416, 1959-2 CB 159* . Furthermore, *Rev Rul 69-43, 1969-1 CB 312* states that "most of the [rulings declared to be obsolete] are now covered by statute, regulations, or later Revenue Rulings."

(n24)Footnote 15. *IRC § 1014(b)(9)*.

(n25)Footnote 16. *Rev Rul 59-86, 1959-1 CB 209* .

(n26)Footnote 17. *IRC § 1031(d)*.

(n27)Footnote 18. *IRC § 1223(1)*.

(n28)Footnote 19. *IRC § 1031(d)*.

(n29)Footnote 20. *1962-2 CB 181* , *amplified by Rev Rul 85-164, 1985-2 CB 117* .

(n30)Footnote 21. *Helvering v San Joaquin Fruit & Inv Co, 297 US 496 (1936)* ; *Edwards Indus, Inc v Commr, TC Memo 1974-120* .

(n31)Footnote 22. *Weir v Commr, 10 TC 996 (1948)* , *aff'd, 173 F2d 222 (3d Cir 1949)* .

(n32)Footnote 23. *IRC § 1223(6); Rev Rul 72-71, 1972-1 CB 100* .

(n33)Footnote 24. The rule was stated in cases such as *Wood v Commr, 75 F2d 364 (1st Cir 1935)* .

(n34)Footnote 25. The Ways and Means Committee report states that the holding period "shall date ... *from* the day upon which the rights to acquire such stock were exercised." H Rep No 2333, 77th Cong, 2d Sess 98 (1942) (emphasis supplied).

(n35)Footnote 26. See § 2.06[2][a][ii] for a discussion of *IRC § 1045*.

(n36)Footnote 27. *IRC § 1223(14)*, which also determines the holding period of a qualified empowerment zone asset, the sale of which results in nonrecognition of gain under *IRC § 1397B*. See § 2.06[2][a][v] for a discussion of *IRC § 1397B*.



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Taxation of Securities Transactions

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CHAPTER 2 Capital Gains and Losses

1-2 Taxation of Securities Transactions § 2.06

§ 2.06 Computing Capital Gains and Losses

[1] Definitions.

[a] Net Long-Term Capital Gain or Loss. *IRC Section 1222(7)* defines "net long-term capital gain" as the excess of long-term capital gains realized in the taxable year over long-term capital losses for the same year. Thus, if total long-term gains for a taxable year amounted to \$10,000 and total long-term losses to \$5,000, the net long-term gain for the year would be \$5,000. Conversely, if the amount of gain and loss were reversed, the taxpayer would realize a net long-term capital loss of \$5,000.ⁿ¹

[b] Net Short-Term Capital Gain or Loss. Net short-term capital gains and losses are determined in the same fashion as those which are long-term, that is, net short-term gain is the excess of short-term gains over short-term losses,ⁿ² and net short-term loss, the excess of such losses over such gains.ⁿ³

[c] Net Capital Gain and Net Capital Loss. A taxpayer is deemed to have a net capital gain in any year in which the taxpayer's net long-term capital gain exceeds the taxpayer's net short-term capital loss.ⁿ⁴ The taxpayer has a net capital loss whenever the losses for the year (long- and short-term taken together) exceed the amount allowed as a loss deduction under *IRC Section 1211*.ⁿ⁵ (If the taxpayer is a corporation, the amount of any loss carried back or forward to the year in question is excluded from the computation of net capital loss.)ⁿ⁶

[2] The Noncorporate Taxpayer.

[a] Treatment of Capital Gains.

[i] In General. Prior to the Tax Reform Act of 1986, the preferential treatment for taxpayers other than corporations was derived from the deduction from gross income of 60 percent of the net capital gain of the taxable year.ⁿ¹ The Act repealed the special treatment, subjecting net capital gains to the same rates as ordinary income.

The increase in tax rates brought about by the Omnibus Budget Reconciliation Acts of 1990 and 1993 returned preferential treatment for long-term capital gains to the Code, but did so by capping the rate of tax imposed on such gains at 28 percent.ⁿ² The Taxpayer Relief Act of 1997 placed different and additional caps on the tax imposed on net capital gains, the differences depending on the holding period and type of asset. The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the rates even further for taxable years prior to January 1, 2009.ⁿ³ The rates prescribed by that legislation for taxable years ending after May 5, 2003 are:ⁿ⁴

1-2 Taxation of Securities Transactions § 2.06

Rate (%)	Application
5	Gain from the sale of assets held more than 12 months (adjusted net capital gain), if the taxpayer's regular rate of tax is 15 percent or less. ⁿ⁵ Adjusted net capital gain does not include collectibles gain, unrecaptured Section 1250 gain, or Section 1202 gain. ⁿ⁶ The rate is reduced to zero for taxable years beginning after 2007.
10	Collectibles gain, Section 1202 gain, and unrecaptured Section 1250 gain realized by a taxpayer whose regular rate of tax is 10 percent.
15	Adjusted net capital gain realized by a taxpayer whose regular rate of tax is greater than 15 percent. ⁿ⁷ The rate also applies to collectibles gain, Section 1202 gain, and unrecaptured Section 1250 gain realized by a person whose regular rate of tax is 15 percent.
25	Unrecaptured Section 1250 gain (gain to the extent of prior depreciation deductions realized on the sale of depreciable real property held for more than 12 months), if the taxpayer's regular rate of tax is greater than 25 percent. ⁿ⁸
Rate (%)	Application
28	Any gain realized by a taxpayer whose regular rate of tax is greater than 28 percent, other than gain taxed at 15 percent or 25 percent. This includes collectibles gain and Section 1202 gain. ⁿ⁹

The creation of various categories of net capital gain requires a special sequence of netting of capital gains and losses.ⁿ¹⁰ Short-term capital losses (including short-term capital loss carryovers) are applied, first, to reduce short-term capital gains. If there is a resulting net short-term capital loss, it is applied to reduce any net long-term capital gain from the 28-percent group, then to reduce gain from the 25-percent group, and, finally, to reduce net gain from the 15-percent group (5 percent for gain that would otherwise be taxed at 10 or 15 percent).

The netting of long-term capital gains and losses calls for a net loss from the 28-percent group (including long-term capital loss carryovers) to be used, first, to reduce gain from the 25-percent group, and then to reduce gain from the 15-percent group. A net loss from the 15-percent group first reduces net gain from the 28-percent group and, then, net gain from the 25-percent group.

The regulations provide for the treatment of look-through capital gain that arises from the sale or exchange of an interest in a partnership, S corporation or nongrantor trust held for more than one year. Look-through capital gain is the share of collectibles gain allocable to an interest in a partnership, S corporation, or trust, plus the share of Section 1250 capital gain allocable to an interest in a partnership.ⁿ¹¹ The share of collectibles gain taken into account is the amount of net gain that would be allocated to the partner, shareholder, or beneficiary if the partnership, corporation, or trust transferred all of its collectibles for cash equal to the fair market value of the assets in a fully taxable transaction immediately before the transfer of the interest; a similar rule applies to Section 1250 capital gain.ⁿ¹² Any capital gain remaining after accounting for look-through capital gain is treated in the normal way by the partner, shareholder, or beneficiary.ⁿ¹³

For years beginning after 2002 and ending before 2011, net capital gain is increased by the amount of qualified dividend income, namely, dividends received from domestic corporations and qualified foreign corporations.ⁿ¹⁴ Tax years from 2008 through 2010 will be subject to various temporary and transitional rules. Taxation of long-term capital gains from sales or exchanges of securities during these years will be based on three principles:

First, the basic tax rate for long-term capital gain and qualified dividend income will be 15 percent. This is the rate that

will apply to ordinary sales of securities, that is, sales which are not affected by recapture, special capital gains rates for collectibles, etc.

Second, if the taxpayer's income would otherwise be taxed at the 10 or 15 percent tax bracket, then a zero percent capital gains rate will apply.

Example:

In the year 2008, for a married couple filing jointly, the 25 percent marginal bracket starts with taxable income of \$65,100. If a couple has \$70,000 of taxable income, \$10,000 of which is attributable to long-term capital gains, then we look at the *marginal* bracket that the \$10,000 would be in. Thus, hypothetically applying regular rates, \$5,100 of that long-term capital gain would be taxed at 15 percent, and \$4,900 would be taxed at 25 percent. The \$4,900 is subject to the basic long-term capitals gains rate of 15 percent, and the \$5,100 is not subject to taxes at all. After calculating the 15 percent tax on \$4,900, that product is adding to the tax at the regular rates that would apply to the remaining \$60,000 of taxable income. If that same couple had \$65,100 or less of taxable income, including long-term capital gains, then there would be no tax at all on their long-term capital gains and only their other income would be taxable.

Third, the scope of the so-called "kiddie tax," an ever-present consideration when calculating tax liability on investment income, has been expanded in recent years. In the Small Business and Work Opportunity Act of 2007 (the "2007 Small Business Act"),ⁿ¹⁵ there were several changes made to the scope of individuals covered by the kiddie tax, that is individuals whose investment income over an amount exempt from the kiddie tax (\$1,800 in 2008) would be taxed at the parent's marginal bracket:

- (1) Prior law enacted in 2006 applied the kiddie tax to individuals who had not attained age 18 at the end of the year. The 2007 Small Business Act extended the kiddie tax to cover individuals who had not attained age 19 at the end of the year.
- (2) The 2007 Small Business Act further applied the kiddie tax to an individual who had not attained age 24 at the end of the year if he or she is a full-time student for at least five months of the year, and the individual's earned income (salary and net income from self-employment) is not more than half of his or her support for the year.

These expanded rules are applicable to tax years after enactment date May 25, 2007, which means for individuals on a calendar year they are first effective with calendar year 2008.

Based on tax law in effect as of the end of 2008, the foregoing will determine how qualified dividends and long-term capital gains from sales and exchanges of securities will be taxed in the years 2008 to 2010. Although the tax law is scheduled to return to its pre-2001 state after 2010, the likelihood is that some intervening legislation will be enacted that will continue the lower rates, although perhaps in some modified form.ⁿ¹⁶

Excluded for the definition of qualified dividend is any dividend received from a tax-exempt corporation, any amount allowed as a deduction for dividends paid by mutual savings banks, and any amount allowed as a deduction for dividends paid on employer securities to pension plan participants.ⁿ¹⁷ Also excluded is any dividend on a share of stock (i) with respect to which the holding period requirements of *IRC Section 246(c)* are not met, substituting "60 days" for "45 days" each time it appears and "121-day period" for "91-day period," or (ii) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.ⁿ¹⁸

A qualified foreign corporation is defined as any corporation incorporated in a possession of the United States, or any

corporation that is eligible for benefits of a comprehensive income tax treaty with the United States that the Secretary of the Treasury determines is satisfactory for purposes of the definition of a qualified foreign corporation and that includes an exchange of information program.ⁿ¹⁹ A foreign corporation can be treated as a qualified corporation if the stock with respect to which the dividend is paid is readily tradable on an established securities market in the United States.ⁿ²⁰ A corporation cannot be a qualified foreign corporation if, in the year the dividend is paid, the corporation is a foreign personal holding company, a foreign investment company, or a passive foreign investment company.ⁿ²¹

Three special rules apply. Qualified dividend income does not include any amount taken into account as investment income under *IRC Section 163(d)(4)(B)*.ⁿ²² If a taxpayer receives, with respect to a share of stock, qualified dividend income from one or more dividends that are extraordinary dividends (within the meaning of *IRC Section 1059(c)*), any loss on a sale or exchange of the share is treated as long-term capital loss to the extent of the dividends.ⁿ²³ Any dividend received from a regulated investment company or real estate investment trust is subject to the limitations prescribed in *IRC Sections 854* and *857*.ⁿ²⁴

[ii] Gain on Sale or Exchange of Qualified Small Business Stock. *IRC Section 1202(a)(1)*, added by the Omnibus Budget Reconciliation Act of 1993, provides a noncorporate taxpayer with an exclusion from gross income of 50 percent of any gain from the sale or exchange of qualified small business stock held for more than five years.ⁿ²⁵ However, if the taxpayer has such gain ("eligible gain") for a taxable year from one or more dispositions of stock issued by any corporation, the aggregate amount of eligible gain from dispositions of qualified small business stock of that corporation in the taxable year cannot exceed the greater of (a) \$10 million (\$5 million in the case of a separate return by a married individual)ⁿ²⁶ reduced by the amount of eligible gain excluded from gross income for prior taxable years and attributable to dispositions of stock issued by the corporation, or (b) ten times the aggregate adjusted bases of qualified small business stock issued by the corporation and disposed of by the taxpayer during the taxable year.ⁿ²⁷

Stock is qualified small business stock if:

- (1) it is originally issued by a C corporation after August 10, 1993;
- (2) the corporation is a qualified small business; and
- (3) the stock is acquired by the taxpayer at its original issue (directly or through an underwriter) either in exchange for money or other property (not including stock), or as compensation for services provided to the issuing corporation, other than as an underwriter of the stock.ⁿ²⁸

Stock acquired by the taxpayer is not treated as qualified small business stock if, in one or more purchases during the four-year period beginning on the date two years before the issuance of the stock, the issuing corporation purchased (directly or indirectly) more than a *de minimis* amount of its stock from the taxpayer or a person related to the taxpayer within the meaning of *IRC Section 267(b)* or *707(b)*.ⁿ²⁹ Stock issued by a corporation is also not qualified small business stock if, in one or more purchases during the two-year period beginning on the date one year before the issuance of the stock, the corporation purchases more than a *de minimis* amount of its stock and the purchased stock has an aggregate value (at the time of the respective purchases) exceeding 5 percent of the aggregate value of its stock as of the beginning of the two-year period.ⁿ³⁰ If any transaction is treated as a distribution in redemption of the stock of the corporation under *IRC Section 304(a)*, the corporation is treated as if it purchased an amount of its stock equal to the amount treated as a distribution under Section 304.ⁿ³¹

A transfer of stock to an employee or independent contractor (or to a beneficiary of an employee or independent contractor) is not treated as a purchase of stock by the issuing corporation.ⁿ³² A stock purchase is disregarded if the stock is acquired in the following circumstances:

- (1) The stock was acquired by the seller in connection with the performance of services as an employee

or director and the stock is purchased from the seller incident to the seller's retirement or other bona fide termination of such services;

(2) Prior to a decedent's death, the stock (or an option to acquire the stock) was held by the decedent or the decedent's spouse (or by both), by the decedent and a joint tenant, or by a trust revocable by the decedent or the decedent's spouse (or both), and, within three years and nine months from the date of the decedent's death, the stock is purchased from the decedent's estate, beneficiary, heir, surviving joint tenant, surviving spouse, or from a trust established by the decedent or decedent's spouse;

(3) The stock is purchased incident to the disability or mental incompetency of the selling shareholder; or

(4) The stock is purchased incident to the divorce of the selling shareholder.ⁿ³³

For purposes of *IRC Section 1202*, any domestic C corporation can be a qualified small business if:

(1) the aggregate gross assets of the corporation (or any predecessor) at all times on or after August 10, 1993, and before issuance of the stock, did not exceed \$50 million;

(2) the aggregate gross assets of the corporation immediately after the issuance (determined by taking into account amounts received in the issuance) do not exceed \$50 million; and

(3) the corporation agrees to submit such reports to the Service and to shareholders as the Service may require to carry out the purposes of *IRC Section 1202*.ⁿ³⁴

All corporations that are members of the same parent-subsidary controlled group are treated as one corporation for this purpose.ⁿ³⁵

Stock will not be treated as qualified small business stock unless, during substantially all of the taxpayer's holding period for the stock, at least 80 percent (by value) of the assets of the corporation are used by it in the active conduct of one or more qualified trades or businesses, and the corporation is not:

(1) a domestic international sales corporation (DISC) or former DISC;

(2) a corporation with respect to which an election under *IRC Section 936* is in effect or that has a direct or indirect subsidiary with respect to which such an election is in effect;

(3) a regulated investment company (RIC), real estate investment trust (REIT), or real estate mortgage investment conduit (REMIC); or

(4) a cooperative.ⁿ³⁶

For this purpose, a qualified trade or business is any trade or business other than:

(1) trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or any trade or business where the principal asset is the reputation or skill of one or more of its employees;

(2) any banking, insurance, financing, leasing, investing, or similar business;

(3) any farming business (including the business of raising or harvesting trees);

(4) any business involving the production or extraction of products of a character with respect to which a deduction for depletion is allowable under *IRC Section 613* or *613A*; or

(5) any business of operating a hotel, motel, restaurant or similar business.ⁿ³⁷

A corporation will fail the active business requirement for any period during which more than 10 percent of the value of its net assets consists of stock or securities in other corporations that are not subsidiaries; a special exception is provided for assets held as part of the working capital of the corporation.ⁿ³⁸ It will fail the requirement for any period during which more than 10 percent of the total value of its assets consists of real property that is not used in the active conduct of a qualified trade or business.ⁿ³⁹ On the other hand, the active business requirement is automatically met for any period during which the corporation qualifies as a specialized small business investment company that is licensed to operate under Section 3(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993).ⁿ⁴⁰

IRC Section 1202(g) governs the treatment of the holder of an interest in a pass-through entity (partnership, S corporation, regulated investment company, or common trust fund) that sells or exchanges qualified small business stock. First, in determining whether the stock qualifies as qualified small business stock, the entity is treated as an individual and must have held the stock for more than five years.ⁿ⁴¹ Second, the taxpayer must have held the interest in the pass-through entity at the time it acquired the stock and at all times thereafter until the disposition of the stock by the entity.ⁿ⁴² Third, the amount excludable by the taxpayer is limited to the interest held by the taxpayer in the pass-through entity at the time the qualified small business stock was acquired.ⁿ⁴³

Pursuant to *IRC Section 1202(j)*, a taxpayer with an offsetting short position with respect to any qualified small business stock is not permitted to take advantage of the exclusion provided by *IRC Section 1202(a)* unless the stock was held by the taxpayer for more than five years as of the first day on which there was a short position, and the taxpayer elects to recognize gain as if the stock were sold on that day at its fair market value. The taxpayer is deemed to have an offsetting short position with respect to any qualified small business stock if:

- (1) the taxpayer has made a short sale of substantially identical property;
- (2) the taxpayer has acquired an option to sell substantially identical property at a fixed price; or
- (3) to the extent provided in regulations, the taxpayer has entered into any other transaction that substantially reduces the risk of loss from holding the qualified small business stock.ⁿ⁴⁴

Two other consequences derive from the sale of qualified small business stock come within the ambit of *IRC Section 1202*. The first is that 42 percent of the excluded gain is treated as an item of tax preference for minimum tax purposes.ⁿ⁴⁵ The second imposes a penalty for failure to file any report required under *IRC Section 1202*.ⁿ⁴⁶

A second provision, *IRC Section 1045(a)* permits a noncorporate taxpayer to elect to roll over tax-free gain from the sale or exchange of qualified small business stock held for more than six months if the taxpayer uses the proceeds of sale to purchase other qualified small business stock within 60 days of the sale.ⁿ⁴⁷ Thus, gain from the sale is recognized only if the amount realized on the sale exceeds the cost of the new stock. Generally, the holding period of the stock purchased will include the holding period of the stock sold, except for determining whether the six-month holding period is met.ⁿ⁴⁸

A partnership that sells qualified small business stock held for more than six months and purchases replacement qualified small business stock can elect to roll over the gain under *IRC Section 1045*.ⁿ⁴⁹ An eligible partner of a partnership that sells qualified small business stock can make the election if the partner purchases replacement qualified small business stock directly or through a partnership in which the taxpayer is a partner (directly or through an

upper-tier partnership).ⁿ⁵⁰ A taxpayer (other than a C corporation) that sells qualified small business stock and elects to roll over the gain can satisfy the replacement qualified small business stock requirement with qualified small business stock that is purchased within the 60-day period by a partnership in which the taxpayer is a partner on the day the replacement stock is purchased.ⁿ⁵¹

A partnership that holds qualified small business stock for more than six months, sells the stock and purchases replacement stock can make an election under *IRC Section 1045*.ⁿ⁵² If the partnership makes the election, each partner does not recognize its distributive share of Section 1045 gain unless the partner opts out of the election.ⁿ⁵³ Partnership Section 1045 gain equals the partnership's gain from the sale of the stock reduced by the greater of (i) the amount of gain from the sale of the stock treated as ordinary income, or (ii) the excess of the amount realized by the partnership on the sale over the total cost of all replacement qualified small business stock purchased by the partnership (excluding the cost of any replacement stock purchased by the partnership that is otherwise taken into account under *IRC Section 1045*).ⁿ⁵⁴ A partner's distributive share of partnership Section 1045 gain must be in the same proportion as the partner's share of the partnership's gain from the sale of the qualified small business stock.ⁿ⁵⁵

The *quid pro quo* for nonrecognition is a basis adjustment. The amount of gain not recognized is applied to reduce the basis of any qualified small business stock acquired during the 60-day period.ⁿ⁵⁶

The election under *IRC Section 1045* must be made on or before the later of December 31, 1998, or the due date (including extensions) for filing the income tax return for the taxable year in which the qualified small business stock is sold.ⁿ⁵⁷ The election is made by:

- (1) reporting the entire gain from the sale of qualified small business stock on Schedule D of the taxpayer's return;
- (2) writing "section 1045 rollover" directly below the line on which the gain is reported; and
- (3) entering the amount of deferred gain on the same line as (2) as a loss.

The election is revocable only with the prior written consent of the Commissioner.

[iii] Gain on Sale or Exchange of DC Zone Asset. A belief that one of the major problems faced by the District of Columbia was insufficient economic activity led Congress to provide, among other things, for a zero percent rate for qualified capital gain from the sale or exchange of any DC Zone asset held for more than five years.ⁿ⁵⁸ Qualified capital gain is defined as any gain recognized on the sale or exchange of a capital asset or property used in the trade or business (as defined in *IRC Section 1231(b)*).ⁿ⁵⁹ It does not include any gain

- (1) attributable to periods before January 1, 1998, or after December 31, 2007;
- (2) that would be treated as ordinary income under *IRC Section 1245* or under *IRC Section 1250* if that provision applied to all depreciation rather than additional depreciation;
- (3) that is attributable to real property, or an intangible asset, that is not an integral part of a DC Zone business; or
- (4) attributable, directly or indirectly, in whole or in part, to a transaction with a related person.ⁿ⁶⁰

A DC Zone asset can be any DC Zone business stock, any DC Zone partnership interest, or any DC Zone business property.ⁿ⁶¹ DC Zone business stock is defined as any stock in a domestic corporation that is originally issued after December 31, 1997, if:

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- (1) the stock is acquired by the taxpayer before January 1, 2003, at its original issue (directly or through an underwriter) solely in exchange for cash;
- (2) as of the time the stock was issued, the corporation was a DC Zone corporation (or, in the case of a new corporation, the corporation was being organized for purposes of being a DC Zone business); and
- (3) during substantially all of the taxpayer's holding period for the stock the corporation qualified as a DC Zone business.ⁿ⁶²

A rule similar to *IRC Section 1202(c)(3)*, discussed in § 2.06[2][a][ii], applies for purposes of the rules relating to DC Zone business stock.ⁿ⁶³

A DC Zone partnership interest is defined as any capital or profits interest in a domestic partnership that is originally issued after December 31, 1997, if:

- (1) the interest was acquired by the taxpayer before January 1, 2003, from the partnership solely in exchange for cash;
- (2) as of the time the interest was acquired, the partnership was a DC Zone business (or, in the case of a new partnership, the partnership was being organized for purposes of being a DC Zone business); and
- (3) during substantially all of the taxpayer's holding period for the interest, the partnership qualified as a DC Zone business.ⁿ⁶⁴

DC Zone property is tangible property if:

- (1) the property was acquired by the taxpayer by purchase after December 31, 1997, and before January 1, 2003;
- (2) the original use of the property in the DC Zone begins with the taxpayer; and
- (3) during substantially all of the taxpayer's period for the property, substantially all of the use of the property was in a DC Zone business of the taxpayer.ⁿ⁶⁵

The first two requirements are treated as met with respect to property that is substantially improved by the taxpayer before January 1, 2003, and any land on which the property is located.ⁿ⁶⁶ Any DC Zone business stock, DC Zone partnership interest, or DC Zone property acquired on or after January 1, 2003, will be treated as a DC Zone asset if it was such in the hands of a prior holder.ⁿ⁶⁷ If any asset ceases to be DC Zone business stock, DC Zone partnership interest, or DC Zone property because the corporation or partnership no longer qualifies as a DC Zone business or the property is no longer used in a DC Zone business, after the five-year period beginning on the date the taxpayer acquired the asset, the asset will continue to be treated as a DC Zone asset, except that the amount of capital gain excluded from income will be limited to the amount that would be qualified capital gain if the property had been sold on the date of cessation.ⁿ⁶⁸

A DC Zone business means any entity that is an enterprise zone business (as defined in *IRC Section 1397C*), determined

- (1) without regard to the requirement that at least 35 percent of the business's employees must be residents of an empowerment zone;

(2) by requiring that at least 80 percent of a qualified business entity's total gross income be derived from the active conduct of a trade or business; and

(3) by treating no area other than the DC Zone as an empowerment zone or enterprise zone.ⁿ⁶⁹

[iv] Renewal Community Capital Gain. Pursuant to *IRC Section 1400F(a)*, gross income does not include any qualified capital gain from the sale or exchange of a qualified community asset held for more than five years. Qualified capital gain is any gain recognized on the sale or exchange of a capital asset, or property used in a trade or business (as defined in *IRC Section 1231(b)*), provided the gain is attributable to the period beginning after January 1, 2002 and ending December 31, 2014.ⁿ⁷⁰

A qualified community asset is any qualified community stock, any qualified community partnership interest, or any qualified community business property.ⁿ⁷¹ Qualified community stock is any stock of a domestic corporation if (i) the stock is acquired by the taxpayer after December 31, 2001, and before January 1, 2010, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash, (ii) as of the time the stock was issued, the corporation was a renewal community business (or, in the case of a new corporation, was being organized for purposes of being a renewal community business), and (iii) during substantially all of the taxpayer's holding period for the stock, the corporation qualified as a renewal community business.ⁿ⁷²

A qualified community partnership interest is any capital or profits interest in a domestic partnership that meets the same time and business requirements that are imposed for qualified community stock.ⁿ⁷³ Qualified community business property consists of tangible property if (a) the property was acquired by the taxpayer by purchase after December 31, 2001, and before January 1, 2010, (b) the original use of the property in the renewal community begins with the taxpayer, and (c) during substantially all of the taxpayer's holding period for the property, substantially all of the use of the property was in a renewal community business of the taxpayer.ⁿ⁷⁴ Property that is substantially improved by the taxpayer before January 10, 2010, and any land on which such property is located also can be treated as qualified community business property.ⁿ⁷⁵

[v] Gain on Rollover of Empowerment Zone Investments. *IRC Section 1397B(a)* provides that, at the election of the taxpayer, any gain realized on the sale of a qualified empowerment zone asset held by the taxpayer for more than one year will be recognized only to the extent that the amount realized exceeds (1) the cost of any qualified empowerment zone asset (with respect to the same zone as the asset sold) purchased by the taxpayer during the 60-day period beginning on the date of the sale, reduced by (2) any portion of that cost previously taken into account under the provision.ⁿ⁷⁶ The consideration exacted for nonrecognition is a corresponding reduction in the basis for determining gain or loss of any qualified empowerment zone asset that is purchased by the taxpayer during the 60-day period mentioned in the preceding sentence.ⁿ⁷⁷ Nonrecognition does not extend to (a) any gain that is treated as ordinary income under the Code, or (b) any gain that is attributable to real property, or to an intangible asset that is not an integral part of an enterprise zone business.ⁿ⁷⁸

The term "qualified empowerment zone asset" means any property that would be a qualified community asset (as defined in *IRC Section 1400F*) if in that section (1) references to empowerment zones were substituted for references to renewal communities, (2) references to enterprise zone businesses (as defined in *IRC Section 1397C*) were substituted for references to renewal community businesses, and (3) any reference to December 31, 2001 is changed to December 21, 2000.ⁿ⁷⁹

[b] Treatment of Capital Losses.

Capital gains, being gains derived from dealings in property, form part of gross income, unless nonrecognition of gain is specifically mandated by some provision of the Code. Therefore, finding that a transaction qualifies for capital, as opposed to ordinary, treatment has no effect on includability.

The same is true of capital losses. Whether an individual may deduct losses incurred in dealings in property is governed solely by *IRC Section 165(c)*. Unless incurred in a trade or business, or in a transaction for profit, the loss cannot be deducted even if the "capital" label has been affixed.ⁿ⁸⁰ The ensuing discussion will assume that the threshold question of deductibility has been resolved in favor of the taxpayer.

[i] Limiting the Deduction. Although both ordinary losses and capital losses must meet the same criteria for deduction, the extent to which capital losses are deductible is limited.ⁿ⁸¹ Total deduction of capital losses is permitted in any year that capital gains exceed capital losses. For example, if a taxpayer has long-term gains of \$2,000, long-term losses of \$3,000, short-term gains of \$4,000 and short-term losses of \$2,000, deduction would be allowed for all of the long-term losses and all of the short-term losses since total gains (\$6,000) are greater than total losses (\$5,000). The fact that the taxpayer has a net long-term capital loss is of no moment; the amount of the deduction is tested by reference to aggregate gains and losses.

The impact of the limitation is felt whenever the sum of the capital losses sustained in a tax year is greater than the aggregate capital gain for the year. In such event, *IRC Section 1211(b)(1)* allows a deduction only to the extent of the gains realized during the year, plus the lower of (1) \$3,000 (\$1,500 in the case of a husband or wife filing a separate return), or (2) the excess of capital losses over capital gains.

[ii] Capital Loss Carryover. We have just seen that *IRC Section 1211(b)(1)* limits the amount of capital loss that can be deducted in the year in which the loss is sustained. Once losses exceed the deductible amount the taxpayer must find relief in the carryover provisions of *IRC Section 1212(b)*.ⁿ⁸²

We may witness the working of the latter section by considering the taxpayer with taxable income greater than \$3,000 who sustains a short-term loss of \$1,500 and a long-term loss of \$10,500 in the taxpayer's only capital transactions. The deduction in the year of loss is limited to \$3,000; the carryover to the first succeeding year consists of \$9,000 of long-term loss.ⁿ⁸³ If in that year, the taxpayer realizes no capital gains, the deduction will be limited to \$3,000. The carryover to the next succeeding year will be \$6,000, all of which will be deemed a long-term capital loss. If, in the second carryover year, a capital gain of \$3,000 is realized, the balance of the carryover loss will be completely deductible.

A special carryback rule comes into play if the taxpayer has a "net Section 1256 contracts loss"ⁿ⁸⁴ for the taxable year and elects to have the provisions of *IRC Section 1212(c)* apply.ⁿ⁸⁵ The amount of such loss is allowed as a carryback to each of the three taxable years preceding the loss year, to the extent the amount does not exceed the net Section 1256 contract gain for such yearⁿ⁸⁶ or increase or produce a net operating loss, with 40 percent of the amount allowed treated as a short-term capital loss from Section 1256 contracts and the balance as a long-term capital loss from such contracts.ⁿ⁸⁷ A further consequence is the effect on the loss carryover rules of *IRC Section 1212(b)(1)*. The amounts carried back are treated as short-term and long-term capital gains in the same percentages as they are carried back, thereby reducing the amount of the carryover.ⁿ⁸⁸ In addition, any amount carried forward after the carryback retains its character as a Section 1256 contracts loss.ⁿ⁸⁹

[3] The Corporate Taxpayer.

[a] Treatment of Capital Gains.

[i] In General. The characterization of gain as capital gain is controlled by the same criteria whether the taxpayer is a corporation or an individual. However, unlike noncorporate taxpayers, net capital gains realized by corporations are taxed at the same rate applied to corporate ordinary income.ⁿ¹

[ii] Gain on Sale or Exchange of DC Zone Asset. Pursuant to *IRC Section 1400B*, the gross income of corporate taxpayers does not include qualified capital gain from the sale or exchange of a DC Zone asset held for more than five

years. See § 2.06[2][a][iii] for a discussion of *IRC Section 1400B*.

[b] Treatment of Capital Losses.

[i] Limiting the Deduction. As in the case of noncorporate taxpayers, the extent to which capital losses are allowed as a deduction is limited. However, in the case of a corporation, capital losses are allowed only to the extent of capital gains, and no part of any excess loss may be offset against ordinary income.ⁿ² The entire excess forms part of the corporation's capital loss carryover.

[ii] Capital Loss Carryover. Perhaps the only similarity in the manner in which corporations and noncorporate taxpayers handle capital loss carryovers is in treating the loss as one sustained in the year to which it is carried. The first difference is that, if a corporation cannot fully deduct a long-term capital loss in the year incurred, the nondeductible portion is treated as a short-term loss when carried to another year.

The second difference concerns the period to which losses may be carried. The corporate taxpayer that suffers a capital loss has a carryover period of five years and a capital loss carryback to each of the three years preceding the loss year.ⁿ³ However, if the corporation is a regulated investment company there is no carryback, but the loss may be carried forward for a period of eight years.ⁿ⁴

Special rules attend the carryback of a capital loss. It may not be carried back if attributable to a foreign expropriation lossⁿ⁵ or if it increases or produces a net operating loss (as defined in *IRC Section 172(c)*) for the taxable year to which the loss is carried back.ⁿ⁶ Furthermore, a loss may not be carried back to a year for which the taxpayer was a regulated investment company or a real estate investment trust.ⁿ⁷

The entire net capital loss for any taxable year must first be carried to the earliest year to which the loss can be carried. Normally, this will be the third year preceding the loss year unless carryback to such year is prohibited by any of the reasons previously mentioned. If net capital gainsⁿ⁸ in the year to which the loss is first carried are insufficient to absorb the entire loss, the balance of the loss is carried, in order, to the other years to which it can be carried, until completely deducted or until the period limitation bars further deduction. Although the statute does not specifically provide the order of deduction, it is assumed that if losses incurred in two years are carried back or carried forward to the same year, the earlier incurred loss is the first to be deducted.ⁿ⁹

On October 3, 2008, the President signed into law the Emergency Economic Stabilization Act of 2008.ⁿ¹⁰ This is the comprehensive legislation generally known for its \$700 billion bailout of financial institutions.

The Act, intended as a multifaceted approach to the financial crises, consisted of three separately-titled divisions: the Emergency Economic Stabilization Act of 2008, the Energy Improvement and Extension Act of 2008, and the Tax Extenders and Alternative Minimum Tax Relief Act of 2008. Most of the Act is beyond the scope of this book, however, the tax provisions that are relevant to this book are mostly contained within the last division, sometimes referred to as the "Extenders Act" or "TEAMTRA."

Although most of the tax provisions of the Act are in the third division, the first division contains some tax provisions as well. The first division is the bail-out core of this massive legislation, centering around a "Troubled Assets Relief Program," or TARP. Tax provisions of TARP include a special rule regarding financial institutions (as defined by *IRC Section 582(c)(2)*) holding preferred stock in the Federal National Mortgage Association ("Fannie Mae") or the Federal Home Loan Mortgage Corporation ("Freddie Mac").ⁿ¹¹

The Act permits losses on these to be treated as ordinary losses rather than as capital losses. This relief provision generally entitles these corporate preferred shareholders to deduct losses currently, rather than to carry them forward, in case there were inadequate capital gains against which capital losses could be taken (which would likely be the case for

these financial institutions).

This relief applies to such stock which either:

- (1) was held by the applicable financial institution on September 6, 2008, or
- (2) was sold or exchanged by the applicable financial institution on or after January 1, 2008, and before September 7, 2008.ⁿ¹²

The Act authorizes regulations to extend ordinary loss treatment to preferred stock not owned by the financial institution on September 6, 2008, if:

- (1) the financial institution sells or exchanges applicable preferred stock after September 6, 2008, which the institution did not hold on such date, but the basis of which in the hands of the institution at the time of the sale or exchange is the same as the basis in the hands of the person which held such stock on such date, or
- (2) the financial institution is a partner in a partnership which either (a) held such stock on September 6, 2008, and later sold or exchanged such stock, or (b) sold or exchanged such stock after September 6, 2008.ⁿ¹³

This relief provisions applies only to corporations. Noncorporate taxpayers will continue to be able to deduct these losses only to the extent of gains (plus \$3,000 in the case of individual taxpayers), with the excess losses carried forward to future years.

FOOTNOTES:

(n1)Footnote 1. *IRC § 1222(8)*.

(n2)Footnote 2. *IRC § 1222(5)*.

(n3)Footnote 3. *IRC § 1222(6)*.

(n4)Footnote 4. *IRC § 1222(11)*.

(n5)Footnote 5. *IRC § 1222(10)*.

(n6)Footnote 6. *IRC § 1222(10)*.

(n7)Footnote 1. *IRC § 1202* prior to its repeal by the Tax Reform Act of 1986.

(n8)Footnote 2. *IRC § 1(h)*. Notice 2004-39, 2004-1 CB 982, provides guidance to regulated investment companies, real estate investment trusts, and their shareholders in applying *IRC § 1(h)* to capital gain dividends of the entities.

(n9)Footnote 3. Jobs and Growth Tax Relief Reconciliation Act of 2003, § 303. The rates revert to pre-2003 rates for taxable years beginning after Dec 31, 2010.

(n10)Footnote 4. Transitional rules are provided for years that include May 6, 2003.

(n11)Footnote 5. *IRC § 1(h)(1)(B)*. For years 2003-2010, adjusted net capital gain is increased by the amount of qualified dividend income.

Adjusted net capital gain must be reduced by the amount of such gain that the taxpayer elects to treat as investment income for purposes of *IRC § 163(d)(4)(B)*.

(n12)Footnote 6. *IRC § 1(h)(3)*. Generally, collectibles gain is gain from the sale of any work of art, any rug or antique, any metal or gem, any stamp or coin, or any alcoholic beverage. *IRC §§ 1(h)(5)(A), 408(m)(2)*.

Any gain from the sale of an interest in a partnership, S corporation, or trust that is attributable to unrealized appreciation in the value of collectibles is treated as gain from the sale of a collectible. *IRC § 1(h)(5)(B)*. Rules similar to the rules of *IRC § 751* apply for this purpose.

For stock acquired before Dec 22, 2000, *IRC § 1202* gain is an amount equal to the gain excluded from gross income under *IRC § 1202(a)*. For stock acquired after Dec 21, 2000, *IRC § 1202* gain is the excess of (a) the gain that would be excluded from gross income under *IRC § 1202* but for the percentage limitation in *IRC § 1202(a)*, over (b) the gain excluded from gross income under *IRC § 1202*. *IRC § 1(h)(7)*.

(n13)Footnote 7. *IRC § 1(h)(1)(C)*.

(n14)Footnote 8. Regulations provide that, if capital gain from an installment sale of real property includes unrecaptured Section 1250 gain taxed at 25 percent as well as capital gain taxed at 15 or 5 percent, the taxpayer must account for the 25-percent gain before any of the 15- or 5-percent gain is included in income. *Treas Reg § 1.453-12(a)*.

The regulations also provide that Section 1231 gain from an installment sale that is recharacterized as ordinary income under either *IRC § 1231(a)* or *IRC § 1231(c)* is deemed to consist first of 25-percent gain and then of 15- or 5-percent gain.

(n15)Footnote 9. *IRC § 1(h)(4)*.

(n16)Footnote 10. *Notice 97-59, 1997-2 CB 309*. See *Notice 98-20, 1998-1 CB 776*, for use of the netting rules in determining how a charitable remainder trust characterizes capital gain distributions. *Notice 98-20*, modified, *Notice 99-17, 1999-1 CB 871*, to reflect later legislative changes.

(n17)Footnote 11. *Treas Reg § 1.1(h)-1(b)(1)*. In determining whether a partnership, S corporation, or trust has gain from collectibles, the partnership, corporation or trust shall be treated as owning its proportionate share of any partnership, S corporation, or trust in which it owns an interest directly or indirectly through a chain of such entities. This tiered-entity rule also applies with respect to Section 1250 capital gain of a partnership. *Treas Reg § 1.1(h)-1(d)*.

(n18)Footnote 12. *Treas Reg § 1.1(h)-1(b)(2)(ii), (3)(ii)*. The rules do not apply to a transaction that is treated, for federal income tax purposes, as a redemption of an interest in a partnership, S corporation, or trust.

(n19)Footnote 13. *Treas Reg § 1.1(h)-1(c)*.

If less than all of the realized gain is recognized upon the sale of the interest, the same methodology applies to determine the collectibles gain recognized by the transferor, except that the partnership, S corporation, or trust is treated as transferring only a proportionate amount of each of its collectibles determined as a fraction that is the amount of gain recognized in the sale or exchange over the amount of gain realized in the transaction. *Treas Reg § 1.1(h)-1(b)(2)(ii)*. The same calculation is made when there is Section 1250 gain and not all of the gain is recognized upon the sale or exchange of a partnership interest. *Treas Reg § 1.1(h)-1(b)(3)(ii)*.

(n20)Footnote 14. *IRC § 1(h)(11)(A), (B)(i)*. Rules similar to the rules contained in *IRC § 904(b)(2)(B)* (capital gain rate differential) apply in determining any limitation on the foreign tax credit for dividends received from a foreign corporation. *IRC § 1(h)(11)(C)(iv)*. See § 20.02[4][e][i] for a discussion of *IRC § 904(2)(b)(B)*.

The Service has determined that it is appropriate for a partner of an electing large partnership to take into account separately the partner's distributive share of the partnership's dividends received that are qualified dividend income. *Notice 2004-5, 2004-1 CB 489*.

(n21)Footnote 15. This was a part of the US Troop Readiness, Veterans' Care, Katrina Recovery, Iraq Accountability Appropriations Act (Pub L No 110-28, May 25, 2007)

(n22)Footnote 16. The Obama Administration's revenue proposals for the Government's fiscal year 2010 would make permanent the taxation of qualified dividend income at net capital gains rates and retain the zero and 15 percent capital gains brackets for taxpayers with incomes up to \$250,000 (\$200,000 in the case of single taxpayers). However, beginning in the calendar year 2011 and future years, a new maximum capital gains rate of 20 percent would apply to taxpayers with incomes in excess of those amounts. See General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (Treasury Dept, May 2009).

(n23)Footnote 17. *IRC § 1(h)(11)(B)(ii)*.

(n24)Footnote 18. *IRC § 1(h)(11)(B)(iii)*. The rules of *IRC § 246(c)(1)* can be found in § 4.04[2][a][v].

(n25)Footnote 19. *IRC § 1(h) ((11)(C)(i)*. *Notice 2006-101, 2006-47 IRB 930*, contains the current list of US tax treaties that meet this requirement.

(n26)Footnote 20. *IRC § 1(h)(11)(C)(ii)*. Common or ordinary stock, or an American depository receipt in respect of such stock, is considered readily tradable on an established securities market in the US if it is listed on a national securities exchange that is registered under § 6 of the Securities Exchange Act of 1934 or on the Nasdaq Stock Market. As of Sept 30, 2002 registered national exchanges include the American Stock Exchange, the Boston Stock Exchange, the Cincinnati Stock Exchange, the Chicago Stock Exchange, the New York Stock Exchange, the Philadelphia Stock Exchange, and the Pacific Exchange, Inc. *Notice 2003-71, 2003-2 CB 922*.

(n27)Footnote 21. *IRC § 1(h)(11)(C)(iii)*. *Notice 2004-70, 2004-2 CB 724*, provides guidance regarding the extent to which distributions, inclusions, and other amounts received by, or included in the income of, individual shareholders as ordinary income from controlled foreign corporations, foreign personal holding companies, foreign investment companies, and passive foreign investment companies may be treated as qualified dividend income.

(n28)Footnote 22. *IRC § 1(h)(11)(D)(i)*.

(n29)Footnote 23. *IRC § 1(h)(11)(D)(ii)*.

(n30)Footnote 24. *IRC § 1(h)(11) (D)(iii)*. Regulated investment companies are the subject of Chapter 12; real estate investment trusts are the subject of Chapter 13.

(n31)Footnote 25. If qualified small business stock is acquired after Dec 21, 2000, in a corporation that is a qualified business entity in an enterprise zone during substantially all of the taxpayer's holding period for the stock, the amount of excluded gain increases to 60 percent. *IRC § 1202(a)(2)(A)*. The provision does not apply to gain attributable to periods after Dec 31, 2014. *IRC § 1202(a)(2)(C)*. The rules were further amended in 2009 to provide that, with respect to any qualified small business stock acquired after February 17, 2009 and before January 1, 2011, the exclusion percentage is increased to 75 percent, whether or not the corporation issuing such stock is engaged in business in an "enterprise zone." See *IRC § 1202(a)(3)*, added by § 1241(a) of the American Recovery and Reinvestment.

The District of Columbia Enterprise Zone is not treated as an empowerment zone for purposes of *IRC § 1202(a)(2)*. *IRC § 1202(a)(2)(D)*.

(n32)Footnote 26. *IRC § 1202(b)(3)(A)*. The limitation is applied on a shareholder-by-shareholder basis. HR Rep

No 213, 103d Cong, 1st Sess 13 (1993).

(n33)Footnote 27. *IRC § 1202(b)(1)*. The adjusted basis of any stock is determined without regard to any addition to basis after the date on which the stock was originally issued. Contributed property is valued at its fair market value on the date of contribution. HR Rep No 213, 103d Cong, 1st Sess 13-14 (1993).

In the case of a joint return, the amount of excludable gain is allocated equally between the spouses for purposes of applying the limitation in subsequent taxable years. *IRC § 1202(b)(3)(B)*.

(n34)Footnote 28. *IRC § 1202(c)(1)*. If property other than money or stock is exchanged for stock, the basis of the acquired stock cannot be less than the fair market value of the property exchanged. *IRC § 1202(i)(1)(B)*. If the adjusted basis of any qualified small basis stock is adjusted by reason of a contribution to capital after the date on which the stock was originally issued, in determining the amount of the adjustment the basis of the contributed property is treated as not less than its fair market value on the date of contribution. *IRC § 1202(i)(2)*.

Stock in a corporation acquired on the conversion of other stock in the corporation that is qualified small business stock in the hands of the taxpayer is treated as qualified small business stock held during the period that the converted stock was held. *IRC § 1202(f)(2)*.

Qualified small business stock acquired by gift, at death, or from a partnership by a partner will also be considered qualified small business stock in the hands of the transferee. *IRC § 1202(h)(1), (2)*. The same holds true for incorporating transfers governed by *IRC § 351* or reorganizations defined in *IRC § 368*, but only to the extent of the gain that would have been realized had the transfer been deemed taxable.

The latter limitation does not apply if the issuing corporation is a qualified small business corporation at the time of the transfer. *IRC § 1202(h)(4)*.

(n35)Footnote 29. *IRC § 1202(c)(3)(A)*; *Treas Reg § 1.1202-2(a)(1)*. For this purpose, stock acquired from the taxpayer or a related person exceeds a *de minimis* amount if the aggregate amount paid for the stock exceeds \$10,000 and more than 2 percent of the stock held by the taxpayer is acquired. In ascertaining whether the 2-percent limit is exceeded, the percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held, directly or indirectly, by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase. *Treas Reg § 1.1202-2(a)(2)*.

(n36)Footnote 30. *IRC § 1202(c)(3)(B)*; *Treas Reg § 1.1202-2(b)(1)*. Stock exceeds a *de minimis* amount only if the aggregate amount paid for the stock exceeds \$10,000 and more than 2 percent of all outstanding stock is purchased. In ascertaining whether the 2-percent limit is exceeded, the percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase. *Treas Reg § 1.1202-2(b)(2)*.

(n37)Footnote 31. *IRC § 1202(c)(3)(C)*.

(n38)Footnote 32. *Treas Reg § 1.1202-2(c)*.

(n39)Footnote 33. *Treas Reg § 1.1202-2(d)*.

(n40)Footnote 34. *IRC § 1202(d)(1)*. The term "aggregate gross assets" means the amount of cash and the aggregate adjusted bases of other property held by the corporation. *IRC § 1202(d)(2)(A)*. The adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the

adjusted basis of the property so contributed) is determined as if the basis of the property immediately after the contribution were its fair market value at that time. *IRC § 1202(d)(2)(B)*.

(n41)Footnote 35. *IRC § 1202(d)(3)(A)*. The term "parent-subsidiary controlled group" means any controlled group of corporations as defined in *IRC § 1563(a)(1)*, except that the required ownership level is reduced from 80 percent to 50 percent. *IRC § 1202(d)(3)(B)*.

(n42)Footnote 36. *IRC §§ 1202(c)(2)(A), 1202(e)(1), (4)*. A parent is deemed to own its ratable share of the assets and conduct its ratable share of the business of any subsidiary in which it owns at least 50 percent of all classes of stock entitled to vote or 50 percent in value of all of the outstanding stock of the subsidiary corporation. *IRC § 1202(e)(5)(A), (C)*.

If in connection with any future qualified trade or business, a corporation is engaged in start-up activities described in *IRC § 195(c)(1)(A)*, activities resulting in the payment or incurring of expenditures that can be treated as research and experimental expenditures under *IRC § 174*, or activities with respect to in-house research expenses described in *IRC § 41(b)(4)*, then assets used in such activities are treated as used in the active conduct of a trade or business. *IRC § 1202(e)(2)*.

(n43)Footnote 37. *IRC § 1202(e)(3)*.

(n44)Footnote 38. *IRC § 1202(e)(5)(B)*. Assets are categorized as working capital if held as part of the reasonably required working capital needs of a qualified trade or business, or held for investment and reasonably expected to be used within two years to finance research and experimentation or increases in the working capital needs of a qualified trade or business. *IRC § 1202(e)(6)*.

(n45)Footnote 39. *IRC § 1202(e)(7)*.

(n46)Footnote 40. *IRC § 1202(c)(2)(B)*.

(n47)Footnote 41. *IRC § 1202(g)(2)(A)*.

(n48)Footnote 42. *IRC § 1202(g)(2)(B)*.

(n49)Footnote 43. *IRC § 1202(g)(3)*. In applying the per-issuer limitation of *IRC § 1202(b)*, the taxpayer's proportionate share of the adjusted basis of the pass-through entity in the stock is taken into account.

(n50)Footnote 44. *IRC § 1202(j)(2)*. A taxpayer is treated as holding an offsetting short position with respect to qualified small business stock if such a position is held by any person related to the taxpayer within the meaning of *IRC § 267(b)* or *707(b)*. *IRC § 1202(j)(2)*.

(n51)Footnote 45. *IRC § 57(a)(7)*. For taxable years ending before May 6, 1997, 50 percent of the excluded gain was an item of tax preference.

(n52)Footnote 46. *IRC § 6652(k)*. The penalty is \$50 for each failure to file. It is increased to \$100 if the failure is due to negligence or intentional disregard.

No penalty is imposed on any failure that is shown to be due to reasonable cause and not willful neglect.

(n53)Footnote 47. The replacement stock must meet the active business requirement for qualified small business stock only for the first six months following the purchase. *IRC § 1045(b)(4)(B)*.

Rules similar to the rules contained in *IRC § 1202(f), (g), (h), (i), (j)* and *(k)* apply to *IRC § 1045(a)*. *IRC § 1045(b)(5)*.

(n54)Footnote 48. *IRC § 1045(b)(4)(A)*.

(n55)Footnote 49. *Treas Reg § 1.1045-1(a)*.

(n56)Footnote 50. *Id.*; *Treas Reg §§ 1.1045-1(c)(1)(i), 1.1045-1(g)(3)(i)*.

(n57)Footnote 51. *Treas Reg § 1.1045-1(a)*.

(n58)Footnote 52. *Treas Reg § 1.1045-1(b)(1)*.

(n59)Footnote 53. *Id.*; *Treas Reg § 1.1045-1(b)(4)*.

(n60)Footnote 54. *Treas Reg § 1.1045-1(b)(1)*. The adjusted basis of a partner's interest in a partnership is not increased under *IRC § 705(a)(1)* by gain from a partnership's sale of qualified small business stock that is not recognized by the partner as a result of a partnership election under *IRC § 1045*. *Treas Reg § 1.1045-1(b)(3)(i)*.

(n61)Footnote 55. *Treas Reg § 1.1045-1(b)(2)*.

(n62)Footnote 56. *IRC § 1045(b)(3)*. The basis of a partnership's replacement qualified small business stock is reduced by the amount of gain from its sale of qualified small business stock that is not recognized by a partner as a result of the partnership's election under *IRC § 1045*. *Treas Reg § 1.1045-1(b)(3)(ii)*.

(n63)Footnote 57. *Rev Proc 98-48, 1998-2 CB 367*. A taxpayer with more than one sale of qualified small business stock that qualifies for the election can make the election for any one or more of the sales.

(n64)Footnote 58. *IRC § 1400B(a)*. The legislation is part of the package creating the District of Columbia Enterprise Zone. See *IRC § 1400*. *Notice 98-57, 1998-2 CB 671*, identifies the census tracts in the District of Columbia constituting the District of Columbia Enterprise Zone for purposes of *IRC § 1400* and the DC Zone for purposes of *IRC § 1400B*.

(n65)Footnote 59. *IRC § 1400B(e)(1)*.

(n66)Footnote 60. *IRC § 1400B(e)(2), (3), (4), (5)*. Persons are related if described in *IRC § 267(b)* or *IRC § 707(b)(1)*.

In the case of the sale or exchange of an interest in a partnership, or stock in an S corporation, that was a DC Zone business during substantially all of the period the taxpayer held the interest or stock, the amount of qualified capital gain is determined without regard to any gain attributable to real property, or an intangible asset, that is not an integral part of a DC Zone business, and any gain attributable to periods before January 1, 1998, or after December 31, 2007. *IRC § 1400B(g)*.

(n67)Footnote 61. *IRC § 1400B(b)(1)*. The termination of the designation of the DC Zone is disregarded for purposes of determining whether any property is a DC Zone asset. *IRC § 1400B(b)(5)*.

(n68)Footnote 62. *IRC § 1400B(b)(2)(A)*.

(n69)Footnote 63. *IRC § 1400B(b)(2)(B)*. *IRC § 1202(c)(3)* contains rules relating to purchases by a corporation of its own stock for purposes of the 50 percent gain exclusion for small business stock. Rules contained in *IRC § 1202(g), (h), (i)(2), and (j)* also apply for purposes of *IRC § 1400B*.

(n70)Footnote 64. *IRC § 1400B(b)(3)*. A rule similar to *IRC § 1202(c)(3)* applies for purposes of determining whether a partnership interest is a DC Zone partnership interest.

(n71)Footnote 65. *IRC § 1400B(b)(4)(A)*. Purchase here has the same definition as in *IRC § 179(d)(2)*. In general, this means the property cannot be acquired from a related party or a member of the same controlled group, and cannot have a substituted basis or a basis determined under *IRC § 1014* (property acquired from a decedent).

(n72)Footnote 66. *IRC § 1400B(b)(4)(B)(i)*. Property is treated as substantially improved by the taxpayer only if, during any 24-month period beginning after December 31, 1997, additions to basis with respect to such property exceed the greater of the amount equal to the adjusted basis of the property at the beginning of the 24-month period in the hands of the taxpayer, or \$5,000. *IRC § 1400B(b)(4)(B)(ii)*.

(n73)Footnote 67. *IRC § 1400B(b)(6)*.

(n74)Footnote 68. *IRC § 1400B(b)(7)*.

(n75)Footnote 69. *IRC § 1400B(c)*. See § 17.03[3][c][ii] for a discussion of *IRC § 1397C*.

(n76)Footnote 70. *IRC § 1400F(c)(1), (2)*. Rules similar to those contained in *IRC § 1400B(e)(3), (4), and (5)*, relating to gain that is not qualified gain on the sale or exchange of a DC Zone asset apply here. *IRC § 1400F(c)(3)*. In addition, rules similar to the rules of *IRC § 1400B(b)(5), (6), and (7)*, and *IRC § 1400B(f), and (g)* are also applicable, except that *IRC § 1400B(g)(2)* is applied by substituting Jan 1, 2002, for Jan 1, 1998, and Dec 31, 2014, for Dec 31, 2008. *IRC § 1400F(d)*. See § 2.06[2][a][iii] for a discussion of the provisions relating to sales or exchanges of DC Zone assets.

(n77)Footnote 71. *IRC § 1400F(b)(1)*.

(n78)Footnote 72. *IRC § 1400F(b)(2)(A)*. A rule similar to the rule of *IRC § 1202(c)(3)* is applicable here. *IRC § 1400F(b)(2)(B)*. See § 2.06[2][a][ii] for a discussion of *IRC § 1202(c)(3)*.

A renewal community business is any entity or proprietorship that would be a qualified business entity or qualified proprietorship under *IRC § 1397C* if reference to renewal communities were substituted for references to empowerment zones in that section. *IRC § 1400G*. See § 17.03[3][b][ii] for a discussion of *IRC § 1397C*.

(n79)Footnote 73. *IRC § 1400F(b)(3)*.

(n80)Footnote 74. *IRC § 1400F(b)(4)(A)*. The definition of purchase for this purpose is found in *IRC § 179(d)(2)*.

(n81)Footnote 75. *IRC § 1400F(b)(4)(B)*. Property is substantially improved only if, during any 24-month period beginning after Dec 31, 2001, additions to the basis of the property in the hands of the taxpayer exceed the greater of (i) an amount equal to the adjusted basis of the property at the beginning of the 24-month period in the hands of the taxpayer, or (ii) \$5,000.

(n82)Footnote 76. In determining whether nonrecognition treatment applies, (i) the taxpayer's holding period for the qualified empowerment zone asset that is sold, and for any qualified empowerment zone asset that is acquired during the 60-day period beginning with the sale, is determined without regard to *IRC § 1223*, and (ii) only the first year of the taxpayer's holding period of the asset acquired during the 60-day period is taken into account in considering whether a corporation or partnership qualifies as a renewal community business or property is used in a renewal community business. *IRC § 1397B(b)(5)*.

Rev Proc 2002-62, 2002-2 CB 682, sets forth the procedure for making the election under *IRC § 1397B(a)*.

The District of Columbia Enterprise Zone is not treated as an empowerment zone for purposes of *IRC § 1397B(b)(1)(B)*.

(n83)Footnote 77. *IRC § 1397B(b)(4)*. The reduction is on a first-acquired, first-reduced basis. The reduction does not apply for purposes of *IRC § 1202*.

A taxpayer is treated as having purchased any property if, but for the reduction in basis, the unadjusted basis of the property in the hands of the taxpayer would be a cost basis. *IRC § 1397B(b)(3)*.

(n84)Footnote 78. *IRC § 1397B(b)(2)*.

(n85)Footnote 79. *IRC § 1397B(b)(1) A*.

(n86)Footnote 80. To be allowable as a deduction under *IRC § 165(a)*, a loss must be evidenced by a closed and completed transaction, fixed by an identifiable event or events, and actually sustained during the taxable year. A decline in the value of stock acquired on the open market, even if due to accounting fraud or other illegal misconduct of officers or directors of the corporation, does not result in an allowable deduction unless the stock becomes wholly worthless. *Notice 2004-27, 2004-1 CB 782*.

(n87)Footnote 81. *IRC § 165(f)* limits the deduction to the extent allowed in *IRC §§ 1211 and 1212*.

The Fourth Circuit upheld a conviction for willfully making and subscribing false tax returns on which the taxpayer claimed ordinary losses on securities traded for his own account. Since the taxpayer was not a dealer, the losses were capital losses subject to the limitation on deductibility. *US v Diamond, 788 F2d 1025 (4th Cir 1986)*.

(n88)Footnote 82. The deduction can be taken only by the taxpayer who actually sustains the loss. Therefore, excess capital losses incurred by a decedent before his death do not give rise to a capital loss carryover for his estate. *Rev Rul 74-175, 1974-1 CB 52*. However, an excess loss incurred by one spouse can be carried over and deducted on joint returns. *Ltr Rul 8510053*.

(n89)Footnote 83. *IRC § 1212(b)*, added by the Revenue Act of 1964, Pub L No 88-272, 88th Cong, 2d Sess, § 230(a), became effective for taxable years beginning after Dec 31, 1963. Prior to this amendment any loss carried over was considered a short-term capital loss even if it had been a long-term loss in the year originally sustained. Furthermore, pre-1964 losses could be carried over only to the five succeeding years, not indefinitely, as is now the case.

In determining the extent to which losses carried over are offset by gains realized in the succeeding year, the excess deduction is considered a short-term capital gain. *IRC § 1212(b)(2)*.

The amount of the loss carryover from one carryover year to another is affected by the amount that could have been deducted in the first of the years, even though the taxpayer does not claim a loss deduction in that year. *Rev Rul 76-177, 1976-1 CB 224*. A taxpayer, who did not report a loss in the year in which it was incurred, was entitled to carry over the loss to a subsequent year to offset gains realized in the later year, after adjustment as provided in *Rev Rul 76-177*. *Lang v Commr, TC Memo 1983-318*.

(n90)Footnote 84. The term "net Section 1256 contracts loss" means the lesser of: (1) the net capital loss for the taxable year taking into account only gains and losses from Section 1256 contracts, namely, regulated futures contracts, foreign currency contracts, nonequity options, and dealer equity options; or (2) the amount of any capital loss carryover to the succeeding taxable year. *IRC §§ 1212(c)(4), 1256(b)*.

(n91)Footnote 85. The provision does not apply to estates or trusts. *IRC § 1212(c)(7)(B)*.

An Illinois district court has held that losses from *IRC § 1256* contracts that are part of a mixed straddle can be carried back under *IRC § 1212(c)*. *Roberts v US, 734 F Supp 314 (ND Ill 1990)*.

(n92)Footnote 86. The term "net Section 1256 contracts gain" means the lesser of the capital gain net income for the year taking into account only gains and losses from Section 1256 contracts, or the capital gain net income for the year. The net Section 1256 gain for any taxable year before the loss year is computed without regard to the net Section 1256 contracts loss for the loss year or for any taxable year thereafter. *IRC § 1212(c)(5)*.

(n93)Footnote 87. *IRC § 1212(c)(1), (3)*.

(n94)Footnote 88. *IRC § 1212(c)(6)(A)*.

(n95)Footnote 89. *IRC § 1212(c)(6)(B)*.

(n96)Footnote 1. *IRC §§ 11, 1201(a)*.

(n97)Footnote 2. *IRC § 1211(a)*.

(n98)Footnote 3. *IRC § 1212(a)(1)(A)*. This conforms the treatment of capital losses with that of net operating losses under § 172(b)(1) of the Code.

IRC § 383 may become operative to limit the extent to which capital losses may otherwise be carried over if certain changes occur in the ownership of the corporation.

(n99)Footnote 4. *IRC § 1212(a)(1)(C)(i)*.

(n100)Footnote 5. *IRC § 1212(a)(1)(A)(i)*. The ten-year carryforward is still available for such losses. *IRC § 1212(a)(1)(C)(ii)*.

(n101)Footnote 6. *IRC § 1212(a)(1)(A)(ii)*.

(n102)Footnote 7. *IRC § 1212(a)(3)*.

(n103)Footnote 8. Net capital gain is to be given the meaning set forth in *IRC § 1222(9)*, except when a net capital loss cannot be carried back in full to a preceding taxable year because it would increase or produce a net operating loss; the net capital gain for such prior year shall not be treated as greater than the amount of loss which can be carried back to the year. *IRC § 1212(a)(1)*.

(n104)Footnote 9. This is the procedure followed in the case of net operating losses, *Treas Reg § 1.172-4(a)(3)*, and pre-1970 net capital losses, *Treas Reg § 1.1212-1(a)(1)(ii)*, Ex (a).

(n105)Footnote 10. Pub L No 110-343.

(n106)Footnote 11. Emergency Economic Stabilization Act of 2008, Pub L No 110-343, Division A, § 301.

(n107)Footnote 12. Emergency Economic Stabilization Act of 2008, Pub L No 110-343, Division A, § 301(b) and (c)(2).

(n108)Footnote 13. Emergency Economic Stabilization Act of 2008, Pub L No 110-343, Division A, § 301(d).



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Taxation of Securities Transactions

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CHAPTER 2 Capital Gains and Losses

1-2 Taxation of Securities Transactions § 2.07

§ 2.07 Specific Exceptions to Capital Gain or Loss Treatmentⁿ¹

Although it is generally true that a transaction meeting the requisites for capital gain or loss, i.e., a sale or exchange of a capital asset, will qualify for such treatment, there are a number of situations wherein this does not obtain. For the most part, the exceptions are decreed by specific provision in the Code, but on occasion the result has come about solely through judicial determination.

[1] Imputed Interest.

[a] The Judicial and Administrative Background. If stock having a basis of \$10,000 is sold for \$20,000, the entire purchase price is paid at the time of sale, and the stock is a capital asset in the hands of the seller, it is clear that the taxpayer realizes \$10,000 of capital gain. Suppose, however, that only \$10,000 of the consideration is paid at the time of sale, and that the \$10,000 balance is deferred for ten years. If the deferred payment bears no interest, is the taxpayer's entire \$10,000 gain still capital gain?

Alternatively, suppose a taxpayer loans \$1,000 to a borrower on January 1, 2010 and takes back a non-interest bearing note with a face value of \$1,060 payable on January 1, 2011. If the taxpayer receives payment of \$1,060 at maturity, is the \$60 profit capital gain?ⁿ¹

The answer is no, because the taxpayer's apparent "gain" in both these cases is actually interest, "compensation for the use or forbearance of [the taxpayer's] money."ⁿ² As the Supreme Court said in *United States v Midland-Ross Corp.*,ⁿ³ "[u]nlike the case of capital appreciation, the earning of discount to maturity is predictable and measurable, and is 'essentially a substitute for ... [interest] payments which [the predecessor of *IRC Section 61(a)*] expressly characterizes as gross income [; thus] it must be regarded as ordinary income, and it is immaterial that for some purposes the contract creating the right to such payments may be treated as 'property' or 'capital.'" *Hort v Commissioner* ... "ⁿ⁴

Accordingly, even before the subject was dealt with by statute, administrative and judicial doctrine reclassified capital gains as taxable interest when it was obviously appropriate to do so from the standpoint of economic reality.ⁿ⁵ However, statutory authority was needed to go beyond the relatively straightforward situations in which the taxpayer sells a noninterest bearing obligation acquired for less than face value, or sells an interest-bearing obligation between interest dates.ⁿ⁶ Congress addressed an entire range of imputed interest issues in a complex statutory scheme in which the two most important Code provisions--from the standpoint of our immediate interest in when interest may be imputed in place of capital gain on the sale or exchange of a capital asset--are *IRC Section 1274*ⁿ⁷ and *IRC Section 483*

.n8

[b] The Statutory Framework. Neither *IRC Section 1274* nor *IRC Section 483* expressly converts capital gain into ordinary income.ⁿ⁹ These and associated provisions instead identify sales or exchanges of property in which deferred payments of the sale price include imputed interest, measure the amount of imputed interest, and prescribe the method of accounting by which such imputed interest is recognized as interest income. For present purposes, it is key that imputed interest is removed entirely from the "amount realized" on the sale or exchange of a capital asset by the seller under *IRC Section 1001* and is instead reported as interest income under *IRC Section 61*.ⁿ¹⁰ Similarly, to the extent payments are reclassified as imputed interest, the purchaser may not treat the reclassified amounts as part of the basis of the asset acquired, although the imputed interest may be deductible under *IRC Section 163*.ⁿ¹¹

The Code's critical contribution to the imputed interest doctrine is its introduction of a standard interest rate--the "applicable federal rate" or "AFR"--by means of which taxpayers can determine whether and to what extent debt instruments issued for property include imputed interest. The AFR is a conservative baseline--calculated on the basis of the average market yield each month on outstanding marketable obligations of the United States--which does not require adjustments for such factors as the creditworthiness of the borrower or the marketability of the particular debt instrument being tested for imputed interest.ⁿ¹² One of three AFRs must be used: a Federal short-term rate, to test debt instruments with a term of 3 years or less; a Federal mid-term rate, for debt instruments with terms of over 3 but not over 9 years, and a Federal long-term rate, for debt instruments with a term in excess of 9 years.ⁿ¹³

In general, imputed interest is taken into account in a sale or exchange of property whenever one or more payments are deferred and the contract of sale or the debt instrument issued pursuant thereto either fails to provide for interest or bears interest at a rate lower than the relevant AFR. When the stated rate of interest is inadequate, imputed interest is generally equal to the excess of the sale price stated in the contract over the present value of the right to receive, as of the date of sale, all amounts payable under the contract (including any stated interest), using the AFR as the discount rate to determine present value.ⁿ¹⁴ Imputed interest is generally recognized over the term of the debt instrument rather than in a lump sum, but the exact timing depends on whether the transaction falls within the jurisdiction of *IRC Section 1274* or *IRC Section 483*. If determined under *IRC Section 1274*, imputed interest is taken into account as earned, regardless of the taxpayer's regular method of accounting or when payments on the debt instrument are actually made.ⁿ¹⁵ If determined under *IRC Section 483*, a portion of the imputed interest is allocated to each deferred principal payment called for in the contract or note, and taken into account in accordance with the taxpayer's regular method of accounting--either when the payment comes due (accrual method taxpayers) or when it is actually or constructively received (cash method taxpayers).ⁿ¹⁶

Example:

On December 31, 2010 a taxpayer sells nonpublicly traded securities held for more than one year with a basis of \$9 million for a sales price of \$10 million. The price is payable in a lump sum, without interest, on December 31, 2012, but payment is not actually nor constructively received by the taxpayer until January 2, 2013. Assume that on December 31, 2010 the present value of the right to receive \$10 million on December 31, 2012, calculated using a discount rate equal to the short-term AFR for December, 2010, is \$9,800,000. The excess of the stated sales price over the present value of the right to receive \$10 million in two years is \$200,000, and this is all imputed interest. If the imputation is made under *IRC Section 1274*, the interest must be reported as earned, \$100,000 in 2011 and \$100,000 in 2012. See *IRC Section 1272*. If the imputation is made under *IRC Section 483*, the entire \$200,000 is allocated to lump sum payment of \$10 million due December 31, 2012. If the taxpayer is on the accrual basis, all \$200,000 of imputed interest under *IRC Section 483* is reportable in 2012 when the lump sum payment is due. If the taxpayer is on the cash basis, all of the imputed interest is reportable when the single payment is received in 2013. In any case, the amount the taxpayer may report as long-term capital gain on the sale of the securities is reduced from \$10 million to \$9,800,000.

[c] Testing for and Measuring Imputed Interest in Debt-Financed Sales and Exchanges.

[i] The OID Rules (IRC Sections 1271-1275). The rules for testing for and measuring imputed interest in a debt-financed sale of property are substantially the same whether the tax consequences of finding imputed interest are determined under *IRC Section 1274* or *IRC Section 483*.ⁿ¹⁷ Since the original issue discount ("OID") rules (including *IRC Section 1274*) take precedence over *IRC Section 483* except in those cases in which a transaction is specifically excepted from the operation of the OID rules,ⁿ¹⁸ and since *IRC Section 483* generally follows the OID rules for testing and measuring imputed interest even when it is applicable,ⁿ¹⁹ we begin by examining the mechanics of the OID rules.

IRC Section 1274 is found in Subpart A ("Original Issue Discount") of Part 5 ("Special Rules for Bonds and Other Debt Instruments") of Subchapter P ("Capital Gains and Losses") of the Internal Revenue Code. Although Subpart A is confined to OID on "debt instruments," that term is broadly defined to encompass not just bonds, debentures, and notes commonly thought of as debt instruments but any other "evidence of indebtedness."ⁿ²⁰ By regulation, any "contractual arrangement that constitutes indebtedness under general principles of Federal income tax law" is an "evidence of indebtedness" that can be a "debt instrument," whether or not the contractual obligation is expressed in the traditional form of a bond or note.ⁿ²¹ It is important to keep in mind, therefore, that any sale or exchange of a capital asset in which payment of the purchase price is deferred in whole or in part is potentially covered by the OID provisions of Subpart A, whether or not the deferred portion of the purchase price is physically evidenced by a note or other type of security.

OID is defined as "the excess (if any) of--(A) the stated redemption price at maturity, over (B) the issue price."ⁿ²² The stated redemption price at maturity is the same as the stated principal amount or face value of the debt instrument as long as all other payments under the instrument are "qualified stated interest" payments; *i.e.*, payments unconditionally due at least annually that are calculated at a single fixed interest rate.ⁿ²³ The issue price, generally speaking, is the price paid to the issuer for the debt instrument.ⁿ²⁴ Determining the issue price is relatively straightforward when a debt instrument is issued for cash,ⁿ²⁵ or the property for which the debt instrument is issued (or the debt instrument itself) is publicly traded.ⁿ²⁶ Matters become more complex when a non-publicly traded debt instrument is issued in connection with a sale or exchange of non-publicly traded property. This is where *IRC Section 1274*, titled "Determination of issue price in the case of certain debt instruments issued for property," becomes applicable.ⁿ²⁷

The Regulations provide that a debt instrument is not subject to the OID rules as long as the excess of its stated redemption price at maturity over the issue price is less than a "de minimis amount."ⁿ²⁸ To qualify as *de minimis*, the excess may not exceed 0.0025 (1/4 of 1 percent) multiplied by the product of the instrument's stated price at maturity and the number of complete years to maturity calculated from the issue date.ⁿ²⁹ For example, the *de minimis* amount of OID on a \$10,000 note payable in 5 years would be \$125 ($.0025 \times \$10,000 \times 5$).ⁿ³⁰ If a seller received a 5-year \$10,000 note on which OID was \$124 or less, no part of the sales price would be reclassified as imputed interest.ⁿ³¹

The issue price of a nonpublicly traded debt instrument issued in exchange for nonpublicly traded property is the same as its stated principal amount as long as the debt instrument provides for "adequate stated interest."ⁿ³² If stated interest is not "adequate," the issue price is its "imputed principal amount,"ⁿ³³ defined as an amount equal to the sum of the present values of all payments due under the debt instrument, including payments of stated interest,ⁿ³⁴ determined as of the date of the sale or exchange using a discount rate equal to the applicable Federal rate or AFR.ⁿ³⁵ A debt instrument provides for adequate stated interest if its stated principal amount is less than or equal to its imputed principal amount.ⁿ³⁶ The AFR is key to determining (a) whether a debt instrument has adequate stated interest and (b) if not, its issue price (*i.e.*, its imputed principal amount).

Application of *IRC Section 1274* can result in a finding of OID even when the AFR indicates that the debt instrument has adequate stated interest. This is due to the fact that the OID provisions are concerned not only with reclassifying as imputed interest payments that are nominally designated as principal, but also with assuring that stated interest, as well as OID, accrues in an economically appropriate manner, with lender and borrower taking account of both types of

interest on a consistent and economically rational basis. To accomplish the latter goal, the OID provisions may reclassify stated interest as OID whether or not an instrument provides for an adequate amount of interest in total, so that stated interest and OID accrue for tax purposes in a more economically realistic manner than the stated interest provided in the debt instrument. As long as interest is adequate in total, however, the issue price of the instrument will be equal to the instrument's stated principal amount, and the "amount realized" by the seller will not be affected. n36.1

[ii] The Test Rate. The first step in finding the appropriate test rate is to determine which AFR applies to the debt instrument in question--the short-term, mid-term or long-term rate. This requires calculating the term of the debt instrument to which the test rate is to be applied, normally a simple process.ⁿ³⁷ It becomes more complex when principal payments are made throughout the term of the instrument, as in an installment obligation, or when principal or interest payments are subject to contingencies.

In the case of an installment obligation,ⁿ³⁸ the term of the debt instrument is deemed to be its "weighted average maturity." This is the sum of the following amounts, determined for each payment under the instrument other than a payment of qualified stated interest--

- (1) The number of complete years from the issue date of the instrument until the payment is due; multiplied by
- (2) A fraction, the numerator of which is the amount of the payment and the denominator of which is debt instrument's stated redemption price at maturity.ⁿ³⁹

Assume, for example, that a debt instrument is issued for property on December 31, 2010 in the face amount of \$100,000, of which \$60,000 is payable in 2 years, and \$40,000 in 6 years. The weighted average maturity of the instrument would be 3.6 years ($2 \times 60\% = 1.2$ yrs) + ($6 \times 40\% = 2.4$ years). Consequently, the AFR would be based on the mid-term rate.

Note that the result would be the same if, instead of issuing a single debt instrument payable in 2 installments, the issuer instead issued two notes, one for \$60,000 payable in 2 years and the other for \$40,000 payable in 6 years. Under an "aggregation rule," debt instruments issued in connection with the same transaction or related transactions (determined based on all the facts and circumstances) are ordinarily treated as a single debt instrument for purposes of *IRC Sections 1271 through 1275* and the regulations thereunder.ⁿ⁴⁰ In other words, the parties may not apply the short-term AFR in determining the present value of the \$60,000 payment and the mid-term AFR in determining the present value of the \$40,000 payment.

If a debt instrument provides for principal payments that are fixed in total amount but uncertain as to time, the term of the instrument, and therefore the term of the AFR to be applied to that instrument, is determined by reference to the latest possible date on which a principal payment can be made or, in the case of an installment obligation, by reference to the longest weighted average maturity under any possible payment schedule.ⁿ⁴¹ For example, if a holder of a debt instrument with a 5 year term has an option to renew the debt for an additional 5 years, the term of the debt instrument is 10 years and the AFR is the long-term rate.

Finally, the regulations provide that in the case of a "variable rate debt instrument" that provides for stated interest at a "qualified floating rate,"ⁿ⁴² the term of the instrument is determined by reference to the longest interval between interest adjustment dates, or, if the variable rate debt instrument also provides for a fixed rate, the interval between the debt instrument's issue date and the last day on which the fixed rate applies, if longer.ⁿ⁴³ However, the variable rate debt instrument's stated term is used if variations in the qualified floating rate are subject to significant restrictions so that "the rate in substance resembles a fixed rate."ⁿ⁴⁴

Once the AFR term is established, the next step is to find the AFR for that term that corresponds to the compounding

period used in the debt instrument to which it will be applied. The statutory OID rules provide that, in computing the imputed principal amount of a debt instrument, the present value of payments called for in that instrument are to be discounted at the AFR "compounded semiannually."ⁿ⁴⁵ However, comparing an AFR compounded semiannually with a debt instrument's stated rate of interest that is compounded more or less frequently than semiannually would be like comparing the proverbial apples and oranges, since the more frequently interest is compounded the higher the actual return will be.ⁿ⁴⁶ Published AFRs issued monthly by the IRS therefore show, for short-term, medium-term and long-term rates, rates compounded on an annual, quarterly, and monthly as well as semiannual basis. The regulations require that the AFR selected be "based on the appropriate compounding period."ⁿ⁴⁷

The "test rate," the AFR ultimately used, is also designated the "3-month rate" in the statute. The "3-month rate" is the lowest AFR appropriate to the term and compounding period of the debt instrument in any month (1) during the 3-month period ending with the first month in which there is a binding written contract substantially setting forth the terms under which the sale or exchange providing for the issuance of the debt instrument is ultimately consummated, or (2) during the 3-month period ending with the month in which the sale or exchange occurs.ⁿ⁴⁸ Assuming there was a binding written contract for the sale or exchange, AFRs for up to six months may have to be compared to determine the test rate, although as a practical matter the two three-month periods will often substantially overlap. For example, if a binding contract for a sale was entered in January, 2011 and the sale was actually consummated in March, 2011, the test rate would be the lowest appropriate AFR in effect during any of the five months from November, 2010 through March, 2011.

Further adjustments to the test rate may be required under certain circumstances. For example, when the debt instrument is given as consideration for the transfer of property, and the transferor of the property, or any related person, pursuant to a plan, leases back a portion of the property transferred, the test rate must be increased to 110 percent of the 3-month rate.ⁿ⁴⁹

Of potentially wider significance, at least when interest rates are high, is the statutory ceiling on the test rate of 9 percent per annum, compounded semiannually, for "qualified debt instruments" within the meaning of *IRC Section 1274A*.ⁿ⁵⁰ In general, a qualified debt instrument is one issued for propertyⁿ⁵¹ with a stated principal amount that does not exceed a maximum that was originally set at \$2,800,000 but is adjusted annually for inflation in accordance with *IRC Section 1274A(d)*.ⁿ⁵² The maximum stated principal amount of a qualified debt instrument issued in 2010 is \$5,115,100.ⁿ⁵³ No adjustment to the test rate is required, of course, when the AFR is below 9 percent.

[iii] Applying the Test Rate to Debt Instruments with Stated Interest Unconditionally Payable at a Single, Fixed Rate. Once a test rate is determined, it may be possible, without present value calculations, to determine by means of a comparison between the stated interest rate and the test rate whether a portion of the principal amount of a debt instrument must be reclassified as imputed interest for tax purposes. Under the regulations, "if a debt instrument has a single fixed rate of interest that is paid or compounded at least annually, and that rate is equal to or greater than the test rate, the debt instrument has adequate stated interest."ⁿ⁵⁴ As we have seen, a debt instrument may have adequate stated interest and still have OID.ⁿ⁵⁵ Nevertheless, any OID determined in such a case will not result in an adjustment to the amount realized, the capital gain or loss recognized, or the basis of property acquired in the sale or exchange of the capital asset for which the debt instrument was issued. This follows because the issue price of a debt instrument determines the amount realized on the sale as well as the basis of the property sold,ⁿ⁵⁶ and the issue price of a debt instrument with adequate stated interest is the same as its stated principal amount.ⁿ⁵⁷

The regulations also provide that *IRC Section 1274* does not apply to a debt instrument, and it will therefore have no OID, if the test rate is less than or equal to the instrument's stated rate of interest and the following three conditions are met.ⁿ⁵⁸

- (1) All interest payable on the instrument is qualified stated interest. Note that although an instrument may have adequate stated interest as long as interest is compounded no less frequently than annually,ⁿ⁵⁹

to be qualified stated interest, so that the debt instrument qualifies for complete exclusion from *IRC Section 1274*, the interest must actually be payable no less frequently than annually. Also, a debt instrument that provides interest at a variable interest rate would not have qualified stated interest unless the instrument was a variable rate debt instrument with a qualified floating rate, as discussed below.

(2) The debt instrument is not issued in a "potentially abusive situation."ⁿ⁶⁰ In such situations, the test rate is disregarded and the issue price of the debt instrument is the fair market value of the property for which it is exchanged, adjusted to take into account any other consideration involved in the transaction.ⁿ⁶¹ A "potentially abusive situation" is defined as a "tax shelter"ⁿ⁶² or any other situation which by reason of (1) recent sales transactions, (2) nonrecourse financing,ⁿ⁶³ (3) financing with a term in excess of the useful life of the property, or (4) a debt instrument with clearly excessive interest,ⁿ⁶⁴ (5) of a type identified by regulations as having a potential for tax avoidance.ⁿ⁶⁵

(3) No payment from the buyer-borrower to the seller-lender designated as points or interest is made at the time of issuance of the debt instrument. If the buyer pays points, the amount so paid is deducted from the stated principal amount of the debt instrument as though the buyer was only loaned the net amount. The issue price is therefore reduced by the points paid, while the stated price at maturity remains the same, with the difference treated as OID.ⁿ⁶⁶

In summary, when a nonpublicly traded debt instrument issued in exchange for nonpublicly traded property provides only qualified stated interest, present value calculations will ordinarily be necessary only if the test rate is greater than the stated rate of interest. In the latter case, present value calculations will be required to determine the issue price of the debt instrument (the "imputed principal amount") and consequently the amount of OID. The following section considers the special issues raised when a debt instrument provides stated interest that is not qualified stated interest either because the rate of interest is not at a single, fixed rate, or because one or more payments are subject to contingencies.

[iv] Applying the Test Rate to Debt Instruments when Stated Interest is Not at a Single, Fixed Rate. If the debt instrument's stated interest rate is a fixed rate that changes during the instrument's term, interest payments will not be considered "qualified stated interest" to the extent they exceed the amount of interest payable at the minimum rate applicable in any accrual period.ⁿ⁶⁷ Any "non-qualified" stated interest must be added to the instrument's stated redemption price at maturity for purposes of determining the amount, if any, by which such stated redemption price exceeds the instrument's issue price; *ie*, whether and to what extent the debt instrument includes OID.ⁿ⁶⁸

Example:

A debt instrument with a principal amount of \$100,000, payable in 3 years, provides for interest payable at the end of each year at a rate of 1 percent in the first year, 2 percent in the second year, and 6 percent in the third year. The interest payments in the second and third years are not "qualified stated interest" to the extent they exceed 1 percent of the principal amount (\$1,000), the minimum interest rate unconditionally payable in every accrual period during the instrument's term. Accordingly, interest payments of \$1,000 (\$2,000-\$1,000) at the end of year 2, and \$5,000 (\$6,000-\$1,000) at the end of year 3 must be added to the stated redemption price at maturity in calculating whether the instrument has OID.

Suppose a debt instrument provides for changes in the rate of interest during the term of the instrument, but instead of the rates being fixed in the debt instrument, they are wholly or partially dependent on an outside event, such as the percentage change in an index. In that event, calculation of the debt instrument's imputed principal amount as of its issue date is impossible because the future values of some of the payments to be made under the instrument are unknown as of the issue date.

The OID Regulations offer two possible solutions to this dilemma when the debt instrument is not

publicly traded and is issued in a sale or exchange for nonpublicly traded property. The first, and most favorable, solution applies only if the debt instrument meets all the conditions requisite to classification as a "variable rate debt instrument," including the requirement that contingent interest must be set in accordance with a "qualified floating rate."ⁿ⁶⁹ In that case, the Regulations provide that, for purposes of calculating the instrument's imputed principal amount, the amount of each future interest payment is determined on the assumption that the value of the qualified floating rate on the date such interest payment becomes fixed will be the same as the value of the qualified floating rate (a) on the the sale or exchange date, or (b) the first date on which there is a binding written contract for the sale or exchange, whichever value is greater.ⁿ⁷⁰ In effect, "the rules convert the debt instrument into a fixed rate instrument and then apply the general OID rules to the debt instrument [as discussed in § 2.07[1][c][iii], *supra*]."ⁿ⁷¹ The second, and significantly less favorable, solution applies to all other contingent payments: such payments are disregarded until actually made, and the debt instrument's issue price is determined solely with reference to the instrument's noncontingent payments.ⁿ⁷² The two solutions can have widely disparate tax consequences.ⁿ⁷³

In general, a debt instrument the issue price of which is determined under *IRC Section 1274* will only be considered a "variable rate debt instrument" if (1) all of its stated interest is determined by one or more qualified floating rates, or by a single fixed rate and one or more qualified floating rates; (2) the qualified floating rate in effect at any time during the term of the instrument must be set at a "current value" of that rate--i.e., determined no earlier than 3 months prior to the first day on which that value is in effect and no later than 1 year following that first day; (3) there are no contingent principal payments under the instrument; and (4) if the instrument is issued at a premium, the premium does not exceed a specified limit.ⁿ⁷⁴

A variable rate of interest is a "qualified floating rate" if variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which the debt instrument is denominated, either for the issuer of the debt instrument or for issuers in general.ⁿ⁷⁵ The prime rate of a bank,ⁿ⁷⁶ the current interest rate of a bank's commercial paper,ⁿ⁷⁷ the London Interbank Offer Rate (LIBOR),ⁿ⁷⁸ and the average yield on 1-year Treasury securities as published in Federal Reserve bulletinsⁿ⁷⁹ are all offered by the regulations as examples of rates that can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. On the other hand, rates based on changes in the value of a commodity index,ⁿ⁸⁰ on a percentage of the S&P 500 Index,ⁿ⁸¹ on changes in the value of French franc LIBOR if used in a dollar-denominated debt instrument,ⁿ⁸² or a rate based on a percentage of the profits earned by the issuer in the preceding year,ⁿ⁸³ are examples of rates that are not qualified floating rates because they cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds.ⁿ⁸⁴

A multiple of a floating rate cannot be a qualified floating rate unless the multiple is not less than .65 and not more than 1.35 of the value of the floating rate.ⁿ⁸⁵ Further, a variable rate is not a qualified floating rate if it is subject to a maximum stated interest rate (cap), minimum stated interest rate (floor), restriction on the amount of increase or decrease in the stated interest rate (governor), or other similar restriction, unless the cap, floor or governor is either fixed throughout the term of the debt instrument, or is not reasonably expected as of the issue date to cause the yield on the debt instrument to be significantly higher or lower than it would have been without the restriction.ⁿ⁸⁶

When the debt instrument's interest payments are contingent but not determined by application of a qualified floating rate, imputed interest is calculated and taken into account under the provisions applicable to "contingent payment debt instruments" in *Treasury Regulation Section 1.1275-4*.ⁿ⁸⁷ Those provisions require that the contingent payment debt instrument (also referred to as the overall debt instrument) be broken up into separate components. All noncontingent payments provided for in the

overall debt instrument are treated as a single component, while each contingent payment is treated as a separate component.ⁿ⁸⁸ The single noncontingent component is treated as a separate debt instrument, the issue price of which is the issue price of the overall debt instrument, determined under *Treasury Regulation Section 1.1274-2(g)*.ⁿ⁸⁹ In the determination of OID for this component, no noncontingent interest payment can be considered qualified stated interest, and the rules regarding de minimis OID do not apply.ⁿ⁹⁰

The tax treatment of each of the contingent components is not determined until payment with respect to that component is actually made. The portion of the payment attributable to principal is deemed equal to the present value of the amount actually paid, discounted back from the actual payment date to the date the overall debt instrument was issued using as the discount rate the overall debt instrument's test rate as of the issue date.ⁿ⁹¹ The excess of the payment over the principal portion is treated as regular interest, not OID, and is taken into account on the cash basis by both the holder and the issuer in the year the payment is made.ⁿ⁹²

Example:

A owns unencumbered real estate known as Blackacre. On January 1, 2011, A sells Blackacre to B. As consideration for the sale, B makes a down payment of \$1 million to A and issues a debt instrument that matures on December 31, 2015. The debt instrument provides for a payment of principal at maturity of \$5 million and a contingent payment of interest on December 31 of each year equal to a fixed percentage of the gross rents B receives from Blackacre in that year. Assume that on January 1, 2011 the short-term applicable Federal rate is 5 percent, compounded annually, and the mid-term applicable Federal rate is 6 percent, compounded annually.

(1) Assume that the present value, as of the issue date, of A's right to receive the debt instrument's \$5 million noncontingent payment in 5 years, discounted at the mid-term AFR of 6 percent in effect on the instrument's issue date, is \$ 3,736,291. This is the issue price of both the overall debt instrument, see *Treasury Regulation Section 1.1274-2(g)*, and the separate debt instrument consisting of the only noncontingent payment provided for in the overall debt instrument. See *Treasury Regulation Section 1.1275-5(c)(3)*. Accordingly, the amount realized by A on the sale of Blackacre, as well as B's basis in Blackacre, is \$4,736,291 (the \$3,736,291 issue price of the separate debt instrument plus B's \$1,000,000 down payment). A must recognize OID (and B may be entitled to interest deductions in an equivalent amount under *IRC Section 163*) in the total amount of \$1,263,709 (\$5,000,000 - \$3,736,291) under the OID accounting rules over the 5 year term of the separate debt instrument.

(2) Assume that the amount of contingent interest (the percentage of rent collected by B in 2011), fixed and paid on December 31, 2011, is \$200,000. This payment is deemed to consist in part of principal in the amount of \$ 190,476, the present value of the \$200,000 payment made on December 31, 2011, discounted to January 1, 2010 using a discount rate of 5 percent, the test rate for the overall debt instrument (the short-term AFR) had its maturity been 1 year instead of 5 years. See *Treasury Regulation Section 1.1275-4(c)(4)(ii)(B)*. The remaining \$9,524 is considered interest. B may add the principal amount of the payment to her basis in Blackacre, and, if she uses a calendar year, may deduct the \$9,524 as interest subject to the limitations of *IRC Section 163*. A, if on the calendar year, must include \$9,524 of interest income in 2011, in addition to the amount includible as OID on the overall debt instrument for that year.

[v] Applying the Test Rate when Imputed Interest is Determined Under *IRC Section 483*. *IRC Section 483* applies to sales and exchanges of propertyⁿ⁹³ if the contract of sale provides for one or more deferred payments due more than one year after the date of the sale or exchange, and none of the exceptions to its application apply to the

transaction.ⁿ⁹⁴ When *IRC Section 483* is applicable, deferred payments due more than six months after the date of the sale or exchange must be tested to determine if the contract provides for "total unstated interest," the term used in *IRC Section 483* to describe imputed interest. A contract has total unstated interest if and to the extent that:

- (1) the sum of the deferred payments due more than six months from the date of the sale or exchange exceeds
- (2) the sum of the present values of such payments and the present values of any interest payments due under the contract.ⁿ⁹⁵

The subtrahend in the above equation is, except for its exclusion of the present values of payments made within six months of the sale or exchange, equivalent to the imputed principal amount which determines the issue price of a debt instrument under *IRC Section 1274*. Moreover, *IRC Section 483(b)* provides that "the present value of a payment shall be determined under the rules of [*IRC Section 1274(b)(2)*] using a discount rate equal to the applicable Federal rate determined under [*IRC Section 1274(d)*]." ⁿ⁹⁶ Thus, the methodologies of section 1274 and 483 are nearly identical.

There are a few minor differences. As noted above, *IRC Section 483* does not apply to deferred payments of the sales price made six months or less from the date of sale. In applying the unstated interest formula, such deferred principal payments are excluded from both the sales price and present value sides of the equation. However, *IRC Section 483(b)* provides that the present value factor includes, in addition to the present values of principal payments made more than six months from the date of sale, "the present values of *any* interest payments due under the contract." (Emphasis added.) Interest payments called for in the first six months of the contract (as opposed to deferred payments of the sales price itself) are therefore included in the present value calculation, even though they are allocable to deferred principal payments made during the first six months which are completely excluded from the formula. This lack of symmetry effectively raises the rate of return on the included (due in more than six months) principal payments, making it slightly easier to avoid or reduce imputed interest under *IRC Section 483* as compared with *IRC Section 1274*.ⁿ⁹⁷

IRC Section 483 applies to contracts with one or more deferred payments due more than one year from the date of sale, whether or not indebtedness under the contract is evidenced by a debt instrument issued in connection with the sale. *IRC Section 1274(c)*, on the other hand, is on its face more limited, since it is applicable only to a "debt instrument" given in consideration for the sale of property, which *IRC Section 1275(a)(1)(A)* defines as a "bond, debenture, note or certificate or other evidence of indebtedness." However, the OID regulations' more expansive interpretation of "debt instrument" as including any "contractual arrangement that constitutes indebtedness under general principles of federal income tax law"ⁿ⁹⁸ would appear to make the distinction a relatively unimportant one.

IRC Section 483 is only concerned with the adequacy of total stated interest, regardless of whether the sales contract accrues stated interest in an economically realistic manner. There is no concept of "qualified stated interest" in *IRC Section 483*.ⁿ⁹⁹ Unlike *IRC Section 1274*, there can be no imputed interest under *IRC Section 483* if the contract provides for adequate stated interest in total, even if all such interest is payable in a lump sum at maturity.ⁿ¹⁰⁰

The most significant difference between *IRC Sections 483* and *1274* is not in their methodology but in how the results of that methodology are applied: the economic accrual of OID determined under *IRC Section 1274* versus the allocation of unstated interest to deferred payments under *IRC Section 483*.ⁿ¹⁰¹ The tax accounting treatment of the holder and issuer of a debt instrument with OID (or unstated interest), including but not limited to the seller and purchaser of a capital asset in a debt-financed sale, is discussed in Chapter 17, § 17.03[2].

IRC Section 483 does not apply to any debt instrument for which an issue price is determined under either *IRC Section 1273(b)* (other than paragraph (b)(4)) or *IRC Section 1274*.ⁿ¹⁰² *IRC Sections 1273(b)(1)* and (2) apply only to debt instruments issued for money, not property, and thus would not fall within *IRC Section 483*'s scope in the first instance. *IRC Section 1273(b)(3)* does apply to debt instruments issued for property, and removes from *IRC Section 483*'s

jurisdiction any such debt issued in a transaction in which either the debt instrument or the property for which it is issued is publicly traded.ⁿ¹⁰³ That leaves *IRC Section 1274*, which appears to cover the rest of the field, since *Section 1274* determines the issue price of debt instruments issued for property where neither the debt instrument nor the property is publicly traded. *IRC Section 483*'s jurisdiction is preserved, however, because of exceptions to *IRC Section 1274* that carve out a number of debt instruments for which *IRC Section 1274* does not determine the issue price. These exceptions create the universe of transactions to which *IRC Section 483* applies.

(1) Cash Method Debt Instruments. *IRC Section 1274A(c)* provides an elective exception to *IRC Section 1274* by which seller and purchaser can jointly choose to have imputed interest determined under *IRC Section 483* rather than *IRC 1274* as long as the stated principal amount of the debt instrument does not exceed an inflation-adjusted maximum.ⁿ¹⁰⁴ The debt instrument must be a "qualified debt instrument," a category which, as previously discussed,ⁿ¹⁰⁵ qualifies for a 9 percent ceiling on the test rate used to calculate imputed interest.ⁿ¹⁰⁶ By making a joint election under *IRC Section 1274(c)*, the seller and purchaser agree to use the cash receipts and disbursements method of accounting for stated as well as unstated interest throughout the term of the debt instrument.ⁿ¹⁰⁷ The seller must not use an accrual method of accounting and must not be a dealer in the property sold or exchanged.ⁿ¹⁰⁸ If a qualified debt instrument meets these requirements, it is known as a "cash method debt instrument."ⁿ¹⁰⁹

If a cash method debt instrument is issued in a potentially abusive situation,ⁿ¹¹⁰ *IRC Section 483* is applied as though it included a provision similar to *IRC Section 1274(b)(3)*; that is, the fair market value of the property sold, less any consideration received for the property other than the cash method debt instrument, is substituted for the present value of payments under the contract in the formula by which the amount of unstated interest is derived.ⁿ¹¹¹

(2) Sales Calling for Total Payments of \$250,000 or Less. A debt instrument arising from the sale or exchange of property is not subject to *IRC Section 1274* if the sum of all of the following does not exceed \$250,000: (a) payments due under the debt instrument, other than stated interest, plus (b) the outstanding principal balance or adjusted issue price (in the case of debt obligations issued with original issue discount) of liabilities assumed or taken subject to by the purchaser, plus (c) the aggregate fair market value of any other consideration given up in the sale or exchange.ⁿ¹¹² The \$250,000 limitation is not indexed for inflation. Since contracts with a sales price of \$3,000 or less are also excepted from *IRC Section 483*,ⁿ¹¹³ a determination of imputed interest in a debt-financed sale or exchange of property in which payments total between \$3,001 and \$250,000 is exclusively within the jurisdiction of *IRC Section 483*.

(3) Sale of a Farm for Less Than One Million Dollars. A debt instrument arising from the sale or exchange of a "farm" (within the meaning of that term as used in *IRC Section 6420(c)(2)*),ⁿ¹¹⁴ for a purchase price which cannot exceed \$1 million, is excepted from *IRC Section 1274* if the sale is made by an individual, estate, testamentary trust, "small business corporation" (within the meaning of *IRC Section 1244(c)(3)*) or partnership which meets requirements similar to those of *IRC Section 1244(c)(3)* on the date of sale.ⁿ¹¹⁵ The regulations provide that the \$1 million limitation on the sale price is to be applied without regard to the substantive provisions of *IRC Section 1274* or the amount of stated interest, and without regard to other exceptions to the applicability of *IRC Section 1274* (including the exceptions for sales of a principal residence and sales of land between related parties as discussed below). The \$1 million limitation on the sale price is not indexed for inflation.

(4) Sale of Principal Residence. A debt instrument arising from the sale by an individual of his "principal residence," within the meaning of *IRC Section 121*, is not subject to *IRC Section 1274*, but may be subject to *IRC Section 483*.ⁿ¹¹⁶ *IRC Section 121* presently provides for the exclusion from gross income of gain from the sale or exchange of property which, during the 5-year period ending on the date of sale,

was used as the taxpayer's principal residence for periods aggregating 2 years or more. In general, whether a property qualifies as a taxpayer's principal residence is determined under a facts and circumstances test, but regulations under *IRC Section 121* provide that a residence may include a houseboat, a house trailer or a house or apartment that a taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation.ⁿ¹¹⁷ When the taxpayer alternates between two residences using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence.ⁿ¹¹⁸

(5) Sales of Land Between Related Parties. *IRC Section 483(e)* provides that, in the case of a "qualified" sale or exchange--that is, a sale of land by an individual to a member of the individual's family,ⁿ¹¹⁹--the discount rate used in determining total unstated interest is not to exceed 6 percent compounded semiannually. The lower discount rate only applies to the first \$500,000 of the stated principal amount of debt instruments issued in qualified sales between the same two individuals during the same calendar year.ⁿ¹²⁰ *IRC Section 1274(c)(3)(F)* cedes jurisdiction to *IRC Section 483* with respect to any debt instrument arising out of a sale to which *IRC Section 483(e)* applies.ⁿ¹²¹

[vi] Transactions Exempt from Imputed Interest Reclassification. Certain other transactions, listed below, are excepted from the operation of both *IRC Section 483* and *IRC Section 1274*. Of these, however, only the first two are potentially applicable to a debt-financed sale of securities.

(1) Marital property settlements between spouses or ex-spouses in which a debt instrument is issued as consideration for property transferred pursuant to the settlement agreement are exempt by regulation from both *IRC Section 1274* and *IRC Section 483*,ⁿ¹²² provided gain or loss on the transaction is not recognized pursuant to *IRC Section 1041*,ⁿ¹²³

(2) Short-term transactions in which all payments are due not more than 6 months after the date of the sale or exchange are not subject to *IRC Section 1274*.ⁿ¹²⁴ Since *IRC Section 483* only applies to transactions in which at least one payment is due more than one year from the date of the sale or exchange,ⁿ¹²⁵ transactions in which all deferred payments are due in 6 months or less are necessarily exempt from *IRC Section 483* as well.

(3) In the case of the issuer of a debt instrument (obligor) only, neither *IRC Section 1274* nor *IRC Section 483* apply to a debt instrument issued as consideration for the sale or exchange of "personal use property," defined as property substantially all the use of which by the taxpayer ["obligor"] is not in connection with a trade or business of the taxpayer or an activity described in [*IRC*] *Section 212*.ⁿ¹²⁶ This means that a purchaser of personal use property will not have deductible OID in connection with deferred payments due the seller as part of the purchase price,ⁿ¹²⁷ even though the seller who holds the debt instrument may be required to take OID attributable to such payments into income.ⁿ¹²⁸ Since the "production or collection of income" is an activity described in *IRC Section 212*,ⁿ¹²⁹ this exception should not apply to a debt-financed purchase of securities.

(4) Transactions involving certain demand loans that are also "below-market loans" described in *IRC Section 7872(c)(1)* are excepted by regulation from the application of *IRC Sections 1274* and *483*, but interest may be imputed instead under the provisions of *IRC Section 7872*.ⁿ¹³⁰

(5) An annuity contract to which *IRC Section 72* applies is not a "debt instrument" and therefore is not subject to *IRC Section 1274*.ⁿ¹³¹ Such contracts are also exempt by regulation from the operation of *IRC Section 483*.ⁿ¹³²

(6) Transfers of patents described in *IRC Section 1235*, to the extent the amount of the deferred payments

is contingent on the productivity, use or disposition of the property transferred, are excepted from both *IRC Section 1274*ⁿ¹³³ and *IRC Section 483*.ⁿ¹³⁴

[2] Transactions Producing Ordinary Loss.

[a] Small Business Investment Company Stock. The sale of stock at a loss will normally produce a capital loss.ⁿ¹ If the stock were to become wholly worthless, the loss resulting therefrom would likewise assume capital characteristics.ⁿ²

One exception to the general rule concerns stock in a small business investment company operating under the Small Business Investment Act of 1958.ⁿ³ The purpose of that legislation was to encourage and stimulate equity investment in small businesses. Consonant with this purpose and as an added incentive,ⁿ⁴ Congress provided that any loss resulting from such investment would be "treated as an ordinary loss."ⁿ⁵

[b] Losses Incurred by Small Business Investment Companies. As a further incentive to capital investment in small businesses, *IRC Section 1243* permits losses, incurred by a small business investment company by reason of the sale or exchange (or worthlessness)ⁿ⁶ of stock acquired through the exercise of a conversion privilege contained in debentures issued by a small business concern, to be treated as ordinary losses.ⁿ⁷

A number of other conditions must be satisfied before the loss can be cloaked with the ordinary character provided by *IRC Section 1243*. First, the loss has to be a loss from the sale or exchange of a capital asset, a loss which would be a capital loss were it not for *IRC Section 1243*.ⁿ⁸ Second, the company suffering the loss must, at the time of the loss, be licensed to operate as a small business investment companyⁿ⁹ and must submit a statement to this effect with the tax return on which the loss is claimed.ⁿ¹⁰

[c] Losses on Small Business Corporation Stock.

A third provision enacted in 1958, *IRC Section 1244*, has as one of its declared purposes the encouragement of "the flow of new funds into small business" by "reducing the risk of a loss for these new funds."ⁿ¹¹ In addition, the section seeks to place "shareholders in small corporations on a more nearly equal basis with ... proprietors and partners."ⁿ¹²

The operative effect of *IRC Section 1244(a)* is to permit an *individual* ⁿ¹³ to treat a loss on "*Section 1244* stock" as an ordinary loss instead of a capital loss. However, the amount which may be so treated in any single taxable year may not exceed \$50,000 (\$100,000 in the case of a husband and wife filing a joint return).ⁿ¹⁴ Furthermore, the benefits of *IRC Section 1244* are available only to individuals who acquire the stock on the original issuance by the corporation; an individual acquiring his stock from another is not entitled to an ordinary loss under *IRC Section 1244*.ⁿ¹⁵ Indeed, an individual who acquires *Section 1244* stock by distribution from a partnership in which he is a partner, and who subsequently sells the stock at a loss, is denied *Section 1244* treatment, even though he could have claimed an ordinary loss if the partnership had sold the stock.ⁿ¹⁶

[i] Section 1244 Stock Defined. In order for stock to qualify as *Section 1244* stock and, therefore, for the special benefits conferred by the section, *IRC Section 1244* requires that the following conditions be satisfied:ⁿ¹⁷

(1) The stock must be stock in a domestic corporation.ⁿ¹⁸

(2) In the case of stock issued before November 7, 1978, the date of enactment of the Revenue Act of 1978, the stock must have been issued pursuant to a plan adopted by the corporation after June 30, 1958, to offer the stock for a specified period ending not later than two years after the plan was adopted.ⁿ¹⁹ The plan must have been in writing, and must have specifically stated, in terms of dollars, the maximum amount to be received by the corporation for the stock.ⁿ²⁰ Additionally, the stock must actually have been issued during period of the offerⁿ²¹ and before a subsequent offering was made by the

corporation.ⁿ²²

The requirement of a written plan and of an offering period is eliminated for stock issued after November 6, 1978. However, good corporate practice dictates the adoption of some form of written plan.

(3) The corporation must be a small business corporation. For stock issued before the enactment of the Revenue Act of 1978, this status must have existed at the time the plan was adopted.ⁿ²³ For shares issued thereafter, the crucial time is when the stock is issued.ⁿ²⁴

(4) In the case of pre-Revenue Act shares, no portion of a prior offering could be outstanding at the time of plan adoption.ⁿ²⁵ No such requirement exists for post-Act shares.

(5) The stock must be issued for money or other property, but not in exchange for stock or securities (including stock or securities of the issuing corporation).ⁿ²⁶ Stock issued for past or future services rendered in behalf of the issuing corporation is also disqualified.ⁿ²⁷

(6) During the period of the five taxable years immediately preceding the loss year (or for a specified lesser period if not in existence that long), the corporation must have derived more than one half of its aggregate gross *receipts* from sources other than royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stock and securities.ⁿ²⁸ The purpose of this provision is an attempt to limit the benefit of *IRC Section 1244* to operating corporations.ⁿ²⁹ This had led the Government to argue, and one court to hold, that Section 1244 treatment is unavailable if the corporation has no gross receipts, for such a corporation cannot be classified as an operating company.ⁿ³⁰

[ii] Small Business Corporation Defined. In the case of stock issued before November 7, 1978, a corporation qualified as a small business corporation under *IRC Section 1244*ⁿ³¹ if, at the time of adoption of the plan, it satisfied two conditions:

(1) The aggregate amount which could have been offered under the plan, plus the aggregate amount of money and other property (taken into account at adjusted basis for determining gain as of the time of receipt by the corporation, reduced by any liabilities to which the property was subject or which were assumed by the corporation) received by the corporation for stock, as a contribution to capital, and as paid-in surplus, did not exceed \$500,000.ⁿ³²

(2) The sum of the aggregate amount which could have been offered under the plan and the equity capital of the corporation on the date of adoption of the plan did not exceed \$1 million.ⁿ³³ Equity capital here means the sum of its money and other property (taken at adjusted basis for determining gain) less the amount of its indebtedness other than indebtedness to shareholders.

The Revenue Act of 1978 removed the equity capital limitation and increased the amount which could be received for stock from \$500,000 to \$1 million.ⁿ³⁴ Determination of the aggregate amount is made at the time of issuance of the stock in question and must take into account the amounts received for such stock and all stock previously issued.ⁿ³⁵

[iii] Limitations on the Amount of Ordinary Loss. It has been seen that the maximum amount which may be taken as an ordinary loss in any year is \$50,000, or, in the case of a husband and wife filing a joint return (even if the loss is sustained by only one of the spouses),ⁿ³⁶ \$100,000. If the taxpayer's loss is within the annual dollar limitation, the inability to fully deduct the loss in the year sustained may not be critical. The part of the loss which cannot be employed as a deduction becomes part of the taxpayer's net operating loss, and for that purpose is deemed attributable to a trade or business of the taxpayer. It should be noted that neither the Code nor the Regulations specifies whether an

IRC Section 1244 loss retains its character as such when carried to a year other than the original loss year. If the original character is retained in another year, the amount of the loss would have to be considered when applying the annual limitation in the other year. With no expression to the contrary, it is arguable that, in applying *IRC Section 1244(b)*, only losses actually sustained in the year should be considered, and that losses incurred in another year should be deductible without regard to *IRC Section 1244(b)*.

A further limitation on the amount of loss that may be treated as an ordinary loss is required whenever (1) Section 1244 stock was issued in exchange for property; (2) the basis of the stock is determined by reference to the basis of the property; and (3) the adjusted basis of the property for loss purposes immediately before the exchange exceeded its fair market value. The limitation is achieved by reducing the basis of the stock by an amount equal to the excess of the adjusted basis of the property over its fair market value.ⁿ³⁷ It is important to note that this limitation does not reduce the quantum of loss, but only changes the amount that can be claimed as an ordinary loss under *IRC Section 1244*. The excluded portion still qualifies as a capital loss.ⁿ³⁸

IRC Section 1244(d)(1)(B) provides one more limitation by requiring any increase in basis resulting from contributions to capital, or otherwise, to be allocated to stock that is not Section 1244 stock. This prevents the basis of Section 1244 stock from rising above the amount of consideration paid when the stock was originally acquired from the corporation.

[iv] Record-Keeping and Filing Requirements. Substantiation of an ordinary loss deduction under *IRC Section 1244* will require proof that the conditions prescribed by the provision have been met. To that end, in addition to any written plan, the corporation should maintain records showing:

- (1) The shareholders to whom the stock was issued, the date of issuance, and the amount and type of consideration received;
- (2) If the consideration for the stock was property, the basis of the property in the hands of the shareholder and its fair market value when received by the corporation;
- (3) The certificates which represent the Section 1244 stock;
- (4) The amount of money and the basis in the hands of the corporation of property received after June 30, 1958 and before adoption of the plan, as contributions to capital and as paid-in surplus;
- (5) The equity capital of the corporation on the date of adoption of the plan; and
- (6) Information relating to any tax-free stock dividend made with respect to the Section 1244 stock and any reorganization in which the corporation exchanged stock for the Section 1244 stock.ⁿ³⁹

Under existing regulations, anyone claiming a loss on Section 1244 stock must file, as part of the return for the year in which the deduction is claimed, a statement indicating (a) the address of the issuing corporation, (b) the manner in which the stock was acquired and the amount and nature of consideration therefor, and (c) if acquired in a nontaxable exchange for property other than money, the type of property and its adjusted basis and fair market value on the date of transfer.ⁿ⁴⁰ Until 1994, the Service took the position that taxpayers were not entitled to ordinary loss treatment under *IRC Section 1244* if they failed to file the information statement. The Tax Court upheld this position.^{n40.1} In 1994, the Service and Treasury Department determined that denying ordinary loss treatment for stock that otherwise qualifies as Section 1244 stock, solely due to a taxpayer's failure to file the information statement, is not necessary to achieve the purposes of *IRC Section 1244*, and announced that the regulations will be revised to eliminate the filing requirement.ⁿ⁴¹

The shareholder must also maintain records sufficient to distinguish the Section 1244 stock from any other stock owned

in the issuing corporation.ⁿ⁴² This is important because the revised regulations will state that a person who owns Section 1244 stock in a corporation must maintain sufficient records to establish that the stock qualifies as Section 1244 stock.ⁿ⁴³

[d] Worthless Securities of an Affiliate. It will be recalled that when a security which is a capital asset becomes worthless, the loss resulting therefrom is treated as a capital loss.ⁿ⁴⁴ However, the general rule set forth in *IRC Section 165(g)(1)* is subject to an exception when the security that becomes worthless is a security in a corporation affiliated with the taxpayer. The exception, which causes the loss to be an ordinary loss by treating the security as a noncapital asset, is invoked whenever (1) the taxpayer is a domestic corporation; (2) the taxpayer directly owns stock that possesses at least 80 percent of the total voting power and that has a value equal to at least 80 percent of the total value of the stock of the corporation whose security has become worthless; and (3) more than 90 percent of the gross *receipts* of the affiliated corporation for *all* taxable years has been derived from sources other than royalties, rents (except rents derived from rentals to employees of the corporation in the ordinary course of its operating business), dividends, interests (except interest received on deferred sales of operating assets), annuities, and gains from the sale or exchange of stocks and securities.ⁿ⁴⁵

The deduction for worthlessness can be claimed even though the affiliated corporation has not been dissolved. The First Circuit so held in *Textron, Inc. v. United States*,ⁿ⁴⁶ over the argument pressed by the Internal Revenue Service that the stock was not worthless because the subsidiary had potential value as a source of loss carryovers. The subsidiary, using funds provided by its parent, had purchased a successful business and used losses generated by an earlier activity as an offset against subsequent profits.

[3] Wash Sales.

[a] Wash Sale Defined.

Suppose a taxpayer owns stock or securities which have declined in value, but which the taxpayer desires to retain as a investment. If it were possible for the stock or securities to be sold and quickly repurchased, the taxpayer could achieve his investment objective while securing the added benefit of a loss deduction. However, if (1) the acquisition occurs within the period beginning thirty days before the sale and ending thirty days thereafter; (2) the acquisition takes the form of a purchase or taxable exchange; and (3) the acquisition is of substantially identical stock or securities, or during the specified period, the taxpayer enters into a contract or option to acquire substantially identical stock or securities, the taxpayer will have engaged in a wash sale.ⁿ¹

[i] Substantially Identical Stock or Securities. Crucial to the definition of a wash sale is the requirement that the acquisition within the sixty-one-day period be of *substantially identical* stock or securities. The phrase is without definition either in the Code or the Regulations and it is to judicial and administrative decision that we must look for the meaning of the term.

In an early case, *Hanlin v. Commissioner*,ⁿ² the Board of Tax Appeals stated:

"The term 'substantially identical' is looser than 'identical,' and was unquestionably so intended; but the retention of the word 'identical'... clearly indicates that approximation to identity, and not mere similarity was the controlling thought."ⁿ³

On appeal, the Third Circuit added its opinion that the term imported something less than precise correspondence and that

"[T]he '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."ⁿ⁴

The court in *Hanlin* was called upon to decide whether bonds of equal value and interest rate issued by the same obligor under the same authority, but with maturity dates differing slightly, were substantially identical. The Board of Tax Appeals opined that, all other things being equal, the only consideration important to an investor would be the permanence of the investment, and it could see "no substantial difference in permanence of investments of approximately sixteen years life, to be found only in a difference of four or ten months in length of life of bonds."⁵ The *Hanlin* case also faced the question of substantial identity in the case of bonds whose maturity dates differed by two and one-half years, but which were subject to redemption at any time after the same date. The Board concluded that the securities were substantially identical, basing its decision on the ground that, to the ordinary investor, the possibility of redemption was a more important feature than the date of ultimate maturity. The decision recognized that if there were unconditional difference of two and one-half years in the maturity of the bonds, a more difficult question as to the substantiality of the difference might arise.

How great a difference in maturity dates is necessary before the securities can be found to lack substantial identity seems to be a function of the difference in dates and time in the future fixed for maturity. Thus, in *Frick v. Driscoll*,⁶ a difference of four years in maturity dates, maturity coming thirty-five years and thirty-nine years, respectively, in the future, was not considered a material difference, with the result that the securities were substantially identical. And in *Revenue Ruling 58-211*,⁷ a difference of six months in earliest call dates and maturity dates was held unsubstantial where the securities sold were to mature six years in the future, and those purchased, nine years in the future. But when those two situations are looked at in the light of the recognition by the Board of Tax Appeals in *Hanlin*, that a two-and-one-half-year difference would be substantial where maturity would not occur until twenty-one years after the wash sale, the point at which a difference in the maturity dates of the securities purchased and those sold requires a decision that the securities are not substantially identical becomes unclear.⁸

A material difference in interest rates can also prevent substantial identity. Again, the line between material and immaterial difference is hazy. However, the Internal Revenue Service has ruled "that two bonds of the same face amount issued by the same debtor *but bearing different rates of interest* are not substantially identical even though other features of the indebtedness are similar."⁹ The ruling concerned a difference in interest rates of 3/8 of one percent. Whether any lesser change in interest rates will produce the same result is an open question.

A finding of substantial identity has occurred where the only difference in the securities is the date of issue.¹⁰ However, if some material factor, such as whether the bonds are redeemable at par to pay estate taxes, depends on the issue date, the difference will be considered material.¹¹

A last consideration in determining whether two bonds have the necessary approximation to identity relates to the security behind the obligation. If in the main, the underlying security is the same, the securities will be held to be substantially identical.¹² Apparently, the test of underlying security is made with respect to the primary obligor; a common secondary obligor will not infuse the securities with substantial identity.¹³

The same basic test, i.e., economic correspondence, is employed to ascertain whether stock purchased is substantially identical to stock sold within the prescribed period.¹⁴ Thus, the purchase of common stock on the same day as the sale of voting trust certificates for the stock has been held to be the acquisition of a substantially identical security.¹⁵ This result follows logically from the conclusion that the only change is in legal title to the stock. There is no effective change in the beneficial ownership, and, therefore, economic equivalence is achieved. But where voting common stock was sold and nonvoting common stock purchased, the acquisition was not of substantially identical property, even though the classes of stock were alike in every respect other than the right to vote.¹⁶ If the lack of voting power is sufficient to remove the necessary economic correspondence and approximation to identity, then the two decisions seem inconsistent unless the fact that the voting trust certificate situation involves a voluntary relinquishment of voting rights is sufficient to distinguish the two cases.

[ii] Options or Contracts to Acquire Substantially Identical Stock or Securities. It is really apparent that wash sale consequences could easily be avoided if, during the sixty-one-day period, it were permissible for a taxpayer to enter into a contract or option to purchase substantially identical stock or securities with actual acquisition of the stock or securities delayed until a date falling without the specified period. *IRC Section 1091(a)* closes this avenue of avoidance by equating the contract or option to purchase with actual acquisition.ⁿ¹⁷ So, if a taxpayer sells stock and simultaneously acquires warrants to purchase the same stock, the wash sale rules will apply because the warrant is, in effect, an option to acquire stock. However, this does not mean that the warrant or option itself is deemed the equivalent of the stock. A sale of the warrant followed by the purchase of the same stock to which the warrant relates will not invoke the wash sale provisionsⁿ¹⁸ "unless the relative values and price changes are so similar as to make the warrants fully convertible securities and therefore substantially identical with the shares of ... stock."ⁿ¹⁹ The unless clause appears to require a finding of substantial identity whenever a change in the price of the stock is matched by a proportionate change in the price of the warrant.

Suppose a taxpayer receives rights to purchase stock or an option to purchase stock without any action on his part. Has he "entered into a contract or option ... to acquire [substantially identical stock]"? The words "entered into" would seem to require affirmative action on the part of the taxpayer. However, the Service has ruled that the grant of an option under an employee restricted option plan is considered an entry into an option agreement under *IRC Section 1091* as of the date of the grant.ⁿ²⁰ This implies that, no matter how accomplished, the acquisition within the sixty-one-day period of an option to acquire substantially identical securities will require application of *IRC Section 1091*.

[b] Tax Consequences of Wash Sales.

[i] In General. *IRC Section 1091(a)* provides that if a wash sale has occurred,

"no deduction shall be allowed under section 165 unless the taxpayer is a dealer in stocks or securities and the loss is sustained in a transaction made in the ordinary course of such business."

The quoted rule applies to sales after December 31, 1984 in taxable years ending after that date.ⁿ²¹ Under prior law, the prohibition of *IRC Section 1091* did not apply in the case of a noncorporate taxpayer if the sale or other disposition of stock was made in connection with the taxpayer's trade or business or if the taxpayer was a corporation and a dealer in stocks or securities, and the sale or other disposition was made in the ordinary course of its business as such a dealer.ⁿ²²

IRC Section 1091(a) poses some additional problems. Suppose a taxpayer sells 200 shares of X Corporation stock on December 1, realizing a loss of \$10,000; sells an additional 200 shares on December 5, realizing a loss of \$5,000; and then purchases 200 shares on December 20. What is the extent of the disallowed loss, \$10,000 or \$5,000? The answer, according to the Regulations, is \$10,000, since that loss was the first sustained.ⁿ²³ This rule will be followed even where both lots are sold on the same day, unless the order of disposition cannot be determined, in which event the shares shall be considered disposed of in the order acquired.ⁿ²⁴

Consideration should be given to the intended scope of *IRC Section 1091*. Is the section to apply if, say, 100 shares are purchased on one day and 50 of those shares are sold at a loss within the next thirty days? Literal application of the Code would require an affirmative answer, but strict adherence to the language of the statute is, here, not the practice. Indeed, it is the position of the Internal Revenue Service that Congress intended to prevent a taxpayer from taking losses for tax purposes while giving up his position in the stock or securities for only a few days and not to "disallow a loss sustained in a bona fide sale of securities made to reduce the taxpayer's holding, even though the sale is made within 30 days after the securities were purchased."ⁿ²⁵ This statement of position came in answer to a single fact situation, the sale at a loss of a portion of shares purchased in one lot on one day. The extent to which deviation from the stated fact pattern will be permitted before the disposition will be considered other than a bona fide sale made to reduce a holding is still in doubt.

Since *IRC Section 1091* is directed at the disallowance of realized losses, it is obvious that a sale at a gain can be preceded or followed by a purchase of substantially identical property without adverse consequences. The requirement that each sale of stock or securities be tested separately to determine gain or loss is important in this regard. For example, suppose a taxpayer purchases 100 shares of stock of a certain corporation at \$100 a share, and an additional 200 shares of its stock at \$80 a share. If all of the stock is sold on the same day at \$95 a share, the result is a loss of \$500 on the sale of the 100 shares, a gain of \$3,000 on the sale of the 200 shares, and a net profit of \$2,500. However, the existence of a net profit on the entire transaction will not prevent disallowance of the \$500 loss (or reduction of the gain by the amount of the loss) if substantially identical stock is purchased within the sixty-one-day period.ⁿ²⁶

[ii] Acquisition of a Greater or Lesser Amount of Stock Than Sold. It is clear that where the amount of stock or securities acquired during the sixty-one-day period matches exactly the amount sold, the loss will be disallowed in its entirety. If, however, the amount acquired is less than that sold, only a portion of the loss is disallowed, the nondeductible part being determined by matching the stock or securities acquired with an equal number of shares of stock or securities sold.ⁿ²⁷ Matching is also necessary when the amount acquired is greater than the amount sold. Here the purpose is to determine the particular shares of stock or securities whose acquisition caused the loss to be non-deductible. This will be achieved by matching the stock or securities sold with an equal number of shares or securities acquired in accordance with the order of acquisition of the stock or securities acquired.ⁿ²⁸

[iii] Basis and Holding Period of Acquired Stock or Securities. An exception to the normal basis rule of *IRC Section 1012* comes into play whenever the acquisition of stock or securities results in a disallowance of loss under *IRC Section 1091(a)*. Instead of cost, the acquired stock or securities take the same basis as the stock or securities sold or disposed of, adjusted for any difference between the acquisition price of the new stock or securities and the selling price of the old.ⁿ²⁹ So, if stock having a basis of \$1,000 is sold for \$900, and within the prescribed sixty-one-day period substantially identical stock is purchased for \$950, the basis of the new stock will be \$1,050 (the basis of the old shares, \$1,000, increased by the excess of the purchase price over the selling price, \$50). If the acquired stock were purchased for \$850, a downward adjustment of \$50 to the basis of the stock disposed of would be required.

Following the general pattern that permits tacking of holding periods whenever the basis of property is in whole or in part a substituted basis, *IRC Section 1223(4)* provides that the holding period of the new stock or securities includes the holding period of those whose loss was not allowed. This rule governs whether the acquisition of the stock itself results in the nondeductibility of the loss, or whether that result obtains because the taxpayer entered into a contract or option to acquire substantially identical securities.

[c] Wash Sale Application.

[i] Limited to Stock and Securities. By definition, non-deductibility of losses from wash sales is limited to losses "sustained from [a] sale or other disposition of *shares of stock or securities*."ⁿ³⁰ The issue posed focuses on the interpretation of the term "securities."

Little difficulty is encountered in affixing the "securities" label to those things that are ordinarily thought of as securities, such as bonds or debentures.ⁿ³¹ With similar ease, security status can be denied to commodities.ⁿ³² Suppose, however, the taxpayer sells, not a commodity, but a commodity future, and reacquires a substantially identical future within the sixty-one-day period. Has he now engaged in a security transaction coming within *IRC Section 1091(a)*? Here the courts disagree. The Sixth Circuit held a future contract to be a security, relying on the fact that they were pledged with a broker who advanced funds for the purchase of the commodity.ⁿ³³ This may have resulted from the court's inability to distinguish between property which serves as security for a debt and property which itself is "a security." The Tax Court, in a later case holding the future contract to be property other than a security, found the reasoning of the Sixth Circuit to be unsound.ⁿ³⁴ The Service's position is similar to that of the Tax Court, to wit, futures contracts are neither stock nor securities.ⁿ³⁵ The conclusions of the Tax Court may not have been necessary for a decision. An alternate ground, namely, that a new future contract is not substantially identical with any prior contract

even though the quantity involved in each is identical, would suffice to remove a future contract from the ambit of the wash sale provision.

The Technical and Miscellaneous Revenue Act of 1988 amended *IRC Section 1091(a)* to provide that the term "stock or securities" includes contracts or options to acquire or sell stock or securities. The amendment, effective for sales made after November 11, 1988, overrules a decision to the contrary in *Gantner v. Commissioner*.ⁿ³⁶

[ii] Short Sales of Stock and Securities. The traditional short sale contemplates the sale of stock or securities which the seller does not own, delivery being made with borrowed property.ⁿ³⁷ While the actual sale occurs on the day executed, for tax purposes it is not deemed to be consummated until the short sale is closed.ⁿ³⁸ Thus, it would appear that a short sale resulting in a loss will not run afoul of the wash sale rules even if the stock used to cover the sale is acquired during the 30-day period following the sale, provided the closing does not occur earlier than the thirty-first day following the sale.

Suppose, however, that the taxpayer seeks to secure the benefit of a loss deduction, but desires to retain the stock or security as an investment. One might suggest that the taxpayer first sell the stock, then enter into a short sale, next reacquire the stock or security, and finally close the short sale more than thirty days after reacquisition. At first glance, this approach would seemingly pass muster, for the Regulations provide that "the principles of paragraph (a) of § 1.1233-1 for determining the consummation of a short sale shall generally apply ..."ⁿ³⁹ However, the Regulations provide that the date of entering into the short sale will be the sale date if, on that date, the taxpayer owns, or has entered into a contract to acquire, substantially identical stock or securities (a short sale "against the box") and delivers such stock or securities to close the short sale.ⁿ⁴⁰

Prior to the enactment of *IRC Section 1091(e)*, as part of the Tax Reform Act of 1984, the Code did not preclude the allowability of losses from short sales of stock against the box in the instance in which the original purpose of the short sale was to defer income. If the value of the stock increased before the short sale was closed, the taxpayer would acquire additional stock at the higher price in order to close the short sale. The short sale would generate a short-term capital loss that could offset unrelated income. The sale of the original stock after the start of the next taxable year would effectively defer income until that year (assuming the stock did not decrease in value). Even if the transactions occurred within a 61-day period, the wash sale rules would not apply if the stock held by the taxpayer was not acquired within the 30-day period preceding the close of the short sale.ⁿ⁴¹ *IRC Section 1091(e)* prevents this outcome by extending the wash sale rules to a loss realized on the closing of a short sale of (or the sale, exchange, or termination of a securities futures contract to sell) stock or securities if, within 30 days before or after such closing, the taxpayer sells or enters into another short sale of (or securities futures contract to sell) substantially identical stock or securities.

Even if the wash sale can be avoided by means of a short sale, the taxpayer may still have to contend with the claim that the entire scheme was undertaken to create a deductible loss without any change in economic position.ⁿ⁴² This attack has occasionally proved successful in cases which fall without the scope of *IRC Section 1091* either because the property sold and subsequently reacquired is not a stock or security,ⁿ⁴³ or because the seller and purchaser are different, albeit related or controlled, persons.ⁿ⁴⁴ Nonetheless, the use of a short sale to circumvent the effect of *IRC Section 1091* still appears to be a viable means of achieving the goal of loss deduction and continued investment. The Regulations appear to approve the use of short sales to avoid nondeductibility by providing that the general rule for fixing the date of consummation of a short sale will be applicable in determining whether a disallowing acquisition has been made within the sixty-one-day period. The "no economic loss" theory cases should be limited to cases involving transactions which could never be subject to *IRC Section 1091*.

[iii] Sale by the Taxpayer, Acquisition by the Taxpayer. *IRC Section 1091(a)* works its disallowance of loss whenever "the taxpayer has acquired ... substantially identical stock or securities ..."ⁿ⁴⁵ This language would seem to look to a sale and acquisition by the same person. And, in general, this is the position which the courts have taken. So, a sale of stock by a taxpayer followed by a purchase of substantially identical stock by a related taxpayer will not run

afoul of the wash sale provisions,ⁿ⁴⁶ unless the sale is not bona fide and the acquiring party is the mere nominee of the taxpayer.ⁿ⁴⁷ Even where the seller lends the buyer the funds with which to make the purchase, the loss will be allowed provided the buyer has not acted as the seller's agent.ⁿ⁴⁸

However, where complete identity can be attributed to the seller and purchaser, the wash sale rule will be applied. Thus, a sale by a partnership followed by a partner's acquisition of substantially identical stock with his own funds has resulted in a nondeductible loss.ⁿ⁴⁹ This is a logical conclusion--the partnership is not an entity apart from its partners; a partnership sale is, in effect, made by the partners. A similar result has been reached when the acquirer was a trust created and so completely controlled by the taxpayer as to be, in reality, no trust at all.ⁿ⁵⁰

Avoiding the consequences of a wash sale does not, by itself, insure deductibility. A purchase by one taxpayer coming immediately upon the heels of a sale at a loss by a related taxpayer may still result in the denial of tax benefits under some other provision of the Code.

[4] Transactions Between Related Parties.

A second disallowance provision also seeks to prevent a taxpayer from reaping the benefit of a loss deduction on investments that, practically speaking, remain under the control of the taxpayer. Unlike the wash sale provisions which require the identical taxpayer, or his agent, to be both seller and purchaser, *IRC Section 267* is based on the relationship between seller and purchaser. It should be noted, however, that section 267 is not exclusive; losses claimed in sales between parties whose relationships are not included in section 267, but nevertheless raise doubts about the "bona fides" of the sale, may not be deductible under section 165 of the Code.ⁿ¹

[a] The Specified Relationships. *IRC Section 267(a)(1)* disallows a loss deduction whenever the sale or exchange is between persons whose relationship is described in one of 13 categories set forth in *IRC Section 267(b)*, namely:

- (1) Members of the family, defined as an individual's brothers and sisters (whether of the whole or half-blood), spouse, ancestors, and lineal descendants;^{n1.1}
- (2) An individual and a corporation in which the individual owns, directly or indirectly, more than 50 percent in value of the outstanding stock;ⁿ²
- (3) Two corporations which are members of the same controlled group;ⁿ³
- (4) A grantor and a fiduciary;ⁿ⁴
- (5) Fiduciaries of different trusts, if both were created by the same grantor;ⁿ⁵
- (6) A fiduciary of a trust and the beneficiary of that trust;ⁿ⁶
- (7) A fiduciary of one trust and the beneficiary of another, if both trusts were created by the same grantor;ⁿ⁷
- (8) A fiduciary of a trust and a corporation in which more than 50 percent in value of the outstanding stock is owned, directly or indirectly, by the trust or by the grantor of the trust;ⁿ⁸
- (9) A person and a tax-exempt organization controlled, directly or indirectly, by the person, or if he is an individual, by members of his family;ⁿ⁹
- (10) A corporation and a partnership if the same person owns more than 50 percent in value of the

outstanding stock of the corporation and more than 50 percent of the capital interest or profits interest in the partnership;ⁿ¹⁰

(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;ⁿ¹¹

(12) An S corporation and a C corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;ⁿ¹² and

(13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of the estate.^{n12.1}

IRC Section 267 requires that certain stock ownership attribution rules be applied before determining whether the parties to a sale or exchange are related within the meaning of one of the categories defined above.

(1) Stock owned, directly or indirectly, by a corporation, partnership, estate, or trust is considered as being owned proportionately by its shareholders, partners, or beneficiaries.ⁿ¹³ Unanswered by the provisions or the Regulations is the manner in which the proportionate interest is to be ascertained. It may be presumed that since the stock ownership relationships contained in *IRC Section 267(b)* are measured in terms of value, the same yardstick should be used in determining constructive ownership. This is certainly logical when attribution is had from corporations, partnerships, or estates. But should it apply when the stock is owned by a trust? It would seem more sensible to determine the proportionate interest of a trust beneficiary on the basis of actuarial values, and this is what another constructive ownership section having no application to *IRC Section 267* expressly provides.ⁿ¹⁴ Whether the failure to specifically mandate use of actuarial values is manifestation of legislative intent to require resort to value as the measurement of proportionate interest remains an open question.

(2) An individual is considered to own the stock owned by his spouse, ancestors, lineal descendants, and his brothers and sisters (of the whole and half-blood).ⁿ¹⁵

(3) An individual that owns or is considered as owning stock in a corporation (other than by reason of the family attribution rules stated in (2) above) will be considered to own any stock in that corporation owned by a partner.ⁿ¹⁶

The consequence of the constructive ownership rule is to make one the owner of shares where he would not otherwise be. And because of this, he can constructively make another the owner of such shares. For example, assume an individual, A, owns all of the shares of X Corporation, which in turn owns all of the shares of Y Corporation. By virtue of *IRC Section 267(c)(1)*, A will be considered the owner of the Y Corporation shares, so that a loss on a sale between A and Y Corporations will be nondeductible. Furthermore, because he is now deemed the owner of the Y Corporation stock, his ownership will be attributed to the specified members of his family.ⁿ¹⁷ However, there is a limit to the extent to which attribution will be carried. Stock owned constructively by an individual by reason of the family attribution rules will not be treated as owned by him for the purpose of again applying the attribution rules.ⁿ¹⁸ Thus, while A's spouse would be considered as owning Y Corporation stock, the same would not hold true for, say, the sister of A's spouse.

[b] Covered Transactions.

IRC Section 267(a)(1) disallows losses if they arise from "sales or exchanges of property ... *directly or indirectly*, between persons [within any of the specified relationships]." ⁿ¹⁹ A special exception is made for transfers between spouses or incident to a divorce that are governed by *IRC Section 1041*.ⁿ²⁰

Few problems should be encountered with a direct sale or exchange. But when is a sale indirectly made? This would appear to be a question of fact to be resolved on a case-by-case basis, though some guidance can be derived from cases that have considered the question.

The starting point of any discussion of indirect sales between related parties must be *McWilliams v. Commissioner*.ⁿ²¹ There, a husband, managing both his portfolio of investments and the extensive investments of his wife, would sell stock from his account through a broker and then purchase an equal amount of the same stock for his wife's account, the purchase also being executed by a broker. In denying the taxpayer's contention that Congress could not have intended to disallow losses on bona fide transactions made through a public market, the Supreme Court concluded

"that the purpose of [Section 267(a)(1)] was to put an end to the right of taxpayers to choose, by intra-family transfers and other designated devices, their own time for realizing tax losses on investments which for the most practical purposes, are continued uninterrupted.

"We are clear as to this purpose, too, that its effectuation obviously had to be made independent of the manner in which an intra-group transfer was accomplished."ⁿ²²

At first glance, the broad interpretation which *McWilliams* gives to the phrase "between [related] persons" would appear to require disallowance whenever a sale is made by one taxpayer, and a purchase of like property by another having the specified relationship. However, does the rationale of *McWilliams* hold forth when neither the seller nor the purchaser knows of the transaction by the other? Or is *McWilliams* to be limited to those situations in which the seller is instrumental in effecting both transactions? The latter construction is the more rational and prevents disallowance when the subsequent purchase by a related party is a fortuitous event. Using this approach, a deduction would still be available to a taxpayer selling stock on the open market even if his brother were to purchase an equal number of the same shares, provided that the transactions were in no way connected.ⁿ²³

Courts have had little difficulty in finding an indirect sale when the transaction is effected through a conduit or strawman who serves no independent purpose. Hence, in *Boehm v. Commissioner*,ⁿ²⁴ losses were disallowed on a sale by a taxpayer to his in-laws, who resold the same securities *at cost* to the taxpayer's wholly owned corporations. A direct sale by the taxpayer to the corporations would have been a sale between related persons. The consequence of such a sale could not be avoided by routing the sale through an unrelated party, when the substance, if not the form, of the transaction remained a sale between related parties.

In both *McWilliams* and *Boehm*, the taxpayers entered into the sales voluntarily. Should a taxpayer be deprived of his loss deduction when the sale is a forced or involuntary sale? The Fifth Circuit provided an affirmative answer in *Merritt v. Commissioner*,ⁿ²⁵ holding that the nature of the sale had no bearing on the issue of disallowance. Thus, a wife's purchase of her spouse's securities in a closed corporation ran afoul of *IRC Section 267(a)(1)*, even though the purchase came at a tax sale held by the Internal Revenue Service. The court likened the Service to an agent playing a role similar to the broker in *McWilliams*, and looked to the substance of the transaction, namely, continued ownership of the property within the family unit. However, it may be significant that the property involved consisted of securities in a closed corporation, the stock of which was owned by the taxpayer, his wife, and his children. One may consider whether in these circumstances there could have been any purchaser other than the wife or children, and therefore, whether *Merritt* should have vitality when the property sold is readily resalable by any purchaser.

[i] Distributions in Corporate Liquidation. *IRC Section 267(a)(1)* is expressly inapplicable to any loss of the distributing or distributee corporation in a complete liquidation. Prior to the Technical and Miscellaneous Revenue Act of 1988, the exception applied to partial liquidations as well.

It must be pointed out that not every loss realized on a distribution in complete liquidation will be saved from disallowance. If it appears that the taxpayer formed the corporation for the sole purpose of effecting a sale of property

previously owned by him to a person related to him, the corporation might be deemed the taxpayer's alter ego, the corporate entity disregarded, and the sale deemed made by the taxpayer.ⁿ²⁶

[c] Treatment of Gain on Subsequent Sale. Partial relief from the consequences of *IRC Section 267(a)(1)*, is afforded the transferee of property, the sale of which resulted in a loss which was not allowed as a deduction to the transferor. The condition upon which relief is grounded is the sale of the property (or other property the basis of which is determined by reference to such property) at a gain. The medium by which relief is afforded is through recognition of gain only to the extent that it exceeds so much of the originally disallowed loss as is allocable to the property sold by the transferee.ⁿ²⁷

The operation of the relief provision can be illustrated by the situation in which a husband sells stock with an adjusted basis of \$2,000 to his wife for \$1,500. The loss of \$500 is nondeductible by reason of *IRC Section 267(a)(1)*. If the wife later sells the stock for \$2,300, her realized gain of \$800 (\$2,300 less her basis of \$1,500) is recognized to the extent of \$300, the excess of the realized gain of \$800 over the previously disallowed loss of \$500.ⁿ²⁸ Had the wife's sale been for \$1,400, the entire realized loss of \$100 would be recognized, for *IRC Section 267(d)* affects only the recognition of gain. If the wife had made a gift of the stock and the donee were to sell it for \$2,300, the donee would have had to recognize the entire gain of \$800. The benefits of *IRC Section 267(d)* are only available to the original transferee, and then only if he acquires the property by purchase or exchange.ⁿ²⁹

IRC Section 267(d) has no effect on the basis of the property.ⁿ³⁰ Nor does it permit tacking of the transferor's holding period to that of the transferee.ⁿ³¹ It operates in one way only, i.e., to affect the amount of recognized gain.

[5] Conversion Transactions.

A "conversion transaction" is a transaction, generally consisting of two or more positions taken with regard to the same or similar property, resulting in a situation where substantially all of the taxpayer's return is attributable to the time value of the taxpayer's net investment in the transaction. In a conversion transaction, the taxpayer is in the economic position of a lender, i.e., the taxpayer has an expectation of a return from the transaction that in substance is in the nature of interest and undertakes no significant risks other than those typical of a lender. In order to have the taxation of such transactions follow their economic posture, Congress enacted *IRC Section 1258(a)* to treat gain from the disposition or other termination of any position held as part of a conversion transaction entered into after April 30, 1993 as ordinary income instead of capital gain (to the extent the gain does not exceed the applicable imputed income amount).ⁿ¹ Thus, such gain will not be taxed at the preferential 28 percent rate accorded capital gains, but at the highest rate applicable to the taxpayer's ordinary income.

The "applicable imputed income amount" is an amount equal to (i) the amount of interest that would have accrued on the taxpayer's net investment in the conversion transaction for the period ending on the date of disposition or other termination at a rate equal to 120 percent of the applicable rate, reduced by (ii) the amount treated as ordinary income under *IRC Section 1258(a)* with respect to any prior disposition or termination of a position that was held as part of the transaction.ⁿ² The applicable rate is, generally, the applicable federal rate determined under *IRC Section 1274(d)* (compounded semiannually) as if the conversion transaction were a debt instrument but if the term of the conversion transaction is indefinite, the applicable rate is the federal short-term rate in effect under *IRC Section 6621(b)* during the period of the conversion transaction (compounded daily).ⁿ³

A transaction is not a conversion transaction unless, in addition to being one where substantially all of the taxpayer's return is attributable to the time value of the taxpayer's net investment in the transaction, it satisfies one of the following four criteria:

- (1) the transaction consists of the acquisition of property by the taxpayer and a substantially contemporaneous agreement to sell the same or substantially identical property in the future;

(2) the transaction is an applicable straddle;ⁿ⁴

(3) the transaction is one that was marketed or sold to the taxpayer on the basis that it would have the economic characteristics of a loan but the interest-like return would be taxed as capital gain; or

(4) the transaction is described as a conversion transaction in regulations to be promulgated on a prospective basis.ⁿ⁵

IRC Section 1258(a) does not apply to transactions of an options dealer in the normal course of the dealer's trade or business of dealing in options, or of a commodities dealer in the normal course of the trader's trade or business of trading *IRC Section 1256* contracts.ⁿ⁶ The exception for options dealers and commodities traders does not apply to gain recognized by an entity that is allocable to a limited partner or limited entrepreneurⁿ⁷ if (i) substantially all of the limited partner's (or limited entrepreneur's) expected return from the entity is attributable to the time value of the partner's (or entrepreneur's) net investment in the entity, (ii) the transaction (or the interest in the entity) was marketed or sold as producing capital gains attributable to the time value of the net investment in the entity, or (iii) the transaction or (interest in the entity) is a transaction (or interest) described in regulations under *IRC Section 1258*.ⁿ⁸

If a position with a built-in loss becomes part of a conversion transaction, and is later disposed of or terminated in a transaction in which gain or loss is recognized, the built-in loss is recognized and has a character determined without regard to *IRC Section 1258*.ⁿ⁹ A built-in loss is any loss that would have been realized if the position had been disposed of or terminated (at its fair market value) as of the time the position became part of the conversion transaction.ⁿ¹⁰

The operation of *IRC Section 1258* can be illustrated by the following examples:

Example 1:

On July 1, 1994, A purchased stock for \$1,000. On the same day, A agreed to sell the stock to B for \$1,200 on January 1, 1996. Assume that the applicable rate is 4 percent. When the sale is completed, of the \$200 realized gain that would be capital gain but for *IRC Section 1258*, \$74 is treated as ordinary income (\$1,000 multiplied by 120 percent of 4 percent compounded semiannually for 18 months) and \$126 as capital gain.

Example 2:

On July 1, 1993, A purchased stock for \$1,100. On July 1, 1994, when the stock was worth \$1,000, A used it as part of the conversion transaction described in Example 1.ⁿ¹¹ The stock is treated as having a basis of \$1,000, producing the same gain result as in Example 1. However, A would also recognize a built-in loss of \$100 when the stock was delivered to B; the character of the loss is unaffected by *IRC Section 1258*.

In determining a taxpayer's net investment in a conversion transaction, the source of the taxpayer's funds generally will not be taken into account.ⁿ¹² Amounts that a taxpayer may be committed to provide in the future generally will not be treated as an investment until such times as such amounts are committed to the transaction and unavailable to the taxpayer to invest in other ways.ⁿ¹³ Finally, the taxpayer's net investment in a conversion transaction generally will be 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, such as when the taxpayer is the grantor of an option.ⁿ¹⁴ The following examples illustrate these rules:

Example 3:

Assume that in Example 1, A borrowed \$900 of the \$1,000 purchase price of the stock from a bank and was required under *IRC Section 263(g)* to capitalize \$60 of interest on that debt into the cost of the stock.

Although A's basis in the stock will be increased to \$1060 to reflect the capitalized interest, A's net investment in the transaction will still be \$1,000. In addition, only \$14 of the gain will be recharacterized as ordinary income; the capitalized interest reduces the amount turned into ordinary income by *IRC Section 1258(a)*.

Example 4:

On January 1, 1995, A enters into a long futures contract committing A to purchase a certain quantity of gold on March 1, 1995 for \$10,000. On January 1, 1995, A also enters into a short futures contract to sell the same quantity of gold on April 1, 1995 for \$10,100. Under these contracts, A is not required to make any investment at the time they are entered into, but is required to make a 'margin' deposit (that may or may not bear interest), as security for A's obligations thereunder. Suppose A terminates both contracts on February 1, 1995, for a net profit of \$25. No part of the gain is subject to recharacterization under *IRC Section 1258(a)*, since A has no investment in the transaction on which the \$25 could be considered to be an interest equivalent return.

Example 5:

On January 1, 1995, A acquires non-publicly traded common stock for \$10,000 and, on the same day grants B a call option to purchase the same stock for \$10,600, exercisable at any time prior to February 1, 1996. B pays A a premium of \$1,000 for the call option. At the time that A grants B the call option, there is no substantial certainty that B will exercise the option. On these facts, A's net investment in the transaction comprised of the stock purchase and the granting of the option would be \$9,000 (\$10,000 paid for the stock less \$1,000 received for granting the option).

If a taxpayer disposes of or terminates all the positions of an identified netting transaction within a 14-day period in a single taxable year, all gains and losses on those positions taken into account for federal tax purposes within that period (other than built-in losses) are netted solely for purposes of determining the amount of gain treated as ordinary income under *IRC Section 1258(a)*.¹⁵ A taxpayer is treated as disposing of any position that is treated as sold under any provision of the Internal Revenue Code or the regulations thereunder, e.g., *IRC Section 1256(a)(1)*.

An identified netting transaction is a conversion transaction that the taxpayer identifies as an identified netting transaction on its books and records.¹⁶ 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. 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.

Example 1:

On December 1, 1996, A purchases 2,000 shares of X Corporation stock for \$200,000 and enters into a forward contract to sell 2,000 shares of X Corporation stock on November 30, 1998 for \$220,000. The X stock is actively traded and is a capital asset in A's hands. A maintains books and records on which, on December 1, 1996, it identifies the two positions as all the positions of a single conversion transaction. A owns no other X stock. On December 1, 1997, when the applicable imputed income amount for the transaction is \$14,000, A sells the 2,000 shares of X stock for \$190,000. On the same day, A terminates its forward contract with its counterparty, receiving \$20,400. No dividends were received on the X stock during the time it was part of the conversion transaction.

The X stock and forward contract are positions of a conversion transaction. Under *IRC 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. Under *IRC Section 1258(c)(2)(B)*, the transaction is an applicable straddle.

A disposed of or terminated all the positions of the conversion transaction within 14 days and within the same taxable year. The transaction is an identified netting transaction because it meets the identification requirements set forth above. Solely for purposes of *IRC Section 1258(a)*, the \$10,000 loss realized (\$200,000 basis less \$190,000 amount realized) on the disposition of the *X* stock is netted against the \$20,400 gain recognized on the disposition of forward contract, yielding a net gain of \$10,400 that is recharacterized as ordinary income under *IRC Section 1258(a)*. For federal tax purposes other than *IRC Section 1258(a)*, A has a recognized gain of \$20,400 on the disposition of the forward contract (\$10,400 of which is treated as ordinary income) and a separate realized loss of \$10,000 on the sale of the *X* stock.

Example 2:

Assume the same facts as in Example 1, except that A had purchased the *X* stock for \$208,000 on May 15, 1996. The *X* stock had a fair market value of \$200,000 on that date. The results are the same as in Example 1, except that A has a built-in loss (in addition to the \$10,000 loss that arose economically during the period of the conversion transaction) of \$8,000 on the *X* stock. The built-in loss is not netted against the \$20,400 gain on the forward contract for purposes of *IRC Section 1258(a)*. Thus, the net gain from the conversion transaction for purposes of *IRC Section 1258(a)* is still \$10,400. The \$8,000 built-in loss is recognized and has a character determined without regard to *IRC Section 1258*.

[6] Gain From Constructive Ownership Transactions.

If a taxpayer has gain from a constructive ownership transaction with respect to any financial asset and that gain would otherwise be treated as a long-term capital gain, (1) the gain is treated as ordinary income to the extent that it exceeds the net underlying long-term capital gain, and (2) to the extent that the gain is treated as long-term capital gain, the capital gain rate (or rates) applicable to the gain under *IRC Section 1(h)* is determined on the basis of the respective rate or rates applicable to the net underlying long-term capital gain.ⁿ¹ The provision does not apply to any constructive ownership transaction if all of the positions that are part of the transaction are marked to market under any provision of the Code or regulations.ⁿ²

A financial asset is (a) any equity interest in a passthrough entity, and, (b) to the extent provided in regulations, any debt instrument, and any stock in a corporation that is not a passthrough entity.ⁿ³ The term "passthrough entity" includes a regulated investment company (RIC), a real estate investment trust (REIT), an S corporation, a partnership, a trust, a common trust fund, a passive foreign investment company (as defined in *IRC Section 1297*), and a REMIC.ⁿ⁴

A taxpayer is treated as having entered into a conversion transaction with respect to a financial asset if the taxpayer (i) holds a long position under a notional principal contract with respect to the financial asset, (ii) enters into a forward or futures contract to acquire the financial asset, (iii) is the holder of a call option, and is the grantor of a put option with respect to the financial asset and the options have substantially equal strike prices and substantially contemporaneous maturity dates, or (iv) to the extent prescribed in regulations, enters into one or more transactions (or acquires one or more positions) that have substantially the same effect as a transaction described in (i), (ii), or (iii).ⁿ⁵ A person is treated as holding a long position under a notional principal contract with respect to any financial asset if the person has the right to be paid (or receive credit for) all or substantially all of the investment yield on the financial asset for a specified period, and is obligated to reimburse (or provide credit for) all or substantially all of any decline in the value of the financial asset.ⁿ⁶

Except as provided in regulations, if a constructive ownership transaction is closed by reason of taking delivery of the financial asset, the rules of *IRC Section 1260(a)* are applied as if the taxpayer had sold all the contracts, options or other positions that are a part of the transaction for fair market value on the closing date.ⁿ⁷ The amount of gain so recognized cannot exceed the amount of gain treated as ordinary income under *IRC § 1260(a)*. An adjustment to basis must be made in the amount of any gain or loss subsequently realized for gain recognized and treated as ordinary income

because the taxpayer took delivery.

In addition to recharacterizing gain as ordinary income, the constructive ownership transaction rules impose an interest charge for each year that the transaction was open. If gain is recharacterized as ordinary income for any taxable year, the tax for that year is increased by an amount equal to the interest that would have been imposed under *IRC Section 6601* on the underpayment of tax for the year that would have resulted had the recharacterized gain been included in gross income in the taxable year in which it accrued (determined by treating the income as accruing at a constant rate equal to the applicable federal rate in effect on the day the transaction closed).ⁿ⁸ The period during which the interest accrues ends on the due date (without extensions) for the tax return for the taxable year in which the transaction closed. The increase in tax due to the interest charge is not treated as an income tax for purposes of determining the amount of any allowable income tax credit or the alternative minimum tax.ⁿ⁹ The interest is taken into account in computing the amount of any interest deduction allowable to the taxpayer for the taxable year.ⁿ¹⁰

The Service is directed to prescribe regulations as may be necessary or appropriate, including regulations to permit taxpayers to mark to market constructive ownership transactions in lieu of applying *IRC Section 1260*, and to exclude certain forward contracts that do not convey substantially all of the economic return with respect to a financial asset.ⁿ¹¹

[7] Gains or Losses From Securities Futures Contracts.

Pursuant to *IRC Section 1234B(a)(1)*, gain or loss attributable to the sale, exchange, or termination of a securities futures contract is treated the same as gain or loss from transactions in the underlying security, and, thus, such gain has the same character as the property to which the contract relates has or would have had in the hands of the taxpayer.ⁿ¹ If gain or loss realized on the sale or exchange of a securities futures contract to sell property is capital gain or loss, it generally will be treated as a short-term gain or loss.ⁿ²

The provision applies only to investors; a dealer securities futures contract is treated as a Section 1256 contract.ⁿ³ However, it does not apply to a contract that constitutes property described in *IRC Section 1221(a)(1)* (inventory or property held for sale to customers in the ordinary course of business) or *IRC Section 1221(a)(7)* (certain hedging transactions), or any income derived in connection with the contract that would be treated as ordinary income.ⁿ⁴

FOOTNOTES:

(n1)Footnote 1. The present discussion is not exhaustive. See also §§ 5.02[3] (redemptions not treated as exchanges); 7.02[2] (dispositions of Section 306 stock); 8.03[1][c][ii] ("boot" in reorganization exchanges); 9.03[3][b][i]; 9.04[3][b] (disqualifying dispositions of stock acquired through exercise of stock options or through employee stock-purchase plans); and 20.04[4] (sale or exchange of controlled foreign corporation stock).

(n2)Footnote 1. Recall that, by statute, retirement of a debt instrument is treated as a sale or exchange for capital gain purposes. See § 2.03[2], *supra*.

(n3)Footnote 2. See *Deputy v DuPont*, 308 US 488, 498 (1940) .

(n4)Footnote 3. 381 US 54, 57-58 (1965) .

(n5)Footnote 4. 313 US 28, 31 (1941) . Cf *Frank Lyon Co v US*, 435, 561, 573 (1978) ("In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed."); *Corn Products Refining Co v Commr*, 350 US 46, 51-52 (1955) (the capital gains provisions "must be narrowly applied ... ").

(n6)Footnote 5. Treasury Regulations have long provided, for example, that when bonds are sold between interest dates, part of the sale price represents imputed interest accrued to the date of the sale and must be reported as interest income. *Treas Reg* § 1.61-1(d); § 2.04[2][b][ii], *supra* .

(n7)Footnote 6. In *Midland-Ross*, the taxpayer purchased noninterest-bearing commercial paper at a discount and sold it in the same taxable year (after holding the paper for more than 6 months, the long-term capital gain holding period at the time) for more than its purchase price. The original issue discount was calculated to yield the equivalent of 2% to 2 1/2% on an annual basis if the paper was held to maturity. The taxpayer's gain on sale approximated the discount earned to date, and it was not contended that any part of its gain was attributable to market fluctuations as opposed to the passage of time. *US v Midland-Ross Corp*, 381 US 54, 55 (fn. 1) (1965). The Supreme Court expressly declined to rule on whether the accrual basis taxpayer would have been required to report annually a portion of the original issue discount as "earned" had it sold the paper in a year subsequent to the year of purchase or held it to maturity, or whether and how original issue discount should be distinguished from "market discount" (see fn 8, *infra*) had there been any evidence that the latter could have accounted for a portion of the taxpayer's gain, issues on which there was in any event no statutory guidance for the taxable years in issue.

In *Lubin v Commr*, 335 F2d 209 (2nd Cir 1964), the Court of Appeals for the Second Circuit, while agreeing with the Internal Revenue Service's position that the portion of the amount received on the sale, exchange or retirement of a debt instrument attributable to original issue discount constitutes interest income rather than capital gain (the same position later accepted by the Supreme Court in *Midland-Ross*), see *Dixon v US*, 333 F2d 1016 (2nd Cir 1964), refused to go farther and accept the Service's argument that "anything above face value paid on notes by an obligor must, as a matter of law, be regarded as interest, no matter what the substance might be of the underlying transaction which has given rise to the obligations." *Lubin v Commr*, 335 F2d 209, 213. The Court of Appeals held that a note acquired by the taxpayer from the obligor for \$1,000,000 less than face value resulted in capital gain and not ordinary income when the note was paid in full because the "discount" actually represented, not interest, but the obligor's promise to share 50% of the profit made on the sale of a business acquired by the obligor, in part with the taxpayer's money.

(n8)Footnote 7. In *IRC § 1274*, and its associated provisions (*IRC §§ 1271-1273, 1274A, and 1275*), imputed interest is referred to as "original issue discount."

(n9)Footnote 8. In *IRC § 483*, imputed interest is referred to as "unstated interest." As further explained below, whether referred to as "original issue discount" or "unstated interest," imputed interest is identified and computed under similar principles in the two Code sections.

(n10)Footnote 9. *IRC § 1276(a)(1)*, which deals with market discount as opposed to original issue discount, takes the conversion approach. Congress there required "gain on the disposition of any market discount bond...[to] be treated as ordinary income to the extent it does not exceed the accrued market discount on such bond." Market discount, unlike original issue discount and unstated interest dealt with in *IRC §§ 1274 and 483*, respectively, generally arises when a taxpayer acquires a bond that has declined in value *after* issuance, typically because of an increase in prevailing interest rates or a decline in the credit-worthiness of the borrower. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (HR 4170, 98th Cong; Pub L 98-369) 93. The operation of *IRC § 1276* is discussed in Chapter 17, § 17.04[2].

(n11)Footnote 10. See *Treas Reg § 1.483-1(a)(2)* ("If section 483 applies to a contract, unstated interest under the contract is treated as interest for tax purposes. Thus, for example, unstated interest is not treated as part of the amount realized from the sale or exchange of property (in the case of the seller), and is not included in the purchaser's basis in the property acquired in the sale or exchange." Thus, the statutory scheme indirectly turns capital gain into ordinary interest income by excluding imputed interest from the sale price of a capital asset and taxing it as interest. However, it can also turn a capital gain into a capital loss. For example, suppose a taxpayer sells securities with a basis of \$9 million, held for more than one year, for a total sales price of \$10 million, receiving \$5 million at the time of sale and taking back a note for \$5 million. If \$2 million of the principal amount of the note is determined to represent imputed interest, the amount realized on the sale will not be \$10 million but \$8 million, and the taxpayer's \$1 million capital gain on the transaction will become a \$1 million loss. See *Treas Reg § 1.1001-1(g)* ("If a debt instrument is issued in exchange for property, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under [*Treas Reg §§ 1.1273-2 or 1.1274-2(b)*], whichever is applicable."); see also *Treas Reg § 1.483-1(a)(2)*

. As discussed in the text below, the "issue price" of a debt instrument, determined under *IRC* § 1274, excludes the portion of the stated principal amount that is determined to be imputed interest.

(n12)Footnote 11. *Treas Reg* §§ 1.1012-1(g), 1.483-1(a)(2), and 1.163-7(a).

(n13)Footnote 12. *IRC* § 1274(d). The Internal Revenue Service publishes applicable Federal rates each month in the Internal Revenue Bulletin. See, *eg*, *Rev Rul* 2010-8, 2010-10 *IRB* 432 (AFRs for debt issued in the month of March, 2010). Applicable Federal rates are based on the yield to maturity of outstanding marketable obligations of the United States of similar maturities during the one month period ending on the 14th day of the month preceding the month for which the rates are applicable. *Treas Reg* § 1.1274-4(b).

(n14)Footnote 13. The IRS calculates each AFR using the average market yields of US marketable obligations having remaining periods to maturity equivalent to the terms of the debt instruments (short-term, mid-term or long-term) to which the AFR is to apply (eg, the short-term AFR is determined with reference to US marketable obligations having remaining terms to maturity of 3 years or less). See *IRC* § 1274(d)(1)(C).

(n15)Footnote 14. This brief description necessarily oversimplifies the process as well as the computation, as subsequent sections will reveal. For example, the AFR may have to be adjusted upward or downward depending on the nature of the transaction, the amount involved, and how often interest is paid or compounded. Imputed interest may be determined without reference to the AFR if the debt instrument or the property for which it is given is publicly traded, or the transaction involves a "potentially abusive situation." Installment sales and debt instruments with variable interest rates or other contingent payments add further complexity to the process.

(n16)Footnote 15. See *IRC* § 1272(a); Ch 17, § 17.03[2].

(n17)Footnote 16. See *IRC* § 483(a); *Treas Reg* § 1.483-1(a)(2)(ii); 1.446-2(a). A discussion of the transactions that fall within the jurisdiction of *IRC* §§ 1274 and 483, respectively, may be found at § 2.07[1][c][v]. A third method of accounting for imputed interest applies if the lender, including a seller of debt-financed property, provides interest-free financing, or financing at below-market rates, as a disguised gift, compensation, or dividend to the borrower, or for some similar tax avoidance purpose. See *IRC* § 7872. Imputed interest in such cases goes by yet another name—"foregone interest" on a "below-market loan"—but is calculated in basically the same manner as OID or unstated interest. An amount identified as "foregone interest" under *IRC* § 7872 is analyzed in a two-step process: first, an amount equal to the imputed interest is deemed to have been transferred by the lender to the borrower as either a gift, compensation for services, a dividend, or other tax avoidance type of payment, and second, the same amount is deemed to have been transferred back to the lender from the borrower as an interest payment. See *Rabkin & Johnson, Federal Tax Guidebook*, § 35.01[3][a] (Matthew Bender).

(n18)Footnote 17. See *Frazee v Commr*, 98 TC 554, 581 (1996) : "Section 483 and 1274 establish two alternative interest imputation schemes for debt instruments issued in sales and exchanges of property. Section 1274 is the general rule; it applies to a note issued in a sale or exchange unless the note is excepted from its application. Section 483 applies to most notes excepted from section 1274. 'The principal difference between section 483 and 1274 is that the former operates on a cash basis, while the latter is an accrual regime', but both yield similar results. Lokken, 'The Time Value of Money Rules', 42 *Tax L Rev* 1, 82 (1986)."

(n19)Footnote 18. See *IRC* § 483(d)(1).

(n20)Footnote 19. See *Treas Reg* § 1.483-3(a).

(n21)Footnote 20. *IRC* § 1275(a)(1).

(n22)Footnote 21. *Treas Reg* § 1.1275-1(d).

(n23)Footnote 22. *IRC § 1273(a)(1)*;

(n24)Footnote 23. See *IRC § 1273(a)(2)*; *Treas Reg §§ 1.1273-1(b)* and *(c)*. Thus, the stated redemption price at maturity of a \$10,000 note, payable in five years, with stated interest payable unconditionally and annually at a fixed rate of 5% per annum, would be its stated principal amount of \$10,000. On the other hand, suppose accrued interest on the note were not payable until maturity. In that case, the interest would not be payable at least annually and therefore would not be "qualified stated interest." In those circumstances, the stated redemption price at maturity includes both the \$10,000 principal amount and the payment of accrued interest at maturity. See *Treas Reg § 1.1273-1(f)*, Example 3.

(n25)Footnote 24. See *IRC § 1273(b)*.

(n26)Footnote 25. If all or a substantial amount of the debt instruments in a public offering is issued for money, the issue price of each debt instrument in the issue is the first price at which a substantial amount of the debt instruments is sold (without regard to sales to bond houses, brokers, and similar organizations) for money. *IRC § 1273(b)(1)*; *Treas Reg §§ 1.1273-2(a)(1)* and *(e)*. Thus, each debt instrument in the issue will have the same issue price for OID purposes, regardless of the price actually paid by a particular holder. If a debt instrument is privately offered for money, the issue price is the amount paid by the first buyer of such instrument. *IRC § 1273(b)(2)*. For example, the issue price of a debt instrument in a simple cash loan transaction would be the amount loaned. *Treas Reg § 1.1273-2(a)(1)*.

(n27)Footnote 26. If the debt instrument is itself publicly traded, its issue price is the fair market value of the debt instrument on the date it is issued. *Treas Reg § 1.1273-2(b)*. If the debt instrument is not publicly traded but is issued in exchange for property that is publicly traded, its issue price is the fair market value of the publicly traded property on the date the debt instrument is issued. *Treas Reg § 1.1273-2(c)*.

(n28)Footnote 27. In general, *IRC § 1274* does not apply to a pre-existing debt instrument that is assumed or taken subject to in connection with a sale or exchange. See *IRC § 1274(c)(4)*. However, if the terms of the debt instrument that is being assumed or taken subject to are modified as part of the sale or exchange in a manner that would constitute an exchange under *IRC § 1001*, the modification may have OID consequences. See *Treas Reg § 1.1274-5(a)*. (As to the circumstances in which the modification of a debt instrument may be treated as an exchange of the unmodified debt for new modified debt under *IRC § 1001*, see Ch 1, § 1.02[3][a][ii].) The regulations treat the modification as having been made immediately prior to the sale and exchange, between the seller and the holder of the pre-existing debt instrument, with any OID consequences of the modification being attributed to the seller (unless the seller can show that it neither knew nor had reason to know about the modification). The purchaser, treated as having assumed the pre-existing debt instrument after the modification, incurs no *IRC § 1274* consequences. *Treas Reg § 1.1274-5(b)(1)*. Alternatively, the regulations allow the purchaser and the seller to jointly elect (in a statement attached to their tax returns for the year in which the sale or exchange occurs) to treat the modification as though it were made after the purchaser assumed the original (unmodified) debt instrument. The modification is then treated as a separate transaction between the purchaser and the holder of the debt instrument that occurs after the sale or exchange. *Treas Reg § 1.1274-5(b)(2)*.

(n29)Footnote 28. *Treas Reg § 1.1273-1(d)*.

(n30)Footnote 29. *Treas Reg § 1.1273-1(d)(2)*. In the case of an installment obligation (that is, an obligation which provides for the payment of any amount other than qualified stated interest before maturity), the number of complete years to maturity is calculated using the "weighted average maturity" of the obligation (see § 2.07[1][c][ii], *infra*) instead of the number of years until the last payment date. Alternatively, the actual number of years to maturity may be used if the installment obligation is a "self-amortizing installment obligation" (one which provides for equal payments composed of principal and qualified stated interest at least annually and requires no significant additional payment at maturity (principal balance fully amortized at maturity)), but the de minimis figure of .00167 is substituted for .0025. *Treas Reg § 1.1273-1(d)(3)*.

(n31)Footnote 30. A special rule applicable to debt instruments with so-called "teaser rates" or "interest holidays"

makes it easier for such instruments to qualify for the de minimis exception. Solely for purposes of calculating the maximum amount that would qualify as de minimis OID, the instrument's stated redemption price at maturity is treated as equal to the instrument's issue price plus the greater of "foregone interest" or the excess (if any) of the stated principal amount over the issue price. Foregone interest in this context means the amount of additional stated interest that would be required during the period of the interest holiday to make all stated interest under the instrument qualified stated interest. Under the rules generally applicable in calculating OID, the instrument's stated redemption price at maturity would have to include all interest payable during the entire term of the instrument in excess of the rate applicable during the interest holiday, because such excess would fail to satisfy the definition of qualified stated interest. *Treas Reg* § 1.1273-1(d)(4); *Treas Reg* § 1.1273-1(f), Examples 5 and 6; *Treas Reg* § 1.1274-2(h), Example 1.

(n32)Footnote 31. *Treas Reg* § 1.1273-1(d)(5).

(n33)Footnote 32. *IRC* § 1274(a)(1).

(n34)Footnote 33. *IRC* § 1274(a)(2).

(n35)Footnote 34. *Treas Reg* § 1.1274-2(c).

(n36)Footnote 35. *IRC* § 1274(b)(2). It would be more accurate to say that the discount or test rate used in calculating present values is based upon, rather than equal to, the AFR as published by the IRS, since as discussed below at least one and possibly more modifications must be made to the published rates before can be used as the discount rate to determine imputed interest.

(n37)Footnote 36. *IRC* § 1274(c)(2); *Treas Reg* § 1.1274-2(c)(1).

(n38)Footnote 36.1. See § 2.07[1][c][iii], *infra*.

(n39)Footnote 37. The Regulations provide in this regard that either the issue date or the maturity date should be included in the term of a debt instrument, but not both. *Treas Reg* § 1.1274-4(e)(3).

(n40)Footnote 38. "Installment obligation" is defined by the regulations as a debt instrument that provides for the payment of any amount other than qualified stated interest before maturity. *Treas Reg* § 1.1273-1(e)(1).

(n41)Footnote 39. *Treas Reg* § 1273-1(e)(3).

(n42)Footnote 40. *Treas Reg* § 1.1275-2(c)(1).

(n43)Footnote 41. *Treas Reg* § 1.1275-2(c)(4).

(n44)Footnote 42. "Variable rate instruments" and "qualified floating rates," defined in *Treas Reg* §§ 1.1275-5(a) and (b), respectively, are discussed in § 2.07[1][c][iv], *infra*. An example of a variable rate instrument with a qualified floating rate would be a debt instrument that provides for annual payments of interest based on the prime rate of a bank. See *Treas Reg* § 1.1274-4(e), Example 1.

(n45)Footnote 43. *Treas Reg* § 1.1274-4(c)(2)(i).

(n46)Footnote 44. *Treas Reg* § 1.1274-4(c)(2)(ii). In *Treas Reg* § 1.1274-4(e), Example 1 cited in fn 43 above, a provision in the debt instrument which restricted the variation in the debt instrument's interest rate to no more than .25 percentage points (25 basis points) from one year to the next was assumed to be a "significant restriction."

(n47)Footnote 45. *IRC* § 1274(b)(2)(B).

(n48)Footnote 46. In the published AFRs for January, 2010, the long-term AFR based on semiannual

compounding is 4.07%. If interest is compounded monthly however, the long-term AFR is reduced to 4.03%, since more frequent compounding makes 4.03% the economic equivalent of a 4.07% rate compounded semiannually. Similarly, the long-term AFR based on less frequent annual compounding is higher (4.11%) than either the monthly or semiannually compounded rates. *Rev Rul 2010-1, 2010-2 IRB 248, 249*.

(n49)Footnote 47. See *Treas Reg* §§ 1274-4(a)(ii)(A) and (B).

(n50)Footnote 48. *Treas Reg* § 1274-4(a)(1).

(n51)Footnote 49. *IRC* § 1274(e); *Treas Reg* § 1274-4(a)(2). For purposes of this provision, related party means a person related to the transferor within the meaning of *IRC* § 267(b) or *IRC* § 707(b)(1).

(n52)Footnote 50. See *IRC* § 1274A(a)(1); *Treas Reg* § 1274-4(a)(2)(ii). In circumstances where the ceiling rate becomes the test rate, if the stated rate in the qualified debt instrument is compounded on other than a semiannual basis, the 9 percent rate will have to be adjusted to make it comparable with the qualified debt instrument's compounding period. See fn 45 and accompanying text, *supra*.

(n53)Footnote 51. The property for which the debt instrument is issued must not be "new section 38 property" eligible for the investment credit within the meaning of *IRC* § 48(b), as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990 [enacted November 5, 1990], *IRC* § 1274A(b)(1), a restriction unlikely to disqualify contemporary debt instruments since the investment credit was repealed in 1986. In addition, a debt instrument issued in a sale-leaseback transaction cannot be a qualified debt instrument, since *IRC* § 1274(e) provides that the test rate for debt instruments issued in such transactions must be set at 110 percent of the AFR. See *Treas Reg* § 1.1274A-1(b)(1); text at fn 51, *supra*.

(n54)Footnote 52. The limitation on the principal amount of debt instruments that qualify for the rate ceiling is set annually for each calendar year, and is applied in accordance with aggregation rules under which (1) all sales or exchanges which are part of the same transaction (or a series of related transactions) are treated as 1 sale or exchange, and (2) all debt instruments arising from the same transaction (or a series of related transactions) are treated as 1 debt instrument. *IRC* § 1274A(d)(1).

(n55)Footnote 53. See *Rev Rul 2010-2, 2010-3 IRB 272, 273*.

(n56)Footnote 54. *Treas Reg* § 1.1274-2(c).

(n57)Footnote 55. See § 2.07[1][c][1], *supra*. OID will ordinarily result if some or all of the instrument's stated interest is not qualified stated interest. Since typically no stated interest accrues on the "unqualified" stated interest, the entire difference between the actual amount of the "unqualified" stated interest payment, added at face value to the instrument's stated redemption price at maturity, and the present value of the payment included in the imputed principal amount, will be OID.

(n58)Footnote 56. *Treas Reg* § 1001-1(g); *Treas Reg* § 1.1012-1(g).

(n59)Footnote 57. *Treas Reg* § 1.1274-2(b)(1). There is one exception: even if there is adequate stated interest, the stated principal amount of a debt instrument in the hands of a seller-lender will be reduced if cash is paid by the borrower-purchaser incident to the lending transaction that is designated as interest or "points" on the loan. *Treas Reg* §§ 1273-2(g)(2)(ii) and 1.1274-2(b)(1). The regulations treat the seller-lender in these circumstances as having made a net loan to the purchaser-borrower equal to the stated principal amount of the debt instrument reduced by the amount the purchaser is required to return to the seller as points. The reduced stated principal amount becomes the instrument's issue price while the instrument's stated redemption price at maturity remains at the original (unreduced) stated principal amount, resulting in OID equal to the difference or "points" paid by the purchaser. On the other hand, the purchaser's payment of "points" is included in the purchaser's basis in the property acquired. *Treas Reg* § 1273-2(g)(2)(ii); *Treas*

Reg § 1273-2(g)(5), Example 2.

(n60)Footnote 58. See *Treas Reg § 1.1274-1(b)(1)*.

(n61)Footnote 59. *Treas Reg § 1.1274-2(c)*.

(n62)Footnote 60. See *IRC § 1274(b)(3)*; *Treas Reg § 1.1274-3*.

(n63)Footnote 61. *IRC § 1274(b)(3)(A)*.

(n64)Footnote 62. As defined in *IRC § 6662(d)(2)(C)(ii)*.

(n65)Footnote 63. Nonrecourse financing does not include a sale or exchange of a real property interest financed by a nonrecourse debt instrument if the purchaser makes a down payment in money that equals or exceeds 20 percent of the total stated purchase price of the real property interest. *Treas Reg § 1.1274-3(b)(2)*.

(n66)Footnote 64. Interest on a debt instrument is clearly excessive if the interest, in light of the terms of the debt instrument and the creditworthiness of the borrower, is clearly greater than the arm's length amount of interest that would have been charged in a cash lending transaction between the same two parties. *Treas Reg § 1.1274-3(b)(3)*.

(n67)Footnote 65. See *IRC § 1274(b)(3)(B)*.

(n68)Footnote 66. Cf fn 55, *supra*.

(n69)Footnote 67. See *Treas Reg § 1.1273-1(f)*, Example 3.

(n70)Footnote 68. *Treas Reg § 1.1273-1(b)* and *Treas Reg § 1.1273-1(c)(4)*.

(n71)Footnote 69. See generally *Treas Reg § 1.1275-5*.

(n72)Footnote 70. *Treas Reg § 1.1274-2(f)(1)*.

(n73)Footnote 71. *Treas Reg § 1.1275-5(e)(1)*.

(n74)Footnote 72. *Treas Reg § 1.1274-2(g)* ("[T]he issue price of the debt instrument is the lesser of the instrument's noncontingent principal payments and the sum of the present values of the [instrument's] noncontingent payments" unless the debt instrument is issued in a potentially abusive situation, in which case the issue price is the fair market value of the noncontingent payments.) See also *Treas Reg § 1.1275-4(c)* (treatment of contingent payment debt instruments); *Treas Reg § 1.1275-4(a)(2)* (excluding variable rate debt instruments from provisions of *Treas Reg § 1.1275-4*).

(n75)Footnote 73. The significance of the difference in treatment can be illustrated by a case in which nonpublicly traded property is sold for \$10 million, resulting in a nominal capital gain to the seller of \$1 million. The entire purchase price is paid by the issuance of a nonpublicly traded 3-year debt instrument providing for payment in full at maturity and annual payments of interest at a floating rate which has a value equal to 6 percent per annum, compounded annually. The test rate on both the first date on which there is a binding contract and the actual date of the sale is 3.5 percent per annum, compounded annually. If the instrument does not qualify as a "variable rate debt instrument" with a "qualified floating rate," the issue price of the debt instrument will be the present value of its one noncontingent payment (\$10 million payable in 3 years), discounted at the test rate of 3.5 percent. Assume this produces an imputed principal amount of \$9 million. The seller's capital gain will be erased and replaced by OID of \$1 million. If, on the other hand, the debt instrument meets the requirements of a variable rate debt instrument and the variable rate is a "qualified floating rate," all interest payments are treated as "qualified stated interest" determined at a rate equal to the value of the qualified floating rate on the date of sale. Since that rate (6 percent) is greater than the test rate (3.5

percent), the instrument's stated principal amount and its issue price are both \$10 million. The seller's capital gain thus remains at \$1 million with no OID. See *Treas Reg* §§ 1.1274-2(f) and 1.1275-5(e)(2).

(n76)Footnote 74. *Treas Reg* § 1.1275-5(a). The limit on the amount of premium (ie, the excess of the instrument's issue price over the amount of its noncontingent principal payments) is the lesser of 15 percent of the total noncontingent principal payments or .015 multiplied by the product of the total noncontingent principal payments and the number of complete years to maturity from the issue date (or, in the case of an installment obligation, the weighted average maturity). *Treas Reg* § 1275-5(a)(2).

(n77)Footnote 75. *Treas Reg* § 1.1275-5(b).

(n78)Footnote 76. Cf *Treas Reg* § 1.1274-4(e), Example 1.

(n79)Footnote 77. *Treas Reg* § 1275-5(d), Example 3.

(n80)Footnote 78. *Treas Reg* § 1275-5(d), Example 1.

(n81)Footnote 79. *Treas Reg* § 1275-5(d), Example 2.

(n82)Footnote 80. *Treas Reg* § 1275-5(d), Example 4.

(n83)Footnote 81. *Treas Reg* § 1275-5(d), Example 5.

(n84)Footnote 82. *Treas Reg* § 1275-5(d), Example 8.

(n85)Footnote 83. *Treas Reg* § 1275-5(d), Example 6.

(n86)Footnote 84. A debt instrument issued for money or publicly traded property, the issue price of which is not governed by section 1274, may qualify as a variable rate debt instrument even though its variable rate is not a qualified floating rate if the variable rate meets the less stringent requirements of a "single objective rate." See *Treas Reg* § 1.1275-5(a)(3)(C) and (D). In general, an "objective rate" is one that uses a fixed formula based on objective financial or economic information that is not within the control, or unique to the circumstances, of the issuer or a related party (e.g., a rate based on the dividends, profits or the value of the issuer's stock would be considered unique to the circumstances or within the control of the issuer.) See *Treas Reg* § 1.1275-5(c)(1).

Suppose a debt instrument provided for interest payments at a rate determined in accordance with changes in the value of a commodity index based on the prices of several actively traded commodities. The debt instrument does not provide interest computed at a qualified floating rate because such an index cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Nevertheless, the commodity index is an "objective rate" since it is based on financial or economic information not within the control or unique to the circumstances of the issuer or a related party, *Treas Reg* § 1.1275-1(d), Example 4. This would be sufficient to make the debt instrument a variable rate debt instrument if it were issued for cash or publicly traded property. However, *Treas Reg* § 1.1274-2(f)(2) provides that in calculating the issue price (imputed principal amount) of a debt instrument subject to *IRC Section 1274*, any interest payment determined by an objective rate that is not a qualified floating rate must be treated as a contingent payment. Making assurance double sure, *Treas Reg* § 1.1275-5(a)(6) also provides that if any stated interest payments on a debt instrument subject to *IRC § 1274* are treated as contingent payments under *Treas Reg* § 1.1274-2, the debt instrument cannot be a variable rate debt instrument.

(n87)Footnote 85. For example, a rate equal to two times the value of 1-year LIBOR as of the payment date would not be a qualified floating rate, while a rate equal to 1.35 times such value would. See *Treas Reg* § 1.1275-1(d), Example 7. A floating rate can be a qualified floating rate even though it is increased or decreased by a fixed amount, however. See *Treas Reg* § 1.1275-1(d), Example 2 (interest rate equal to 200 basis points (2 %) plus the current value,

at the end of each year, of the average yield on 1-year Treasury securities is a qualified floating rate).

(n88)Footnote 86. *Treas Reg § 1.1275-5(b)(3)*.

(n89)Footnote 87. *Treas Reg § 1.1275-4* actually prescribes two sets of rules: one set for contingent payment debt instruments issued for money or publicly traded property, known collectively as the noncontingent bond method, see *Treas Reg § 1.1275-4(b)*, and another for contingent payment debt instruments issued for nonpublicly traded property. See *Treas Reg § 1.1275-4(c)*. The noncontingent bond method is discussed in Chapter 17; this section considers only the rules applicable to contingent payment debt instruments issued for nonpublicly traded property.

(n90)Footnote 88. *Treas Reg § 1.1275-4(c)(2)*.

(n91)Footnote 89. See fn 72, *supra*.

(n92)Footnote 90. *Treas Reg § 1.1275-4(c)(3)*.

(n93)Footnote 91. *Treas Reg § 1.1275-4(c)(4)(ii)(A)*. However, for purposes of determining the test rate, the overall debt instrument's term must be recalculated as though the payment date of the contingent payment were the instrument's maturity date. *Treas Reg § 1.1275-4(c)(4)(ii)(B)*. For example, if the overall debt instrument's term was 10 years, but the actual date on which the contingent payment was made was 1 year after the issue date, the term of the instrument would be considered 1 year rather than 10 years, and the AFR selected as the basis of the test rate would be the short-term rather than the long-term AFR, on the date the instrument was issued.

(n94)Footnote 92. *Treas Reg § 1.1275-4(c)(4)(i)*.

(n95)Footnote 93. The regulations under *IRC § 483* provide that property does not include money, services, or the right to use property, but refer to *IRC §§ 404* and *407* for the treatment of certain obligations given in exchange for services or the use of property. *Treas Reg § 1.483-1(a)*.

(n96)Footnote 94. See *IRC §§ 483(a)* and *(d)*. The exceptions to the application of *IRC § 483* are discussed below.

(n97)Footnote 95. *IRC § 483(b)*.

(n98)Footnote 96. *IRC § 483(b)* (flush language).

(n99)Footnote 97. See Lokken, *The Time Value of Money*, 42 *Tax L Rev* 1, 127 (1986).

(n100)Footnote 98. *Treas Reg § 1.1275-1(d)*.

(n101)Footnote 99. Nevertheless, the concept of a "qualified variable rate instrument" can be important under *IRC § 483* if the stated interest rate in the contract depends upon the movement of a designated index. As under *IRC § 1274*, interest payments on a qualified variable rate instrument are determined under *IRC § 483* as though the interest rate were fixed throughout the instrument's term at the value of the rate on the date of sale or the date on which there was a binding contract to make the sale, whichever value is greater. See § 2.07[1][c][iv]. Otherwise, contingent interest payments are disregarded until payment is actually made, at which time the principal and interest components of the payment are determined. See *Treas Reg § 1.483-4(a)*.

(n102)Footnote 100. For a description of the circumstances under which a debt instrument may have OID under *IRC Section 1274* even though it has adequate stated interest, see fn 57, *supra*, and accompanying text.

(n103)Footnote 101. The accounting treatment of OID is governed by the provisions of *IRC § 1272* and the regulations thereunder. The accounting treatment of unstated interest is governed by *IRC §§ 446, 451* and *461* and the regulations thereunder, and in particular *Treas Reg § 1.446-2(e)*. See *Treas Reg § 1.483-1(a)(2)(ii)*. *IRC § 483(d)(1)*.

(n104)Footnote 102. *IRC § 483(d)(1)*.

(n105)Footnote 103. As previously mentioned, the issue price of those debt instruments is determined either by the fair market value of the publicly traded debt instrument or the fair market value of the publicly traded property for which it is issued. See fn 28, *supra*.

(n106)Footnote 104. The maximum stated principal amount was originally set at \$2,000,000, but with required adjustments for inflation each year has increased to \$3,653,600 for debt instruments issued in 2010. See *IRC § 1274A(c)(2)(A)*; *Rev Rul 2010-2, 2010-3 IRB 272, 273*. *Rev Rul 2010-2* includes a table showing the inflation-adjusted maximum for cash method debt instruments in each year from 1990 through 2010.

(n107)Footnote 105. See fns 53-55 and accompanying text.

(n108)Footnote 106. See § 2.07[1][c][ii]. As a practical matter, a debt instrument issued for property which does not exceed the maximum principal amount of a cash method debt instrument should be a qualified debt instrument as well, since the maximum stated principal amount of a qualified debt instrument is substantially higher than the maximum prescribed for cash method debt instruments. However, since a debt instrument issued in a sale-leaseback transaction cannot be a qualified debt instrument regardless of its stated principal amount, (see fn 53, *supra*), it cannot be a cash method debt instrument either. See *Treas Reg § 1.1274A(b)(1)*. Whether a debt instrument satisfies the statutory maxima on qualified debt instruments and cash method debt instruments is determined after the application of aggregation rules under which all debt instruments arising from the same transaction (or a series of related transactions) are treated as a single instrument. *IRC § 1274A(d)(1)*; *Treas Reg § 1.1274A-1(a)(3)*. Further, a debt instrument that calls for contingent payments cannot meet the statutory maximum in either case unless it can be determined at the time of the sale or exchange that the stated principal amount due under the debt instrument cannot under any circumstances exceed the statutory maximum.

(n109)Footnote 107. *IRC §§ 1274A(c)(1)(B) and 1274A(c)(2)(D)*. The election is generally binding on their successors in interest. If, however, the seller transfers the debt instrument to a taxpayer on the accrual basis, the cash method election is no longer binding on the transferee or its successors, although it continues to be binding on the purchaser and the purchaser's successors. See *Treas Reg § 1274A-1(c)(2)(ii)(B)*.

(n110)Footnote 108. *IRC § 1274A(c)(2)(B)*.

(n111)Footnote 109. *IRC § 1274A(c)(2)*.

(n112)Footnote 110. See fns 62-66 and accompanying text for the definition of a "potentially abusive situation."

(n113)Footnote 111. *IRC § 1274A(c)(4)*.

(n114)Footnote 112. See *IRC § 1274(c)(3)(C)*. The determination of the total amount of payments is made as of the date of the sale or exchange or, if earlier, the contract date. If the precise amount due under any debt instrument or the precise amount of any other consideration to be received cannot be determined as of that date, the \$250,000 exception applies only if it can be determined that the maximum of the aggregate amount of payments due under debt instruments issued, assumed or taken subject to under the contract, and any other consideration to be received, cannot exceed \$250,000. *Treas Reg § 1.1274-1(b)(2)(B)*. The aggregation rule also applies here: all sales and exchanges which are part of the same transaction (or a series of related transactions) are treated as a single sale. *IRC § 1274(c)(3)(C)(iii)*.

(n115)Footnote 113. *IRC § 483(d)(2)*.

(n116)Footnote 114. *IRC § 6420*, which provides a credit against the federal excise tax on gasoline for gasoline used on a farm for farming purposes, defines a "farm" to include "stock, dairy, poultry, fruit, fur-bearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising

of agricultural or horticultural commodities, and orchards."

(n117)Footnote 115. *IRC § 1274(c)(3)(A)*. For purposes of applying the \$1 million limitation, the sales price includes the amount of any liability assumed or taken subject to by the purchaser which is includible in the amount realized from the sale or exchange. *Treas Reg § 1.1274-1(b)(2)(ii)*.

(n118)Footnote 116. *IRC § 1274(c)(3)(B)*.

(n119)Footnote 117. *Treas Reg § 1.121-1(b)(1)*.

(n120)Footnote 118. *Treas Reg § 1.121-1(b)(2)*.

(n121)Footnote 119. "Family" for this purpose has the same basic meaning as in *IRC § 267(c)(4)*, with some modifications added by the *IRC § 483* regulations; "family" includes an individual's brothers or sisters, spouse, parents and grandparents, children and grandchildren. and the spouses of those individuals, giving full effect to any legal adoptions. *Treas Reg § 1.483-3(c)(2)(i)*.

(n122)Footnote 120. *Treas Reg § 1.483-3(b)(2)(ii)*. As interpreted by the regulations, it is not the total sale price of the land but the stated principal amount of the indebtedness arising out of the sale that is critical in applying the \$500,000 limitation. Thus, if an individual sells land to a member of his family for \$650,000, but the purchaser pays \$250,000 down and issues a note for the \$400,000 difference, the entire \$400,000 note is within the jurisdiction of *IRC § 483* even though the sales price exceeds \$500,000. If the seller were to sell additional land to the same member of his family within the same taxable year for a \$150,000 note, only the \$50,000 excess of the \$550,000 sum of the stated principal amounts of the two notes received by the seller over the \$500,000 annual limitation would not satisfy *IRC § 483(e)*. In that case, the regulations would treat the \$150,000 note as if it were two separate debt instruments, one for \$100,000 that qualifies under *IRC § 483(e)* for the 6 percent ceiling on the discount rate and the other for the \$50,000 excess, which does not. See *Treas Reg § 1.483-3(b)(3)*, Examples 1 and 3.

(n123)Footnote 121. In a case where the principal stated amount of a debt instrument falls within the \$500,000 limitation of *IRC § 483(e)* in part, and in part exceeds those limitations, *IRC § 1274* may apply to the excess portion of the stated principal amount. See fn 122, *supra*; *Treas Reg § 1.1274-1(c)*, Example 3.

(n124)Footnote 122. *Treas Reg § 1.1274-1(b)(3)(iii)*; *Treas Reg § 1.483-(c)(3)(i)*.

(n125)Footnote 123. Marital property settlements and the provisions of *IRC § 1041* are discussed in Ch 1, § 1.02[3][d].

(n126)Footnote 124. *IRC § 1274(c)(1)(B)*.

(n127)Footnote 125. *IRC § 483(c)(1)(A)*; *Treas Reg § 1.483-1(a)(1)*.

(n128)Footnote 126. *IRC § 1275(b)(2)*.

(n129)Footnote 127. OID would presumably be nondeductible "personal interest" even without the exception unless the personal use property acquired was a qualified residence of the taxpayer, making the OID deductible "qualified residence interest." See *IRC § 163(h)*. However, exemption from *IRC Section 1274* and *483* would allow the purchaser to avoid the reduction in basis of the personal use property that would be otherwise be required under the OID rules.

(n130)Footnote 128. Although the seller is not covered by the exception, the regulations (*Treas Reg §§ 1.1274-2(b)(3)* and *1.483-1(a)(3)(ii)*) create an administrative exception to both *IRC §§ 1274* and *483* which becomes applicable to the seller if the debt instrument is a "below-market loan" as described in *IRC § 7872(c)(1)*. This does not let the seller off the hook, however, for in that case the imputed interest will be taxed in accordance with the provisions

of IRC § 7872. See fn 17, *supra*.

(n131)Footnote 129. See Ch 19, § 19.05.

(n132)Footnote 130. *Treas Reg § 1.1274-1(b)(3)(ii)* and *Treas Reg § 1.483-1(c)(3)(iii)*; see also fn 126, *supra*. Regarding the basic operation of IRC § 7872, see fn 37, *supra*.

(n133)Footnote 131. *IRC § 1275(a)(1)(B)*. The annuity contract (1) must depend on the life expectancy of one or more individuals; (2) be issued by an insurance company subject to tax under Subchapter L of the Code or by an organization exempt from tax under *IRC § 501(a)* which would be taxable under Subchapter L if it were not tax exempt; and (3) be issued (a) for cash or in exchange for another annuity contract meeting the requirements of *IRC § 1275(a)(1)(B)*, or (b) pursuant to the exercise of an election under an insurance contract by a beneficiary thereof upon the death of the insured party under such contract, or (c) in a transaction involving a qualified pension or employee benefit plan.

(n134)Footnote 132. See *Treas Reg § 1.483-1(c)(iv)*.

(n135)Footnote 133. *IRC § 1274(c)(3)(E)*.

(n136)Footnote 134. *IRC § 483(d)(4)*.

(n137)Footnote 1. This, of course, assumes that the stock is a capital asset in the taxpayer's hands.

(n138)Footnote 2. *IRC § 165(g)(1)*. No sale or exchange is here required, for the section provides that the loss shall be treated as resulting "from [a] sale or exchange, on the last day of the taxable year. ..." If the stock is not a capital asset, the loss may be deducted under § 165(a) as an ordinary loss. *Treas Reg § 1.165-5(b)*.

(n139)Footnote 3. Pub L No 85-866, § 57(a), 72 Stat 1645.

(n140)Footnote 4. S Rep No 1983, 85th Cong, 2d Sess 80 (1958). The Senate Finance Committee was convinced that the provisions would "substantially increase the effectiveness of ... small-business investment companies." S Rep No 1983, 85th Cong, 2d Sess 80 (1958).

(n141)Footnote 5. *IRC § 1242* (emphasis supplied).

(n142)Footnote 6. *Treas Reg § 1.1243-1(a)(1)*.

(n143)Footnote 7. The debentures or stock must be acquired in accordance with Section 304 of the Small Business Investment Act of 1958 (15 USC § 684), and the regulations thereunder. *Treas Reg § 1.1243-1(a)(1)(i)*.

IRC § 582(c)(1) provides the same treatment for losses sustained on the sale or exchange of the debenture itself. But for taxable years beginning after July 11, 1969, any gain realized on the sale of such debenture will be taxed as ordinary income.

(n144)Footnote 8. *IRC § 1243(2)*.

(n145)Footnote 9. *Treas Reg § 1.1243-1(a)(1)(ii)*; *Rev Rul 62-58, 1962-1 CB 158*.

(n146)Footnote 10. *Treas Reg § 1.1243-1(b)*.

(n147)Footnote 11. H Rep No 2198, 85th Cong, 1st Sess, 4 (1958).

(n148)Footnote 12. H Rep No 2198, 85th Cong, 1st Sess, 4 (1958).

(n149)Footnote 13. The term "individual" does not include a trust or estate, *IRC § 1244(d)(4)*. It does include an individual who is a partner in a partnership at the time the partnership acquires § 1244 stock and whose distributive share of partnership items reflects the loss sustained by the partnership. *Treas Reg § 1.1244(a)-1(b)(2)*.

Individual shareholders of an S corporation cannot treat losses on the sale of stock by the corporation as ordinary losses under *IRC § 1244*. *Rath v Commr, 101 TC 196 (1993)* ; *Ltr Rul 9130003* .

(n150)Footnote 14. *IRC § 1244(b)*. Any loss in excess of the applicable limitation will be treated as a capital loss. *Treas Reg § 1.1244(b)-1*.

(n151)Footnote 15. *Treas Reg § 1.1244(a)-1(b)(2)*; *Magee v Commr, TC Memo 1993-305* ; *Harwell v Commr, TC Memo 1974-153* .

(n152)Footnote 16. *Treas Reg § 1.1244(a)-1(b)(2), (c), Ex (2)*; *Harwell v Commr, TC Memo 1974-153* . The regulations echo the language of the Conference Report, H Rep No 2632, 85th Cong, 2d Sess, 43. They were applied to deny ordinary loss treatment in *Prizant v Commr, TC Memo 1971-196* .

(n153)Footnote 17. Taylor & Tripp, "Section 1244; Avoiding Its Problems," 29 *NYU Inst on Fed Tax* 201 (1971).

(n154)Footnote 18. *IRC § 1244(c)(1)*. The provision extends to preferred stock only if issued after July 18, 1984.

Stock issued by a corporation contemplating liquidation does not qualify for ordinary loss treatment under *IRC § 1244*. See, eg, *Heger v Commr, TC Memo 1993-408* .

(n155)Footnote 19. *IRC § 1244(c)(1)(A)* as it read before the Revenue Act of 1978. Language adopted May 21, 1960 to the effect that all of the stock would be issued "within 2 years and by no later than May, 1962," was held to meet the two-year requirement. *Hayden v Commr, 52 TC 1112 (1969)* , *acq* 1970-1 CB xvi.

A denial of § 1244 treatment most often resulted from the absence of an adequate plan. See, eg, *Rickey v Commr, 502 F2d 748 (9th Cir 1974)* ; *Anderson v US, 436 F2d 356 (10th Cir 1971)* ; *Godart v Commr, 425 F2d 633 (2d Cir 1970)* ; *Kaplan v Commr, 59 TC 178 (1972)* ; *Malawer v Commr, TC Memo 1975-351* ; *Fox v Commr, TC Memo 1975-64* ; *Hurd v Commr, TC Memo 1975-6* ; *Frahm v Commr, TC Memo 1974-138* ; *Coloman v Commr, TC Memo 1974-78* , *affd* 540 F2d 427 (9th Cir 1976) .

(n156)Footnote 20. *Treas Reg § 1.1244(c)-1(c)(1)*.

Casco Bank & Trust Co v US, 403 F Supp 687 (D Me 1975) , *aff'd*, 544 F2d 528 (1st Cir 1976) , *cert. denied*, 430 US 907 ; *Farr v Commr, TC Memo 1973-283* (failure to specifically state total dollar consideration to be received for stock prevented resort to § 1244 ordinary loss treatment).

Stock issued for a payment which, alone or together with prior payments, exceeds the maximum amount that can be received under the plan is not considered issued pursuant to the plan and none of such stock will be deemed § 1244 stock. *Treas Reg § 1.1244(c)-2(d), Ex (2)*.

(n157)Footnote 21. *Treas Reg § 1.1244(c)-(2)*; cf *Bruce v US, 279 F Supp 686 (SD Tex 1967)* , *aff'd*, 409 F2d 1317 (5th Cir 1969) . Stock subscribed for prior to adoption can qualify as § 1244 stock, provided it was not issued prior to adoption. *Treas Reg § 1.1244(c)-1(c)(3)*; *Rev Rul 67-256, 1967-2 CB 294* . However, stock issued on the exercise of a stock right or option will be considered issued pursuant to the plan only if the right or option was not outstanding at the time the plan was adopted, the right or option is applicable solely to unissued stock offered under the plan, and the right or option was exercised during the specified period. *Treas Reg § 1.1244(c)-1(c)(2)*.

(n158)Footnote 22. *IRC § 1244(c)(1)(E)* as it read prior to repeal by the Revenue Act of 1978.

(n159)Footnote 23. *IRC § 1244(c)(1)(B)* as it read prior to the Revenue Act of 1978.

(n160)Footnote 24. *IRC § 1244(c)(1)(A)*.

(n161)Footnote 25. Outstanding preferred stock, stock rights, stock warrants, stock options, or securities convertible into stock are deemed prior offerings. *Treas Reg § 1.1244(c)-1(e)*.

(n162)Footnote 26. *IRC § 1244(c)(1)(B)*; *Treas Reg § 1.1244(c)-1(f)*. However, *IRC § 1244(d)(2)* permits the adoption of Regulations permitting common stock received in exchange for qualifying § 1224 stock to be treated as such if the stock is received in a reorganization under *IRC § 368(a)(1)(F)* or its basis is determined by reference to the basis of the exchanged § 1244 stock in the hands of the taxpayer. *Treas Reg § 1.1244(d)-3* authorizes two exceptions other than an "F" reorganization, namely, stock received as a stock dividend and stock received in a reorganization described in *IRC § 368(a)(1)(E)* (recapitalization).

Stock issued in exchange for an earlier advance to the corporation was not § 1244 stock; the initial advance constituted equity rather than debt. *Ginsberg v Commr, TC Memo 1992-372*.

(n163)Footnote 27. *Treas Reg § 1.1244(c)-1(f)*.

(n164)Footnote 28. *IRC § 1244(c)(1)(C)*. The gross receipts test does not apply if, for the period in question, the corporation's deductions, other than the net operating loss deduction and the deduction for dividends received, exceeded its income. *IRC § 1244(c)(2)(C)*.

(n165)Footnote 29. H Rep No 2198, 85th Cong, 1st Sess 4 (1958); *Treas Reg § 1.1244(c)-1(e)(2)*. The regulation was held to be valid in *Davenport v Commr, 70 TC 922 (1978)*. See also *Crigler v Commr, TC Memo 2003-93*.

Stock in a corporation engaged in the business of making small loans to the public could not be § 1244 stock because more than 50 percent of the corporation's gross receipts consisted of interest. *Rev Rul 75-431, 1975-2 CB 346*. The Service could find nothing in the Code, Regulations, or legislative history excepting a corporation actively engaged in the loan business, and earning interest income, from the gross receipts requirement of *IRC § 1244*.

(n166)Footnote 30. *Bates v US, 1976 US Dist LEXIS 15880 (ND Ohio 1976)*, *affd* 581 F2d 575 (6th Cir 1978). The court originally reasoned that it was impossible to derive more than 50 percent of gross receipts from passive income sources if, in fact, there were no receipts. The earlier decision is reported at 36 AFTR2d 75-6074 (ND Ohio 1976).

(n167)Footnote 31. The definition of small business corporation provided by *IRC § 1244(c)(2)* should be compared with that of *IRC § 1361* relating to Subchapter S corporations. The latter is based on stock ownership rather than aggregate capital amount.

(n168)Footnote 32. *IRC § 1244(c)(2)(A)* as it read prior to the Revenue Act of 1978.

(n169)Footnote 33. *IRC § 1244(c)(2)(B)* as it read prior to the Revenue Act of 1978.

(n170)Footnote 34. *IRC § 1244(c)(3)(A)*.

(n171)Footnote 35. *Id.*

(n172)Footnote 36. *Treas Reg § 1.1244(b)-1*.

(n173)Footnote 37. *IRC § 1244(d)(1)(A)*.

(n174)Footnote 38. The effect of *IRC § 1244(d)(1)(A)* can be illustrated by the following example: Assume a

taxpayer transfers property having a basis of \$12,000 and a value of \$10,000 to a corporation in a transaction which requires him to assign a basis of \$12,000 to the stock received. If the stock is subsequently sold for \$5,000, the total realized loss is \$7,000 of which \$5,000 (\$10,000, the basis of the stock for *IRC § 1244* purposes, less \$5,000) would be treated as an ordinary loss under *IRC § 1244*, and \$2,000 treated as a capital loss.

(n175)Footnote 39. *Treas Reg § 1.1244(e)-1(a)*. Poor record keeping at the corporate level prevented the taking of an ordinary loss in *Dwyer v Commr, TC Memo 1991-65*.

(n176)Footnote 40. *Treas Reg § 1.1244(e)-1(b)*.

(n177)Footnote 40.1. *Wong v Commr, TC Memo 1994-202*; *Cournan v Commr, TC Memo 1989-520*.

(n178)Footnote 41. *Notice 94-89*, 1994-2 CB 560.

(n179)Footnote 42. *Treas Reg § 1.1244(e)-1(b)*.

(n180)Footnote 43. *Notice 94-89*, 1994-2 CB 560. The revisions to *Treas Reg § 1.1244(e)-1(b)* will be effective for all open tax years covered by the existing regulations under *IRC § 1244*.

(n181)Footnote 44. *IRC § 165(g)(1)*. See Ch 17 for a discussion of the disallowance of losses on certain obligations not in registered form.

(n182)Footnote 45. *IRC § 165(g)(3)*. A corporation owned all of the stock of a holding corporation that owned all of the stock of a foreign operating company. The ownership format was a consequence of local law that forbade direct ownership of the operating company by a US corporation. The stock of the operating company and, thus, the stock of the holding company became worthless. The Service held, in a Technical Advice Memorandum, that the parent corporation's loss was limited to a capital loss under *IRC § 165(g)(1)*; an ordinary loss is permitted only when the worthless subsidiary is an operating company. *Ltr Rul 8939001*. But in *Ltr Rul 200914021*, a National Office Technical Advice Memorandum ruled that stock of a wholly owned foreign subsidiary that never had any gross receipts in any taxable year, but would have had substantial receipts from operations had its activities been successful, qualified for ordinary loss treatment. The Service reasoned that the purpose of *IRC § 165(g)(3)(B)* is to distinguish operating affiliates from mere investment or holding companies, but in the absence of any gross receipts the test could not fulfill its intended purpose. Since the taxpayer demonstrated that its affiliate was intended to be an operating company, inability to meet the gross receipts test in these circumstances did not prevent the taxpayer from qualifying for ordinary loss treatment.

When an election is made to change the classification of an entity from a corporation to a disregarded entity, the shareholder of the entity is allowed a worthless security deduction under *IRC § 165(g)(3)* if the entity's liabilities exceed the fair market value of all of its assets so that the shareholder receives no payment on its stock on the deemed liquidation of the entity. *Rev Rul 2003-125*, 2003-2 CB 1243.

(n183)Footnote 46. *561 F2d 1023 (1st Cir 1977)*.

(n184)Footnote 1. *IRC § 1091(a)*. The wash sale rule is applicable even if a contract or option to acquire or sell stock or securities settles in, or can be settled in, cash or property other than stock or securities. *IRC § 1091(f)*.

The wash sale rule applies to securities purchased on margin, *Rev Rul 71-316*, 1971-2 CB 311, and when the contract to repurchase is unenforceable but not void *ab initio*, *Est of Estroff v Commr, TC Memo 1983-666*.

On the day following the sale of shares at a loss, the taxpayer sold a "put" option with an exercise price that was substantially higher than the existing market price of the stock. Objective factors, including the spread between option price and market value, led the Service to conclude that there was substantial likelihood that the "put" would be

exercised and that the option was a contract to acquire the stock. Thus, the sale of the "put" invoked the wash sale rule and caused the loss to be disallowed. *Rev Rul 85-87, 1985-1 CB 268* .

(n185)Footnote 2. *38 BTA 811 (1938)* , *aff'd, 108 F2d 429 (3d Cir 1939)* .

(n186)Footnote 3. *38 BTA at 814-815* . The Service defines securities as being "substantially identical ... if they are not substantially different in any material feature ... or because of differences in several material features considered together." *Rev Rul 58-211, 1958-1 CB 529, 530* . Thus differences in several material factors considered together would make securities not substantially identical even though each of the differences considered alone might not produce this result.

(n187)Footnote 4. *108 F2d at 430* .

(n188)Footnote 5. *38 BTA at 817-818* .

(n189)Footnote 6. *29 AFTR 1298 (WD Pa 1941)* , *rev'd on other grounds 129 F2d 148 (3d Cir 1942)* .

(n190)Footnote 7. *1958-1 CB 529, 530* .

(n191)Footnote 8. See also *Campbell v Commr, 39 BTA 916 (1939)* , *rev'd on other grounds 112 F2d 530 (2d Cir 1940)* , *rev'd 313 US 15 (1941)* . The date difference in *Campbell* was over five years; the nearest maturity date more than twenty-three years after the purchase and sale. The bonds were not substantially identical. However, the bonds were also issued on different dates, bore different interest payment dates, and were different in form (one was registered; the other bore coupons). IT 2672 , XII-1 CB 72 (1935) , held that a difference of approximately three months on bonds that were to mature forty-five and forty-eight years after the sale was substantial. A subsequent ruling, *Rev Rul 58-210, 1958-1 CB 523* , regarded the prior ruling as borderline, but stated that it would be followed in like cases. IT 2672 was declared obsolete in *Rev Rul 69-43 1969-1 CB 310* . The 1958 ruling also held that any reliance on different issuance dates or interest payment dates was unwarranted.

(n192)Footnote 9. The statement is contained in an unpublished ruling. See Dixon, "Wash Sales and Short Sales," *NYU 18th Inst on Fed Tax* 335, 350 (1960). See also *Rev Rul 60-195, 1960-1 CB 300* .

(n193)Footnote 10. IT 2778, XIII-1 CB 79 (1934). The securities here were debentures of different series identical in all respects except for the date of issue and the amounts to be redeemed annually. IT 2778 was eventually revoked by IT 4081, *1952-1 CB 65*, on the ground that the transaction involved in the former was one in which gain or loss would no longer be recognized. IT 4081 was declared obsolete in *Rev Rul 69-44, 1969-1 CB 312* .

(n194)Footnote 11. *Rev Rul 58-210, 1958-1 CB 523* . See also *Rev Rul 76-346, 1976-2 CB 247* .

(n195)Footnote 12. *Rev Rul 60-195, 1960-1 CB 300* .

(n196)Footnote 13. *Hanlin v Commr, 38 BTA 811 (1938)* , *aff'd 108 F2d 429 (3d Cir 1939)* . This portion of the *Hanlin* decision held that bonds of two different Federal Land Banks were not substantially identical because of the difference in the collateral securing the bonds. The Service issued its nonacquiescence in this part of the decision on the ground that each Land Bank was secondarily liable on the bonds of the other. *1939-1 CB (Pt. 1) 55* . In *Rev Rul 59-44, 1959-1 CB 205* , the primary obligors were not secondarily liable with respect to the other's obligations; the securities were not substantially identical.

The issue of whether substantial identity prevented the realization of a loss in the first instance was present in *Cottage Savings Assn v Commr, 111 S Ct 1503 (1991)* , and *US v Centennial Savings Bank FSB, 111 S Ct 1512 (1991)* . In both cases, the losses resulted from mortgage exchanges made pursuant to a regulatory directive of the Federal Home Loan Bank Board that determined that the savings and loan associations need not report losses associated with mortgages that

were exchanged for "substantially identical" mortgages held by other lenders. Notwithstanding the characterization of the new mortgages by the Federal Home Loan Bank Board for accounting purposes, the Supreme Court held that, for tax purposes, the new mortgages were materially different from the old because they embodied legally different entitlements--different obligors and different security.

(n197)Footnote 14. Substantial identity was found where convertible preferred stock and the common stock into which it was convertible, had selling prices that did not vary greatly from the conversion ratio. *Rev Rul 77-201, 1977-1 CB 250* .

(n198)Footnote 15. *Kidder v Commr, 30 BTA 59 (1934)* .

(n199)Footnote 16. *IT 2585, X-2 CB 182 (1931)* .

(n200)Footnote 17. The contract to repurchase can be oral. *Stein v Commr, TC Memo 1977-241* .

The wash sale rule does not apply where the purchaser has the option to put the acquired stock to the seller. *GIC Corp v US, 77 AFTR2d 96-2411 (SD Fla 1996)* .

(n201)Footnote 18. *Rev Rul 56-406, 1956-2 CB 523* .

(n202)Footnote 19. *Id* at 525 ; cf *Ltr Rul, Feb 27, 1957, 5 Stand Fed Tax Rep (CCH) P 6332 (1957)* (for short sale purposes, a call (option to purchase) is not substantially identical to stock subject to the call).

Preferred stock convertible into common stock at a shareholder's election without restriction was treated as an option to purchase in *Rev Rul 77-201* , N 13, *supra*.

(n203)Footnote 20. *Rev Rul 56-452, 1956-2 CB 525* . The shares acquired pursuant to the exercise of the option will be deemed to have been acquired on the date of issuance. However, to the extent that the grant of the option to acquire shares has resulted in the disallowance of a loss under *IRC § 1091*, the acquisition of the shares through exercise of the option will not cause a further disallowance of any loss realized on shares sold within the specified period before and after the stock issuance.

(n204)Footnote 21. Tax Reform Act of 1984, § 106(c)(2).

(n205)Footnote 22. The supervision of one's investments, no matter how extensive, is not a trade or business, *Higgins v Commr, 312 US 212 (1941)* .

A corporation whose only business was buying or selling securities for profit through a stock exchange was held not a dealer in securities. *Donander Co v Commr, 29 BTA 312 (1933)* .

(n206)Footnote 23. *Treas Reg § 1.1091-1(b)*. The regulation states that "the provisions of [Section 1091] shall be applied to the losses in the order in which the stock or securities the disposition of which resulted in the respective losses were disposed of (beginning with the earliest disposition)."

(n207)Footnote 24. *Treas Reg § 1.1091-1(b); cf Coulter v Commr, 32 BTA 617 (1935)* .

(n208)Footnote 25. *Rev Rul 56-602, 1956-2 CB 527, at 528* . The Service based its conclusion as to legislative intent on consistent reference in discussions and reports to "new acquisition," "repurchasing," and "buying back."

A taxpayer's sale of shares at a loss within 30 days of the acquisition of an equal number of shares through the exercise of stock rights is a wash sale. The fact that the principal motive for the stock subscription is not the replacement of shares sold at a loss, but the desire to take advantage of a low price, does not alter the status of the

transaction. *Rev Rul 71-520, 1971-2 CB 311* .

(n209)Footnote 26. *Rev Rul 70-231, 1970-1 CB 171* .

(n210)Footnote 27. *IRC § 1091(b); Treas Reg § 1.1091-1(c)*.

(n211)Footnote 28. *IRC § 1091(c); Treas Reg § 1.1091-1(d)*.

(n212)Footnote 29. *IRC § 1091(d)*. See § 1.05[9][d] *supra*, for the application of *IRC § 1091(d)* to mutual fund shares with respect to which an average basis election has been made.

(n213)Footnote 30. *IRC § 1091(a)*. Emphasis supplied.

The Service takes the position that a loss on a sale by a cooperative bank of Government National Mortgage Association mortgage-backed certificates should be disallowed under *IRC § 1091* when the taxpayer acquires substantially similar certificates within 30 days of the sale. The certificates are securities for purposes of the wash sale rules. *GCM 39551* .

(n214)Footnote 31. Thus, it has been held that "when issued" securities fall within the scope of *IRC § 1091(a)*. *IT 3858, 1947-2 CB 71*. ("When issued" securities are the subject matter of Ch 11, *infra* .)

(n215)Footnote 32. A like conclusion has been reached in the case of a membership certificate in a commodity exchange, *Horne v Commr, 5 TC 250 (1945)* , as well as in the case of foreign money. *Rev Rul 74-218, 1974-1 CB 202* .

(n216)Footnote 33. *Trenton Cotton Oil Co v Commr, 147 F2d 33 (6th Cir 1945)* .

(n217)Footnote 34. *Corn Products Refining Corp v Commr, 16 TC 395 (1951)* , *aff'd, 215 F2d 513 (2d Cir 1954)* , *aff'd on other grounds, 350 US 46 (1955)* .

(n218)Footnote 35. *Rev Rul 71-568, 1971-2 CB 312* .

(n219)Footnote 36. *91 TC 713 (1989)* , *aff'd, 905 F2d 241 (8th Cir 1990)* .

(n220)Footnote 37. Short sales are discussed in Ch 10, *infra*.

(n221)Footnote 38. *Treas Reg § 1.1233-1(a)(1956)*; *cf Doyle v Commr, 286 F2d 654 (7th Cir 1961)* .

(n222)Footnote 39. *Treas Reg § 1.1091-1(g)*.

(n223)Footnote 40. *Treas Reg § 1.1091-1(g)*.

(n224)Footnote 41. Alternatively, the taxpayer could replace the closed short position by entering into a new short sale after the beginning of the next taxable year in order to claim a tax loss without any essential change in position.

(n225)Footnote 42. *Rev Rul 78-414, 1978-2 CB 214* ; *Rev Rul 77-185, 1977-1 CB 48* .

(n226)Footnote 43. *Horne v Commr, 5 TC 250 (1945)* .

(n227)Footnote 44. *Shoenberg v Commr, 77 F2d 446 (8th Cir 1935)* , *cert denied, 296 US 586* ; *Rev Rul 72-225, 1972-1 CB 59* .

(n228)Footnote 45. Emphasis supplied. A mutual life insurance company realized a loss on the sale of shares of stock held in its general asset accounts. Within 30 days, the company purchased substantially identical stock and allocated the shares to its segregated asset accounts. The loss was disallowed pursuant to *IRC § 1091*; the company was

not a separate taxpayer with respect to its segregated accounts. *Rev Rul 74-4, 1974-1 CB 51* .

(n229)Footnote 46. *Twining v Commr*, 32 BTA 600 (1935) , *aff'd* 83 F2d 954 (2d Cir 1936) , *cert denied* 299 US 578 (husband-seller, wife-buyer); *Cole v Helburn*, 4 F Supp 230 (WD Ky 1933) (father-seller, son-buyer). However, depending upon the relationship, the loss may still be disallowed, under *IRC § 267*, discussed in § 2.07[4], or, if the buyer is the spouse of the seller, treated as a transfer governed by *IRC § 1041*.

(n230)Footnote 47. *Brochon v Commr*, 30 BTA 404 (1934) ; *Weyl v Commr*, 38 BTA 850 (1938) ; *Kaplan v Commr*, 21 TC 134 (1953) , *acq* 1954-1 CB 5 .

(n231)Footnote 48. *Cole v Helburn*, N 46, *supra*; *Atkins v Commr*, 28 BTA 500 (1933) , *aff'd* 76 F2d 387 (5th Cir 1935) .

(n232)Footnote 49. *Ltr Rul*, Oct 11, 1946, 1956 *Fed Taxes (P-H)* P 76,039 (1947).

(n233)Footnote 50. *Security First Natl Bank v Commr*, 28 BTA 289 (1933) . In *Rev Rul 2008-5, 2008-1 CB 271* , the Internal Revenue Service took the position that a sale by an individual within 30 days before or after a purchase by that individual's IRA or Roth IRA will trigger the wash sale rule.

(n234)Footnote 1. See *Treas Reg § 1.267(a)-1(c)*; *Scully v US*, 840 F2d 478 (7th Cir 1988) , discussed at n 5, *infra*.

(n235)Footnote 1.1. *IRC § 267(b)(1), (c)(4)*. A taxpayer's stepmother is not his ancestor. *Rev Rul 71-50, 1971-5 CB 106* . The existence of "family hostility" does not prevent application of the disallowance rule. *Miller v Commr*, 75 TC 182 (1980) .

(n236)Footnote 2. *IRC § 267(b)(2)*. The term "individual" is strictly construed. *Est of Hanna v Commr*, 320 F2d 54 (6th Cir 1963) (estate not an "individual").

Transfers of stock between an individual and his controlled corporation resulted in gain with respect to some shares and loss with respect to others. *IRC § 267(a)(1)* disallowed the entire loss while *IRC § 61(a)* mandated inclusion in income of the entire gain; the two could not netted. *Rev Rul 76-377, 1976-2 CB 89* .

A controlling shareholder who voluntarily surrenders a portion of his stock to the corporation, and continues to retain control, does not sustain an immediate loss deductible for income tax purposes as a result of the surrender of stock. See, eg, *Yei v Commr*, *TC Memo 1997-57* .

(n237)Footnote 3. *IRC § 267(b)(3)*. The term "controlled group" has the meaning given it by *IRC § 1563(a)* except that it does not include a DISC, and the percentage of stock ownership required is 50 percent rather than 80 percent. *IRC § 267(f)(1), (3)(A)*.

The loss in this instance is not disallowed but is deferred until the property is transferred outside the controlled group and there would be recognition of the loss under consolidated return principles or until such other time as may be prescribed by regulations. *IRC § 267(f)(2)*.

Where a corporation that is a member of a controlled group is acquired by an unrelated third party, thereby terminating the controlled group relationship, and that corporation simultaneously sells an asset at a loss to a member of the former controlled group, the loss is not deferred or denied. *Turner Broadcasting System Inc v Commr*, 111 TC 315 (1998) .

In *Transport Mfg & Equip Co v Commr*, *TC Memo 1968-190* , *aff'd*, 431 F2d 729 (8th Cir 1970) , the loss was disallowed even though *IRC § 267* was inapplicable. The sale between the related corporations was at a price which the Tax Court found to be grossly inadequate. The "loss" was treated as a contribution to the purchasing corporation by the

shareholders of the taxpayer.

(n238)Footnote 4. *IRC § 267(b)(4)*.

(n239)Footnote 5. *IRC § 267(b)(5)*. Losses on sales of securities between trusts having a common trustee and same income beneficiary, but created by different grantors, were allowed in *Widener Trust No 5 v Commr*, 80 TC 304 (1983) , *acq*, 1984-1 CB 2 . None of the relationships specified in *IRC § 267* existed, and though the Tax Court acknowledged that this did not insure the deductibility of the losses, it found that since the transactions were "bona fide" (referencing *Treas Reg § 267(a)-1(c)*) there was no reason why the losses should be disallowed. But see *Scully v US*, 840 F2d 478, n 1 , which denied a deduction for losses produced by sales of real estate between family trusts which, similarly, did not fall within any of the categories in *IRC § 267*. The Court of Appeals held that the losses still had to qualify under *IRC § 165*, which ever since *Higgins v Smith*, 308 US 473 (1940) has incorporated the principle that a sale of property at a loss will not be given significance for tax purposes if the seller continues to retain dominion and control over the property through his control of the purchaser. Though decided under pre-§ 267 law, the Court of Appeals made clear that the *Higgins v Smith* principle continues to apply after *IRC § 267*. The Court of Appeals distinguished the result reached by the Tax Court in *Widener* on the ground that co-trustees of the buyer and seller trusts in that case were different, the termination dates of the trusts were significantly different, and the trusts' investment objectives were different. In *Widener*, therefore, because of the relative independence of the buyer and seller trusts, the sale was found to be "bona fide." In *Scully*, as a result of the integrated nature of the buying and selling trusts, the sale was not "bona fide."

(n240)Footnote 6. *IRC § 267(b)(6)*. *IRC § 267* does not preclude a deduction for a loss sustained by an estate upon a sale to the executor. The sale is not between related parties as defined in the Code. *Rev Rul 77-439*, 1977-2 CB 85 .

(n241)Footnote 7. *IRC § 267(b)(7)*.

(n242)Footnote 8. *IRC § 267(b)(8)*.

(n243)Footnote 9. *IRC § 267(b)(9)*; the term "members of the family" is here, too, limited to an individual's brothers and sisters of the whole and half-blood, spouse, ancestors, and lineal descendants. *IRC § 267(c)(4)*.

(n244)Footnote 10. *IRC § 267(b)(10)*.

(n245)Footnote 11. *IRC § 267(b)(11)*.

(n246)Footnote 12. *IRC § 267(b)(12)*.

(n247)Footnote 12.1. *IRC § 267(b)(13)*.

(n248)Footnote 13. *IRC § 267(c)(1)*.

(n249)Footnote 14. *IRC § 318(a)(2)(i)*.

(n250)Footnote 15. *IRC § 267(c)(2), (4)*.

(n251)Footnote 16. *IRC § 267(c)(3)*; *Treas Reg § 1.267(c)-1*.

(n252)Footnote 17. *IRC § 267(c)(5)*.

(n253)Footnote 18. *Id*; see also *Arizona Publishing Co*, 9 TC 85 (1947) . Reattribution is also prohibited where the original attribution is pursuant to *IRC § 267(c)(3)*. Cf *Liflans Corp v US*, 390 F2d 965 (Ct Cl 1968) .

(n254)Footnote 19. Emphasis added.

(n255)Footnote 20. *IRC § 267(g)*.

(n256)Footnote 21. *331 US 694 (1947)* . See also *Shethar v Commr*, *28 TC 1222 (1957)* (indirect sales include over-the-counter sales).

(n257)Footnote 22. *331 US at 700* .

(n258)Footnote 23. A taxpayer was precluded from deducting his losses on sales through an exchange by a broker acting under an investment authority where the same broker, acting under a separate, but similar investment authority, immediately purchased similar amounts of the same stock for the account of the taxpayer's mother. *US v Norton*, *250 F2d 902 (5th Cir 1958)* . The crux of the decision is the simultaneous instruction to buy and sell, action which is tantamount to an indirect sale.

(n259)Footnote 24. *255 F2d 684 (2d Cir 1958)* .

(n260)Footnote 25. *400 F2d 417 (5th Cir 1968)* ; contra, *McNeill v Commr*, *251 F2d 863 (4th Cir)* , *cert denied 358 US 825 (1958)* .

(n261)Footnote 26. *Cf Hopkins v Commr*, *15 TC 160 (1950)* , *acq 1951-1 CB 2* .

(n262)Footnote 27. *IRC § 267(d)*. The subsection is inapplicable if the loss would also be disallowed by *IRC § 1091*. The provision is also inapplicable if the loss occurs in a transaction between members of a controlled group. In such case, the loss is deferred until the property is transferred outside the group. *IRC § 267(f)(2)*.

(n263)Footnote 28. An allocation of both the loss disallowed and the basis of acquired property is necessary whenever the taxpayer acquires divisible property or property consisting of several items in a single transaction in which loss was not allowable to the transferor. *Treas Reg § 1.267(d)-1(b)*.

(n264)Footnote 29. *Treas Reg § 1.267(d)-1(a)(3)*.

(n265)Footnote 30. *Treas Reg § 1.267(d)-1(c)(1)*.

(n266)Footnote 31. *Treas Reg § 1.267(d)-1(c)(3)*.

(n267)Footnote 1. The recharacterized gain is ordinary income (but not interest income) for all purposes of the Code. Taggart & McCavitt, "Coping with the Confusing Anti-Conversion Provisions of RRA'93," *80 J Tax'n 38 (1994)* .

(n268)Footnote 2. *IRC § 1258(b)*. The Service can, by regulations, provide for reductions in the applicable imputed amount as may be appropriate by reason of amounts capitalized under *IRC § 263(g)*, ordinary income received, or otherwise.

(n269)Footnote 3. *IRC § 1258(d)(2)*.

(n270)Footnote 4. For this purpose, an applicable straddle is any straddle defined in *IRC § 1092(c)*, namely offsetting positions with respect to personal property. *IRC § 1258(d)(1)*.

(n271)Footnote 5. *IRC § 1258(c)*.

(n272)Footnote 6. *IRC § 1258(d)(5)(A)*. An "options dealer" is defined in *IRC § 1256(g)* as any person registered with an appropriate securities exchange as a market maker or specialist in listed options. A "commodities trader" is, generally, a person who is a member of a domestic board of trade that is designated as a contract market by the Commodity Futures Trading Commission. *IRC § 1258(d)(5)(B)*. The term also includes a person entitled to trade as a member, such as a lessee of a membership or an entity that is, or is affiliated with, a beneficial owner of a membership,

if the entity is eligible for any preferential rates available to members with respect to fees or margins imposed by the board of trade or for the clearing of trades on the board of trade. HR Rep No 213, 103d Cong, 1st Sess 80 (1993).

(n273)Footnote 7. A "limited entrepreneur" is a person who has an interest in an enterprise other than as a limited partner, and does not actively participate in the management of the enterprise. *IRC § 464(e)(2)*.

(n274)Footnote 8. *IRC § 1258(d)(5)(C)*.

(n275)Footnote 9. *IRC § 1258(d)(3)(A)*.

(n276)Footnote 10. *IRC § 1258(d)(3)(B)*.

(n277)Footnote 11. In determining the taxpayer's net investment in any conversion transaction, there is included the fair market value of any position that becomes a part of the transaction as of the time that it becomes a part. *IRC § 1258(d)(4)*.

(n278)Footnote 12. S Rep No 103-36, 103d Cong, 1st Sess 56 (1993).

(n279)Footnote 13. S Rep No 103-36, 103d Cong, 1st Sess 56-57 (1993).

(n280)Footnote 14. S Rep No 103-36, 103d Cong, 1st Sess 57 (1993).

(n281)Footnote 15. *Treas Reg § 1.1258-1(b)(1)*. For this purpose, a built-in loss means (1) a built-in loss as defined in *IRC § 1258(d)(3)(B)* (see text at N 10, *supra*), and (2) if a taxpayer realizes gain or loss on any one position of a conversion transaction, as of the date that gain or loss is realized, any unrecognized loss in any other position of the conversion transaction that is not disposed of, terminated, or treated as sold under any provision of the Code or regulations within 14 days of and within the same taxable year as the realization event. *Treas Reg § 1.1258-1(c)*.

(n282)Footnote 16. *Treas Reg § 1.1258-1(b)(2)*.

(n283)Footnote 1. *IRC § 1260(a)*. Net underlying capital gain is the aggregate net capital gain that the taxpayer would have had (i) if the financial asset had been acquired for fair market value on the date the constructive ownership transaction was opened and sold for fair market value on the date the transaction was closed, and (ii) if only gains and losses that would have resulted from the deemed ownership were taken into account. The amount of net underlying long-term capital gain is treated as zero unless the amount thereof is established by clear and convincing evidence. *IRC § 1260(e)*.

The provision applies to transactions entered into after July 11, 1999. It is expected that a contract, option, or other arrangement entered into or exercised after that date that extends or modifies the terms of an earlier transaction will be subject to *IRC § 1260(a)*. H Rep 106-478, 106th Cong, 1st Sess (1999).

No inference is intended as to the proper treatment of a constructive ownership transaction entered into before July 12, 1999. H Rep 106-478, 106th Cong, 1st Sess (1999).

(n284)Footnote 2. *IRC § 1260(d)(2)*.

(n285)Footnote 3. *IRC § 1260(c)(1)*.

(n286)Footnote 4. *IRC § 1260(c)(2)*.

(n287)Footnote 5. *IRC § 1260(d)(1)*. A forward contract is any contract to acquire in the future (or provide or receive credit for the future value of) any financial asset. *IRC § 1260(d)(4)*.

(n288)Footnote 6. *IRC § 1260(d)(3)*.

(n289)Footnote 7. *IRC § 1260(f)*.

(n290)Footnote 8. *IRC § 1260(b)(1), (2)*. The applicable federal rate for this purpose is the applicable federal rate determined under *IRC § 1274(d)*, compounded semiannually, that would apply to a debt instrument with a term equal to the period the transaction was open. *IRC § 1260(b)(3)*.

(n291)Footnote 9. *IRC § 1260(b)(4)*.

(n292)Footnote 10. *IRC § 1260(b)(1)*.

(n293)Footnote 11. *IRC § 1260(g)*.

(n294)Footnote 1. Gain or loss attributable to the cancellation, lapse, expiration, or other termination of a securities futures contract that is a capital asset in the hands of the taxpayer is treated as capital gain or loss. *IRC § 1234A*.

A securities futures contract is any security future as defined in § 3(a)(55)(A) of the Securities Exchange Act of 1934. *IRC § 1234B(c)*. The Service may prescribe regulations regarding the status of contracts the value of which are determined directly or indirectly by reference to an index that becomes (or ceases to be) a narrow-based security index (as defined for purposes of *IRC § 1256(g)(6)*).

A securities futures contract is not treated as a commodity futures contract for purposes of the Code. *IRC § 1234B(d)*.

(n295)Footnote 2. *IRC § 1234B(b)*. Rules relating to straddles and the special holding period rules applicable to short sales may apply in lieu of the stated rule.

(n296)Footnote 3. See § 9.02[4].

(n297)Footnote 4. *IRC § 1234B(a)(2)*.



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CHAPTER 2A The Alternative Minimum Tax

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CHAPTER 2A The Alternative Minimum Tax

1-2A Taxation of Securities Transactions § 2A.01

§ 2A.01 Introduction

The Tax Reform Act of 1969 introduced the concept of the minimum tax on preferences, a provision designed to limit the escape from taxation that could be achieved by taxpayers who availed themselves of the preferential treatment of certain types of income and the allowance of certain deductions. The Revenue Act of 1978 brought with it a new concept, the alternative minimum tax, operating only with respect to noncorporate taxpayers and concerned with the excluded portion of long-term capital gains and with excess itemized deductions. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) changed the ambit of the alternative minimum tax by including within it all items of tax preference. At the same time, the minimum tax was made applicable only to corporations. Finally, the Tax Reform Act of 1986 repealed the corporate minimum tax and replaced it with an alternative minimum tax applicable to both corporate and noncorporate taxpayers, which is what we have today.ⁿ¹

As currently structured, the alternative minimum tax is calculated on an expanded tax base known as "alternative minimum taxable income" (AMTI).ⁿ² Computation of AMTI starts with the taxable income on which the taxpayer's regular tax is computed. Adjustments prescribed by *IRC Sections 56-59* are added or subtracted from this starting point to arrive at AMTI. These adjustments are generally intended to eliminate or modify departures from "economic income" found in the regular income tax, such as the exclusion of interest on state and local bonds, the allowance of deductions for personal expenditures, and the expensing of items that would be capitalized under economic concepts. After AMTI is determined, it is reduced by an "exemption amount." The excess of AMTI over the exemption amount is multiplied by an alternative minimum tax rate of (1) 20 percent, in the case of corporations, or (2) 26 percent of the first \$175,000, and 28 percent of the amount over \$175,000, in the case of individuals. The result is the taxpayer's "tentative minimum tax."ⁿ³ The alternative minimum tax actually imposed, however, is limited to the excess, if any, of the tentative minimum tax for the taxable year over the regular tax imposed in such year.ⁿ⁴

Since long-term capital gains are no longer considered a preference for minimum tax purposes, the alternative minimum tax is of considerably less importance to investors in stocks and securities than it once was. Still, all taxpayers need to be aware of the minimum tax or risk unpleasant surprises. For example, interest on some types of municipal bonds may be tax exempt for regular tax purposes but subject to the alternative minimum tax. Consulting fees for legal, accounting and investment advice may be deductible for regular tax purposes but nondeductible in the alternative minimum tax base. A taxpayer may sell investments producing short-term capital gain believing the gain will be absorbed by losses from other investments, only to find that the losses disappear after adjustments are made for alternative minimum tax purposes. Some acquaintance with the alternative minimum tax, then, is prudent for securities investors as for other

taxpayers.

The remainder of this chapter will review the more significant adjustments made to regular taxable income in arriving at AMTI;ⁿ⁵ the calculation of the tax;ⁿ⁶ and circumstances under which a taxpayer may be able to recover minimum taxes paid in prior years through the minimum tax credit.ⁿ⁷

FOOTNOTES:

(n1)Footnote 1. "Small corporations" with average gross receipts of not more than \$7,500,000 annually are wholly exempt from the alternative minimum tax. *IRC § 55(e)*.

(n2)Footnote 2. *IRC § 55(b)(2)*.

(n3)Footnote 3. *IRC § 55(b)*. The 26 percent rate is applied to the first \$87,500 in the case of a married person filing separately, and 28 percent to any excess over that amount. *IRC § 55(b)(1)(A)(iii)*. Lower maximum rates of alternative minimum tax are applied to the net capital gain of noncorporate taxpayers and to the "qualified timber gain" of corporations. See *IRC §§ 55(b)(3)* and *55(b)(4)*, respectively.

(n4)Footnote 4. *IRC § 55(a)*.

(n5)Footnote 5. *IRC §§ 56-59*.

(n6)Footnote 6. *IRC § 55*.

(n7)Footnote 7. *IRC § 53*.



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CHAPTER 2A The Alternative Minimum Tax

1-2A Taxation of Securities Transactions § 2A.02

§ 2A.02 Alternative Minimum Taxable Income: A Separate Tax Base

Treasury regulations state that "except as otherwise provided by statute, regulations or other published guidance issued by the Commissioner, all Internal Revenue Code provisions that apply in determining the regular taxable income of a taxpayer also apply in determining the alternative minimum taxable income of the taxpayer."¹ The key words are "except as otherwise provided..." Regular taxable income is the starting point, but the adjustments prescribed by the minimum tax provisions, and adjustments generated by those adjustments, effectively create a second tax base for taxpayers to contend with, one that in many cases requires keeping an additional set of books. Some adjustments affect only individuals, others affect only corporations, and others affect both. Some adjustments include items that would otherwise escape taxation completely, while other adjustments merely affect the timing of income or deductions. Taken together, the adjustments potentially affect all taxpayers and can produce an AMTI tax base that is very different from the taxpayer's regular taxable income.

[1] Income Items

[a] Tax-exempt Interest

IRC Section 57(a)(5) treats interest on municipal bonds that are "specified private activity bonds" as a tax preference item, adding the interest to income for AMTI purposes. As a general rule, interest on private activity bonds is already includible in income for regular tax purposes, making an AMTI adjustment seemingly superfluous, but interest on a subset of private activity bonds, known as "qualified bonds," is exempt from regular tax.¹ Private activity bonds that pay tax-exempt interest include (a) qualified Section 501(c)(3) bonds; (b) exempt facility bonds, (3) qualified mortgage bonds, (4) qualified veterans' mortgage bonds, (5) qualified small issue bonds, (6) qualified student loan bonds, and (7) qualified redevelopment bonds.²

Although *IRC Section 57(a)(5)* begins by nominally taxing interest on all such tax-exempt qualified bonds, statutory exceptions exclude interest on the first four types of qualified bonds from the AMTI adjustment.³ Furthermore, interest on any bonds that remain subject to *IRC Section 57(a)(5)*, if such bonds are issued in 2009 or 2010, may not be considered an item of tax preference nor taken into account in any way in calculating AMTI.⁴

[b] Gain on Qualified Small Business Stock

IRC Section 1202 excludes from the gross income of taxpayers other than corporations a percentage of the gain realized

on the sale or exchange of qualified small business stock held for more than 5 years. The excluded amount is generally 50 percent of the gain but can be 60 percent or as much as 75 percent of the gain in certain cases.ⁿ⁵ *IRC Section 57(a)(7)* recaptures a portion of the excluded gain in calculating AMTI by including in income an amount currently equal to 7 percent of the gain excluded from gross income by *IRC Section 1202*.ⁿ⁶

[c] Income from Exercise of Incentive Stock Options

The income that ordinarily would be recognized when an employee purchases stock from an employer at a price below its fair market value is excluded by *IRC Section 421(a)* for regular tax purposes if the purchase is made pursuant to an "incentive stock option" ("ISO") described in *IRC Section 422*.ⁿ⁷ This exclusion is considered a tax preference under *IRC Section 56(b)(3)*, however, and the employee who exercises an ISO must disregard *IRC Sections 421* and *422* in calculating income for AMTI purposes. If the stock is transferrable or not subject to a substantial risk of forfeiture, the employee must include in income for alternative minimum tax purposes the difference between the fair market value of the stock and its option or exercise price in the taxable year the option is exercised.ⁿ⁸

The ISO adjustment has proven to be one of the most controversial tax preferences addressed in the alternative minimum tax because the AMTI adjustment leaves the employee at risk that the value of the stock received at the time the option is exercised may decline before the stock can be sold, so that the employee ends up having paid alternative minimum tax on a substantial amount of "phantom income." *IRC Section 56(b)(3)* contains two provisions that partially address the problem. First, *IRC Section 56(b)(3)* provides that the adjusted basis of stock acquired pursuant to the exercise of an ISO is stepped up to its fair market value on the option exercise date for AMTI purposes, consistently with the amount of income required to be recognized under that subsection. Second, if the stock is sold at a loss (calculated using its AMTI basis) before the end of the taxable year in which the option was exercised, the measure of income on exercise of the option for minimum tax purposes is the difference between the option price and the price actually received for the stock rather than the higher fair market value of the stock at time the option was exercised.ⁿ⁹

Neither of these provisions is particularly helpful, however, if the stock is sold at a loss in a year subsequent to the year in which the ISO was exercised, as was discovered by executives who exercised ISOs during the "dot.com" bubble in 1999 and 2000. They paid alternative minimum tax on the substantial spreads between the exercise price and the fair market value of their companies' high flying stocks, only to watch their stocks become worthless (or nearly so) when the bubble burst in 2001. Although the step-up in basis produced substantial losses for AMTI purposes when the stock became worthless or was sold at a fraction of its exercise date value, the losses were capital losses that could only be used to offset capital gains (of which there were precious little in 2001) plus \$3,000 of ordinary income.ⁿ¹⁰ Further, since capital losses cannot be carried back by individuals,ⁿ¹¹ and as noted are generally not deductible from ordinary income in any event, there was no way the taxpayers could offset their AMTI stock losses against the AMTI income that had been recognized on exercise of the ISO in a prior year.

Although taxpayers fought these conclusions in the courts, they were uniformly unsuccessful.ⁿ¹² The cases affirmed the basic principle referred to at the beginning of this section: even though the alternative minimum tax has its own tax base separate from regular taxable income, in the absence of alternative minimum tax provisions providing specifically to the contrary Code sections applicable in calculating regular taxable income (such as the capital loss limitations in *IRC Section 1211* and the limitation on loss carrybacks in *IRC Section 1212*) also apply for purposes of calculating AMTI.ⁿ¹³ Finally, in an extraordinary measure, Congress in 2008 simply abated (forgave) all taxes (along with interest and penalties) due and unpaid on AMTI income resulting from the exercise of an ISO in all taxable years ending before January 1, 2008, while leaving the underlying problem unresolved for 2008 and future years.ⁿ¹⁴

[d] Adjusted Corporate Earnings (ACE) Adjustment

The adjusted current earnings or "ACE" adjustment utilizes an alternative tax base within the alternative minimum tax base, applicable only to corporations.ⁿ¹⁵ To calculate the ACE adjustment, a corporate taxpayer must first calculate its

"adjusted current earnings" which equals AMTI (without any ACE adjustments, and without regard to the alternative tax net operating loss deduction) modified by the adjustments prescribed in *IRC Section 56(g)(4)*.ⁿ¹⁶ The actual ACE adjustment equals 75 percent of the excess of adjusted current earnings over AMTI, which is added to the AMTI tax base.ⁿ¹⁷ If AMTI exceeds adjusted current earnings, a negative ACE adjustment results, equal to 75 percent of the difference between AMTI and adjusted current earnings. The negative adjustment may be deducted from the AMTI tax base provided, however, that the amount deducted may not exceed the net amount (if any) by which AMTI was increased by ACE adjustments in prior years.ⁿ¹⁸

[i] The Earnings and Profits Standard

The adjustments in *IRC Section 56(g)(4)* are designed to make adjusted current earnings correspond roughly to the corporation's earnings and profits for the current year.ⁿ¹⁹ Consistent with that view, *IRC Section 56(g)(4)* conforms AMTI to the earnings and profits standard by adding (1) income items taken into account in calculating earnings and profits but omitted from AMTI, and (2) deductions allowed in computing AMTI that are not allowed in calculating earnings and profits.ⁿ²⁰ The alignment between current earnings and profits and adjusted current earnings is not perfect, as might be inferred from use of the word "adjusted." Congress has sanctioned many exceptions to the earnings and profits standard, usually to preserve tax incentives it considers especially important by not subjecting the special exclusions or deductions associated with them to the alternative minimum tax. Conversely, however, some deductions are allowable in computing earnings and profits but disallowed for various reasons for regular tax and AMTI purposes; typically, no adjustment is permitted to allow a deduction for such disallowed expenses in computing the ACE adjustment.ⁿ²¹

Since earnings and profits is the standard that the ACE adjustment aims for, a necessary threshold question is: what income and deduction items are taken into account in the computation of "earnings and profits"? The statute provides that for purposes of calculating the ACE adjustment the term "earnings and profits" has the same meaning as in Subchapter C,ⁿ²² but there is no comprehensive statutory definition of "earnings and profits" in Subchapter C or elsewhere in the Code.ⁿ²³

Congress authorized the Treasury to issue guidance on this question,ⁿ²⁴ and in response it has provided "partial lists" of items that increase the ACE adjustment either because they are excluded from gross income for regular tax and AMTI purposes but included in earnings and profits,ⁿ²⁵ or are deductible for AMTI purposes but not earnings and profits purposes.ⁿ²⁶ There is also a partial list of items of income and deduction that are treated consistently in calculating both AMTI and earnings and profits and therefore require no ACE adjustment.ⁿ²⁷ These regulations have been deemed legislative in character, so that their provisions are entitled to "controlling weight" unless in a particular instance they are found to be "arbitrary, capricious, or manifestly contrary to the statute."ⁿ²⁸

The Treasury regulations also make a significant but appropriate concession regarding the ACE adjustment: it is only intended to reach permanent discontinuities between AMTI and earnings and profits, not temporary timing differences.ⁿ²⁹ Thus, even though an eligible taxpayer that uses the completed contract method of accounting to defer income for regular tax and AMTI purposes is required to use the percentage of completion method in calculating earnings and profits,ⁿ³⁰ no ACE adjustment is required under *IRC § 56(g)(4)(B)* because the income is only temporarily deferred and will ultimately be included in regular taxable income and AMTI.ⁿ³¹ Similarly, a deduction claimed by the taxpayer under *IRC Section 196* for unused research credits attributable to amounts expended on research in prior years does not increase its ACE adjustment even though no deduction is taken for such expenditures in calculating earnings and profits for the current year because earnings and profits were previously reduced by a deduction for the expenditures in the year they were made.ⁿ³²

The regulations further provide that in calculating adjusted current earnings, as in calculating AMTI, all Internal Revenue Code provisions that apply in determining the regular taxable income of a taxpayer also apply in determining adjusted current earnings, except to the extent the statute, regulations or guidance from the Internal Revenue Service

provide otherwise.ⁿ³³ In applying Internal Revenue Code provisions, however, the adjustments of *IRC Section 56(g)* must be taken into account.ⁿ³⁴ For example, if a manufacturer's depreciation of plant and equipment is \$80,000 for regular tax purposes, \$60,000 for AMTI purposes, and \$40,000 for ACE purposes, its adjusted basis in such plant and equipment will be \$20,000 less for AMTI than for regular tax purposes, and \$40,000 less for ACE purposes than for regular tax purposes. Moreover, if *IRC Section 263A* requires that the manufacturer capitalize depreciation into cost of goods sold for regular tax and AMTI purposes, it must also capitalize the depreciation in calculating adjusted current earnings, and the basis of its closing inventory will consequently be different depending on whether regular taxable income, AMTI, or adjusted current earnings is being calculated.ⁿ³⁵

The most significant item excluded from AMTI but includible in earnings and profits is undoubtedly tax-exempt interest on municipal bonds, which must be added back to AMTI in calculating the ACE adjustment.ⁿ³⁶ Interest on qualified private activity bonds that is exempt for regular tax purposes but includible in AMTI does not require an ACE adjustment. However, interest on qualified bonds that are excepted from the tax preference provisions of *IRC Section 57(a)(5)*ⁿ³⁷ must be included in the ACE adjustment unless a specific exception also applies for ACE purposes. Such exceptions have been made for interest on exempt facility bonds, qualified mortgage bonds, and qualified veterans' mortgage bonds, the interest on which is consequently excluded from adjusted current earnings as well as AMTI.ⁿ³⁸

If an item of income is included in the ACE adjustment because it is excluded from AMTI but included in earnings and profits, any expense related to that item which would have been deductible had the item been includible in gross income for AMTI purposes is allowable for purposes of the ACE adjustment.ⁿ³⁹ For example, if a corporate taxpayer is required to add otherwise tax-exempt interest on municipal bonds to AMTI for purposes of calculating the ACE adjustment, the taxpayer is entitled to deduct any interest paid or incurred to purchase or carry the bonds. The deduction is allowed notwithstanding *IRC Section 265(a)(2)*, which disallows the deduction when the municipal bond interest is excluded from gross income for regular and alternative minimum tax purposes.ⁿ⁴⁰

Although there is no earnings and profits counterpart to the dividends received deduction allowed by *IRC Section 243*, a statutory exception prohibits adding the deduction back to AMTI for purposes of calculating the ACE adjustment in the case of (1) the deduction for 100 percent of dividends received from domestic corporations that are in the same affiliated group as the recipient,ⁿ⁴¹ and (2) the deduction for 80 percent of dividends received from domestic companies that do not meet the affiliated group requirement but are at least 20 percent owned by the recipient.ⁿ⁴² This leaves the deduction for 70 percent of dividends received by corporate taxpayers from domestic corporations in which they own less than 20 percent of the stock as the only *IRC Section 243* deduction still subject to the ACE adjustment.

An exception from the ACE adjustment is also made for discharge of indebtedness income that is excluded from gross income under *IRC Section 108*, whether or not such excluded income correspondingly increases earnings and profits.ⁿ⁴³ Moreover, no adjustment may be made to adjusted current earnings with respect to the difference, if any, between AMTI and earnings and profits treatment of charitable contributions.ⁿ⁴⁴ Finally, no ACE adjustment is allowed to dilute the incentive effect of the special deduction allowed by *IRC Section 199* to encourage domestic production activities (scheduled to expire after 2009).ⁿ⁴⁵

[ii] Specific Items Adjusted for ACE Purposes

In addition to the general directives in *IRC Sections 56(g)(4)(B)* and *(C)* to conform AMTI to the earnings and profits standard, *IRC Section 56(g)(4)* prescribes that the following additional adjustments be made to specific items in AMTI:

Depreciation. ACE depreciation follows AMTI depreciation for tangible assets placed in service after December 31, 1993.ⁿ⁴⁶ However, adjustments applicable only for ACE purposes are prescribed for assets placed in service in 1993 and prior years.ⁿ⁴⁷

Intangible drilling costs. The adjustment to earnings and profits prescribed in *IRC § 312(n)(2)(A)*, requiring the

capitalization of intangible drilling costs and their amortization over a 60 month period, is applied in taxable years beginning after December 31, 1989. However, no such adjustment may be made to intangible drilling costs of oil and gas wells paid or incurred by a corporate taxpayer in taxable years beginning after December 31, 1992 unless the taxpayer is an "integrated oil company" (as defined in *IRC Section 291(b)(4)*).ⁿ⁴⁸

Circulation and organizational expenditures. Following the adjustment to earnings and profits prescribed in *IRC Section 312(n)(3)*, adjusted current earnings must be calculated without regard to *IRC Section 173* (which provides, at the election of the taxpayer, for either expensing or capitalization and amortization of circulation expenditures) and *IRC Section 248* (which provides for the expensing of the first \$5,000 of organizational expenditures and amortization of the remainder over a 180 month period).ⁿ⁴⁹ Note that if a corporation elects, under *IRC § 59(e)*, to capitalize circulation expenditures and amortize them over 3 years for regular and alternative minimum tax purposes, it may do so for purposes of calculating the ACE adjustment as well.ⁿ⁵⁰ In the absence of such an election, it appears that circulation expenditures, like organizational expenditures, must be permanently capitalized in calculating ACE.

LIFO recapture adjustment. Incorporating a similar adjustment to earnings and profits in *IRC Sections 56(g)(4)(D)(iii)* and *312(n)(4)*, requires that taxpayers using a LIFO method of accounting for inventory add to AMTI, for purposes of calculating adjusted current earnings, a LIFO recapture amount equal to the difference between the taxpayer's closing inventory as valued under LIFO and the value of such closing inventory had the FIFO method been used.ⁿ⁵¹

Installment method adjustment. The installment method may not be used in calculating adjusted current earnings because it cannot be used in computing earnings and profits.ⁿ⁵² Gain deferred to later years under the installment method must therefore be reported in the year of sale when computing adjusted current earnings, although the taxpayer is presumably entitled to make negative adjustments in subsequent years when AMTI reflects installment sales gain that has already been recognized for ACE purposes.

There is an exception to the rule if the installment sale qualifies for installment reporting under *IRC Section 453A*; i.e., as a nondealer sale of property for a sales price in excess of \$150,000 in which the taxpayer is required to pay annual interest on an "applicable percentage" of its deferred tax liability each year. The numerator of the applicable percentage is the amount of installment obligations in excess of \$5 million remaining outstanding at the close of the taxable year, and the denominator is the total amount of such outstanding installment obligations at the close of the year (hence, no interest is due on deferred tax liabilities if installment obligations are \$5 million or less). For ACE calculation purposes, the amount of gain eligible for installment reporting is determined by multiplying the same applicable percentage by the total amount of gain realized on the sale. Ineligible gain from the nondealer sale must be recognized in full in the year of sale.ⁿ⁵³

Debt pool exchange adjustment. In *Cottage Savings Ass'n v Comm'r*,ⁿ⁵⁴ the Supreme Court held that a savings bank that exchanged its portfolio of home mortgages for another bank's portfolio of home mortgages with substantially the same interest rates, maturity dates and, in the aggregate, equivalent economic value, could recognize a tax loss on the exchange, though no such loss was recognized on its financial statements, because the mortgages represented "legally distinct entitlements."ⁿ⁵⁵ *IRC Section 56(g)(4)(E)* provides that if any such loss is recognized for regular and AMTI tax purposes, it must be added back to AMTI for purposes of calculating the ACE adjustment.

Depletion. The allowance for depletion with respect to any property placed in service in a taxable year beginning after December 31, 1989 is limited to cost depletion under *IRC Section 611* for purposes of the ACE adjustment. Thus, the difference between any percentage depletion deduction allowed in calculating AMTI and cost depletion allowable with respect to the property under *IRC Section 611* must be added back to adjusted current earnings in calculating the ACE adjustment.ⁿ⁵⁶ The Tax Court has held that, independently of *IRC Section 56(g)(4)(F)(i)*, *IRC Section 56(g)(4)(C)*, which mandates generally that all deductions taken for ACE purposes conform to the earnings and profits standard, also requires an add-back of percentage depletion (though computed differently than the adjustment required by *IRC Section 56(G)(4)(F)(i)*) since only cost depletion is allowable when calculating earnings and profits.ⁿ⁵⁷ Hence, even if *IRC*

Section 56(g)(4)(F)(i) does not apply to the taxpayer's property because it was placed in service in a taxable year beginning before December 31, 1989, *IRC Section 56(g)(4)(C)* may apply, regardless of when the property was placed in service.ⁿ⁵⁸

As previously observed, once all the adjustments above have been made to AMTI, the resulting "adjusted current earnings" is compared with pre-adjustment AMTI. Seventy-five percent of the excess (as it will prove to be in most cases) of adjusted current earnings over pre-adjustment AMTI becomes the ACE adjustment, added to AMTI and potentially subject to the alternative minimum tax.

[e] Completed Contract Method of Accounting

Taxpayers using the completed contract method of accounting for post-March 1, 1986 long-term contracts are required to use the percentage of completion method, as modified by *IRC § 460(b)*, for purposes of computing AMTI, thus accelerating the recognition of income generated by such contracts.ⁿ⁵⁹

[2] Deduction Items

[a] Below-the-line Deductions

For most individual taxpayers, the adjustments to regular taxable income that pose the greatest threat of liability for the alternative minimum tax are those which wholly or partially disallow for AMTI purposes certain below-the-line deductions; i.e., expenses deductible from adjusted gross income (AGI) rather than gross income. ⁿ¹ Many of these are personal expenses for which deductions are permitted for equitable reasons (such as ability to pay) that have little to do with the measurement of disposable economic or business income. But the adjustment's net also catches deductions that do not appear to be departures from an economic concept of income, principally employee business expenses and expenses incurred for the production of income. The following deductions are affected.

[i] Miscellaneous Itemized Deductions

All "miscellaneous itemized deductions," as defined in *IRC Section 67(b)*, are disallowed for AMTI purposes.ⁿ² *IRC § 67(b)* defines the term "miscellaneous itemized deductions" comprehensively to include all itemized deductions other than those specifically excluded from the definition by that subsection. There are currently twelve types of itemized deductions expressly excluded from the "miscellaneous itemized deductions" category, of which the most important are the deductions for charitable contributions, medical expenses, state and local taxes, casualty and theft losses, and expenses allocable to income in respect of a decedent.ⁿ³ All non-excluded itemized deductions, including expenses incurred for the production of income under *IRC Section 212(1)*, are miscellaneous itemized deductions for which no deduction may be taken in calculating AMTI.ⁿ⁴

Expenses deductible from gross income in arriving at AGI are not itemized deductions and therefore cannot be in the "miscellaneous itemized deductions" category. Above-the-line deductions are allowed principally for expenses incurred in connection with an individual's trade or business,ⁿ⁵ but Congress has allowed above-the-line deductions in *IRC Section 62* for many other specific categories of expenses.ⁿ⁶ Expenses for which above-the-line deductions are allowed include: employee expenses reimbursed by the employer;ⁿ⁷ unreimbursed employee expenses of performing artists, certain state and local officials, elementary and secondary school teachers, and members of the Armed Forces' reserves;ⁿ⁸ losses from the sale or exchange of property;ⁿ⁹ deductions attributable to property held for the production of rents and royalties;ⁿ¹⁰ and alimony deductible under *IRC Section 215*.ⁿ¹¹ Congress has also reversed in part the result in *Banks* and other cases holding legal fees nondeductible for AMTI purposes by classifying legal fees as *IRC Section 62(a)* above-the-line deductions when incurred in pursuance of unlawful discrimination claims under certain federal statutesⁿ¹² or "whistleblower" claims made under *IRC Section 7623(b)*.ⁿ¹³

[ii] Deduction for State and Local Taxes

Deductions for state and local income, personal property, real property and sales taxes are disallowed for AMTI purposes.ⁿ¹⁴

[iii] Deduction for Medical Expenses

The regular tax itemized deduction for medical expenses in excess of 7.5 percent of adjusted gross income (AGI) is modified so that only medical expenses in excess of 10 percent of AGI are deductible for AMTI purposes.ⁿ¹⁵

[iv] Deduction for Personal Interest

Personal interest other than interest on the taxpayer's home mortgage is non-deductible for both regular tax and AMTI purposes.ⁿ¹⁶ However, deductible "qualified housing interest" allowed for AMTI purposes is defined somewhat more narrowly than "qualified residence interest" allowed for regular tax purposes: *viz*, interest on a home equity loan of up to \$100,000, secured by the taxpayer's residence, is deductible for regular tax purposes regardless of the use to which the proceeds of the loan are put, while under the AMTI the proceeds of any home mortgage loan, including a home equity loan, must be used to acquire, construct or substantially improve the taxpayer's residence or interest on the loan will not be deductible.ⁿ¹⁷

[v] Standard Deduction and Personal Exemptions

Neither the standard deduction, the deduction for personal exemptions, nor the exemptions for estates and trusts allowed for regular tax purposes in *IRC Sections 63(c), 151 and 642(b)*, respectively, are allowed in computing AMTI.ⁿ¹⁸ The alternative minimum tax does have its own exemptions, however.ⁿ¹⁹ On the positive side, the overall limitation on itemized deductions in *IRC Section 68* does not apply for AMTI purposes.ⁿ²⁰

[b] Depreciation

IRC Section 56(a)(1) requires the taxpayer to calculate depreciation for AMTI purposes in a manner that, as compared with the modified Accelerated Cost Recovery System (MACRS) allowed by *IRC Section 168(a)* in computing regular taxable income, produces lower depreciation deductions in the early years of an asset's life but higher deductions in later years. The intention is to allow depreciation for AMTI purposes that more closely corresponds with economic depreciation. The AMTI depreciation rules generally follow the regular tax MACRS rules for property placed in service on and after January 1, 1999, except that AMTI depreciation is limited to the 150 percent declining balance method for personal property,ⁿ²¹ and is limited to the straight line method for real estate.ⁿ²² Tangible real and personal property placed in service before January 1, 1999 (but after the January 1, 1987 effective date of MACRS) is depreciated for AMTI purposes using the alternative depreciation system (ADS) prescribed by *IRC Section 168(g)*, which is limited to the straight-line method and uses longer recovery periods than MACRS.ⁿ²³

[c] Depletion

IRC Section 57(a)(1) requires that there be added to regular taxable income, in computing AMTI, the excess of the depletion deductions allowable for the taxable year under *IRC Section 611* with respect to each mining property (as defined in *IRC Section 614*) over the adjusted basis of such property at the close of the year, determined without regard to any depletion deduction for the taxable year.ⁿ²⁴ The term "property" in *IRC Section 57(a)(1)* refers only to the mineral deposit in place, and does not include depreciable improvements to the property in the form of investments in machinery, tools, pipes, and other equipment used to exploit the deposits.ⁿ²⁵

[d] Mining Exploration and Development Costs

IRC Sections 616 and 617 give taxpayers an election to claim a current deduction for the costs of exploring for and

developing a mineral deposit (other than oil or gas). The election is not available for purposes of calculating AMTI, however; rather, the taxpayer is required to capitalize such costs and amortize them over a 10-year period.ⁿ²⁶ The taxpayer may deduct mining costs which remain unamortized for AMTI purposes when it abandons or otherwise disposes of the mine at a loss, in an amount not to exceed the loss that would have been recognized under *IRC Section 165* had the mining costs remained capitalized.ⁿ²⁷

[e] Intangible Drilling Costs

For purposes of calculating AMTI, the taxpayer must add the amount by which "excess intangible drilling costs" paid or incurred in connection with oil and gas wells is greater than 65 percent of the taxpayer's net income from such properties.ⁿ²⁸ The term "excess intangible drilling costs" means the excess of the amount deducted currently for regular tax purposes under *IRC Section 263(c)* or *IRC Section 291(b)*ⁿ²⁹ over the amount that would have been allowable if intangible drilling costs had been capitalized and amortized using the straight line method over a 120 month period.ⁿ³⁰

[f] Amortization of Pollution Control Facilities

Under *IRC Section 169*, a taxpayer may elect to amortize the cost of certified pollution control over a period of 60 months.ⁿ³¹ *IRC Section 56(a)(5)* requires that, for AMTI purposes, such facilities must be amortized under the MACRS system but using the straight line method of depreciation.ⁿ³²

[g] Circulation and Research Expenditures

In the case of individuals only, the deductions allowed by *IRC Section 173* (allowing a current deduction for expenditures incurred to establish, maintain or increase the circulation of a newspaper, magazine or other periodical) and *IRC Section 174* (allowing a current deduction for research and experimental expenditures) are disallowed for AMTI purposes.ⁿ³³ Instead, such expenditures must be capitalized and amortized over 3 years (in the case of circulation expenditures) or 10 years (in the case of research or experimental expenditures).ⁿ³⁴

[h] Denial of Loss from Tax Shelter Farm Activity

Individuals may not deduct for AMTI purposes any loss from a "tax shelter farm activity."ⁿ³⁵ A tax shelter farm activity includes a farming syndicate, as defined in *IRC Section 464(c)*, and any other activity consisting of farming which is a passive activity (within the meaning of *IRC Section 469(c)*) with respect to the taxpayer.ⁿ³⁶

[3] Impact of Adjustments on Other Items

Several of the preceding adjustments change the regular tax methods of expensing, depreciating or amortizing assets to different methods for AMTI purposes.ⁿ¹ In these cases, *IRC Section 56(a)(6)* requires a recalculation of the adjusted basis of each affected asset for AMTI purposes so that the asset's adjusted basis is consistent with the AMTI method prescribed. For example, if the taxpayer purchases an asset for \$1,500 and deducts \$500 in depreciation for regular tax purposes but is allowed only \$300 in depreciation in computing AMTI, the asset will have a regular tax basis of \$1,000 and an AMTI tax basis of \$1,200. If the asset is sold for \$1,100, the taxpayer would report a gain of \$100 in calculating regular taxable income and a loss of \$100 in calculating AMTI.ⁿ²

Similarly, *IRC Section 58(b)(1)* requires that the provisions of *IRC Sections 469*, governing when and how losses from "passive activities" may be deducted in computing regular taxable income, be re-applied when calculating AMTI in light of the adjustments required by *IRC Sections 56* and *57* that affect the *IRC Section 469* calculations. Taxpayer losses (and gains) from passive activities, and the amounts of passive activity losses and credits that may be carried over to subsequent years, may be different for regular and alternative minimum tax purposes after the AMTI adjustments are taken into account.

For example, suppose that for regular tax purposes a taxpayer has a net loss of \$100,000 from a passive activity in Year 1. In calculating this loss the taxpayer uses a method of depreciation that produces a deduction of \$20,000. However, *IRC Section 56(a)(1)* requires that the taxpayer use a different depreciation method, which reduces the depreciation deduction to only \$10,000 for AMTI purposes, which in turn reduces the passive activity loss for the year to \$90,000. If the taxpayer has income from the passive activity of \$50,000 in Year 1, the passive activity rules in *IRC Section 469* will limit the amount deductible in respect of that activity to \$50,000 for purposes of both the regular and alternative minimum taxes. However, the amount of the passive activity loss that can be carried over to Year 2 under *IRC § 469(b)* is \$50,000 for regular tax purposes (\$100,000 - \$50,000) but only \$40,000 (\$90,000 - \$50,000) for AMTI purposes.ⁿ³

AMTI adjustments also affect the net operating loss deduction available for AMTI calculation purposes, known as the "alternative tax net operating loss or "ATNOL."ⁿ⁴ Pursuant to *IRC § 56(d)*, the net operating loss deduction allowable for regular tax purposes is modified in two principal respects to arrive at the ATNOL for the taxable year. First, all the adjustments required to be taken into account by *IRC §§ 56-58* in calculating AMTI must also be taken into account when calculating the ATNOL.ⁿ⁵ Second, the ATNOL deduction may not exceed the lesser of the NOL deduction for the year or 90 percent of AMTI (determined without regard to the ATNOL deduction or the deduction allowed by *IRC Section 199*).ⁿ⁶

ATNOLs, like NOLs, may generally be carried back two years and forward 20 years.ⁿ⁷ Also like NOLs, ATNOLs are first carried back to the earliest available year and then carried forward to the next succeeding year until fully used.ⁿ⁸ The ATNOL will be absorbed by any AMTI the taxpayer may have in the earliest taxable year to which it is properly carried, even though the taxpayer has no alternative minimum tax liability for that year because its regular tax equals or exceeds its tentative minimum tax.ⁿ⁹

The difference in application of the NOL and ATNOL can be seen in the following example:

Example:

In Year 1, a taxpayer has \$20,000 of income and \$35,000 of losses, of which \$10,000 are preference items. The regular tax NOL for the year is \$15,000; the ATNOL is \$5,000, since the preferences are added back and reduce the amount of the loss.

In Year 2, the taxpayer has AMTI of \$20,000, determined without regard to its ATNOL. The ATNOL reduces that amount to \$15,000. The NOL deduction for regular tax purposes is not affected by this computation; the taxpayer has a \$15,000 NOL from Year 1 to be used for regular tax purposes.

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.55-1(a)*.

(n2)Footnote 1. See *IRC §§ 103(b), 141*.

(n3)Footnote 2. See *IRC § 141(e)*.

(n4)Footnote 3. See *IRC § 57(a)(5)(C)(ii)* and *(iii)*. In addition, interest on Gulf Opportunity (GO) Zone Bonds is excluded from the *IRC § 57(a)(5)* adjustment. *IRC § 1400N(a)(5)(G)*.

(n5)Footnote 4. See Section 1503 of the American Recovery and Reinvestment Act of 2009, Pub L No 111-5, 123 Stat 115 (2009) ("ARRA of 2009"), adding *IRC § 57(a)(5)(C)(vi)(I)*. For purposes of determining eligibility for the 2009-2010 exception, refunding bonds issued in 2009 and 2010 (whether current or advanced refunding) are treated as if issued on the date the refunded bond was issued, *IRC § 57(a)(5)(C)(vi)(II)*. Nevertheless, interest on such refunding bonds will not be included in income for AMTI purposes if the refunded bond was issued after December 31, 2003 and before January 1, 2009. *IRC § 57(a)(5)(C)(vi)(III)*.

(n6)Footnote 5. See *IRC § 1202(a)*. The 60 percent exclusion applies to sales of qualified small business stock when the issuer of the stock is a "qualified business entity" operating in an "empowerment zone." *IRC § 1202(a)(2)*. The 75 percent exclusion applies to sales (after the 5 year holding period) of all qualified small business stock issued after February 17, 2009 and before January 1, 2011. *IRC § 1202(a)(3)*. These and other rules governing the exclusion of gain from the sale of qualified small business stock are discussed in § 2.06[2][a][ii].

(n7)Footnote 6. Prior to its amendment by section 301 of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), *IRC § 57(a)(7)* treated 42 percent of the excluded gain as a tax preference if the qualified small business stock was acquired before January 1, 2001, lowered to 28 percent if the stock disposed of was acquired after that date. JGTRRA reduced the amount of tax preference income to 7 percent of the gain excluded under *IRC § 1202* for all qualified small business stock disposed of after May 6, 2003, regardless of the date of acquisition. However, JGTRRA contains a "sunset" provision pursuant to which the amendment to *IRC § 57(a)(7)* is scheduled to expire, and the old recapture rules restored, in taxable years beginning after December 31, 2008. The effective date of the sunset provision was delayed by section 102 of the Tax Increase Prevention and Reconciliation Act of 2005 (Pub L 109-222) until taxable years beginning after December 31, 2010. In summary, the percentage of excluded gain treated as a tax preference is: (i) seven percent in the case of stock disposed of in a taxable year beginning before 2011; (ii) 42 percent in the case of stock acquired before January 1, 2001 and disposed of in a taxable year beginning after 2010; and (3) 28 percent in the case of stock acquired after December 31, 2000 and disposed of in a taxable year beginning after 2010. See HR Conf Rep 111-16, (House Conference Report on ARRA of 2009, 111th Cong, 1st Sess (February 12, 2009) at 569.

(n8)Footnote 7. If the stock option fails to qualify as an ISO or other qualified stock option, *IRC § 83(a)* requires that the employee recognize income equal to the difference between the fair market value of property received (i.e., the stock) and the amount paid (if any) as soon as the employee's rights in the stock are either transferable or are not subject to a substantial risk of forfeiture. The rules governing the regular tax treatment of stock options, including ISOs and nonqualified stock options, are covered in Chapter 9.

(n9)Footnote 8. *IRC § 83*.

(n10)Footnote 9. In these circumstances only, *IRC § 56(b)(3)* makes *IRC § 422(c)(2)* applicable for purposes of determining the amount of income reportable in calculating AMTI.

(n11)Footnote 10. *IRC § 1211*.

(n12)Footnote 11. *IRC § 1212(b)*.

(n13)Footnote 12. See, eg, *Palahnuk v Comm'r*, 544 F3d 471 (2nd Cir 2008); *Kadillak v Comm'r*, 534 F 3d 1197 (9th Cir 2008); *Merlo v Comm'r*, 492 F3d 618 (5th Cir 2007) ; *Pierce v US*, 76 Fed Cl 638 (2008), *affd without opinion* 274 Fed Appx 897 (Fed Cir 2008); *Nemitz v Comm'r*, 130 TC 102 (2008) .

(n14)Footnote 13. See *Treas. Reg. § 1.55-1(a)*.

(n15)Footnote 14. Pub L 110-343, Emergency Economic Stabilization Act of 2008 (EESA), sec. 103(b), 122 Stat 3765 (Oct 3, 2008), adding new *IRC § 53(f)*. In program manager technical assistance issued November 17, 2008, the Internal Revenue Service ruled that taxpayers who had previously entered into an offer in compromise (OIC) with the Service settling tax liabilities attributable to the exercise of ISO options that were forgiven in *IRC § 53(f)* were not entitled to a refund of taxes paid before the October 3, 2008 effective date of *IRC § 53(f)*, but were relieved of the obligation to make any further deferred payments under an OIC to the extent such deferred payments represented unpaid tax liabilities, interest or penalties abated by *IRC § 53(f)*. See 2009 TNT 82-16 (Service Explains Relief for Taxes on Exercised Incentive Stock Options) (Doc 2009-8991). Taxpayers that paid the alternative minimum tax due on income generated by the exercise of ISOs before the October 3, 2008 effective date of *IRC § 53(f)* (whether pursuant to an OIC or otherwise) are given tax relief in the form of a relaxation of the rules governing the minimum tax credit, as

well as an acceleration of the availability of the credit, as explained below in the discussion of the minimum tax credit. See *IRC* § 53(e).

(n16)Footnote 15. See *IRC* §§ 56(c)(1) and 56(g). The ACE adjustment does not apply to S corporations, regulated investment companies, real estate investment trusts, and real estate investment conduits. See *IRC* § 56(g)(6).

(n17)Footnote 16. See *IRC* § 56(g)(3).

(n18)Footnote 17. *IRC* § 56(g)(1).

(n19)Footnote 18. *IRC* § 56(g)(2).

(n20)Footnote 19. See *Snap-Drape, Inc v Comm'r*, 98 F3d 194, 200 (5th Cir 1996), cert denied 522 US 821 (1997) (the ACE adjustment uses earnings and profits as a measure of a corporation's economic income available for distribution to its shareholders).

(n21)Footnote 20. See *IRC* § 56(g)((4)(B) and (C).

(n22)Footnote 21. For example, meals and entertainment expenses are fully deductible when computing earnings and profits, but half are disallowed for regular tax and AMTI purposes. See *IRC* § 274(n). Such disallowed expenses are not allowed to reduce "adjusted" current earnings.

(n23)Footnote 22. *IRC* § 56(g)(5)(A).

(n24)Footnote 23. Treasury regulations define "earnings and profits" as "current earnings and profits within the meaning of section 316(a)(2), that is, earnings and profits for the taxable year computed as of the close of the taxable year of the corporation without diminution by reason of any distributions made during the taxable year." While largely circular, this definition does make clear that the ACE adjustment is concerned with current, not accumulated earnings and profits, and that dividends are not taken into account for purposes of the ACE adjustment. *Treas Reg* § 1.56(g)-1(a)(6)(iii). In addition, *IRC* § 312 contains rules regarding the computation of earnings and profits in respect of certain specific items though several of these have incorporated into statutory ACE adjustments under *IRC* § 56(g)(4)(D).

(n25)Footnote 24. Section 7611(g)(3) of the Omnibus Budget Reconciliation Act of 1989, Pub L No. 101-239, 103 Stat 2106, 2373 (1989).

(n26)Footnote 25. See *Treas Reg* § 1.56(g)-1(c)(6). These include the inside buildup on a life insurance contract excluded for regular and AMTI purposes by *IRC* § 101 (subject to the deduction allowed by *IRC* § 56(g)(4)(B)(ii)(II) for the portion of any premium on such contract attributable to insurance coverage) and tax-exempt interest excluded by *IRC* § 103.

(n27)Footnote 26. See *Treas Reg* § 1.56(g)-1(d)(3). These include the deductions for dividends received by a corporation under *IRC* §§ 243, 244, 245 and 247 to the extent not excluded from the ACE adjustment by *IRC* § 56(g)(4)(C)(ii) and (iv) (see discussion below), and the deduction for dividends paid to an employee stock ownership plan under *IRC* § 404(k).

(n28)Footnote 27. See *Treas Reg* §§ 1.56(g)-1(c)(7) and 1.56(g)-1(d)(4). Such items include the value of improvements made by a lessee to a lessor's property that is excluded from the lessor's gross income under *IRC* § 109; contributions to the capital of a corporation by a non-shareholder excludible under *IRC* § 118; and payments by a US corporation with respect to employees of certain foreign corporations that are deductible under *IRC* § 176.

(n29)Footnote 28. See *Snap-Drape, Inc v Comm'r*, 98 F3d 194, 197, citing *Chevron, USA, Inc v Natural Resources Defense Council, Inc*, 467 US 837, 844; and *Dresser Indus v Comm'r*, 911 F2d 1128, 1137 (5th Cir 1990).

In *Snap-Drape*, the court upheld an increase in the taxpayer's adjusted current earnings equal to the regular tax and AMTI deduction it had claimed for dividends paid to an employee stock ownership plan. Treasury regulations specifically provide that such dividends are not deductible in computing current earnings and profits and therefore must be added back to adjusted current earnings. The court found taxpayer's argument that these "dividends" are more akin to compensation than corporate distributions "compelling and...likely to carry the day" but for the "highly deferential standard of review" a legislative regulation commands. *Snap-Drape, Inc v Comm'r*, 98 F3d at 201.

(n30)Footnote 29. See *Treas Reg* §§ 1.56(g)-1(c)(1) and 1.56(g)-1(d)(1).

(n31)Footnote 30. See *IRC* § 312(n)(6).

(n32)Footnote 31. *Treas Reg* § 1.56(g)-1(c)(1).

(n33)Footnote 32. *Treas Reg* § 1.56(g)-1(d)(1).

(n34)Footnote 33. *Treas Reg* § 1.56(g)-1(a)(5).

(n35)Footnote 34. *Id.* See also *IRC* § 56(g)(4)(H) (the adjusted basis of any property with respect to which an ACE adjustment is made must be redetermined to take such adjustment into account for all purposes in calculating adjusted current earnings.)

(n36)Footnote 35. See *Treas Reg* § 1.56(g)-1(a)(5)(ii). Fortunately, as noted below, there is no difference between AMTI depreciation and ACE depreciation for assets placed in service after December 31, 1993. *IRC* § 56(g)(4)(A)(i).

(n37)Footnote 36. However, no interest on any tax-exempt municipal bond issued during 2009 or 2010 may be taken into account in calculating the ACE adjustment. See *IRC* § 56(g)(4)(B)(iv).

(n38)Footnote 37. See § 2A.02[1][a].

(n39)Footnote 38. *IRC* § 56(g)(4)(B)(iii).

(n40)Footnote 39. *IRC* § 56(g)(4)(B)(i)(II); *Treas Reg* § 1.56(g)-1(c)(3).

(n41)Footnote 40. See *Treas Reg* § 1.56(g)-1(c)(3).

(n42)Footnote 41. For purposes of this deduction, "affiliated group" has substantially the same meaning as in *IRC* § 1504(a), which generally requires that each corporation within the affiliated group (except the common parent) be at least 80 percent owned by one or more members of the group. See *IRC* § 243(b)(2).

(N43)Footnote 42. *IRC* § 56(g)(4)(C)(ii). Another statutory exception prohibits taking into account for ACE adjustment purposes the 85 percent dividends received deduction allowed by *IRC* § 965 for dividends received by US shareholders from certain controlled foreign corporations. See *IRC* § 56(g)(4)(C)(vi).

(n44)Footnote 43. *IRC* § 56(g)(4)(B)(i). Under *IRC* § 312(l)(1), discharge of indebtedness income is excluded from earnings and profits only to the extent of any reduction of basis under *IRC* § 1017.

(n45)Footnote 44. Although it is clear that charitable contributions reduce earnings and profits, when the contribution is in the form of appreciated property the Internal Revenue Service takes the position that earnings and profits are only reduced by the adjusted basis of the property, *Rev Rul* 78-123, 1978-1 CB 87, while the Tax Court has held that earnings and profits are reduced by the fair market value of the property. *Kaplan v Comm'r*, 43 TC 580 (1965), *acq withdrawn and nonacq substituted*, 1978-1 CB 2. Whether or not the Service is correct about the effect of a charitable contribution of appreciated property on earnings and profits, *IRC* § 56(g)(4)(I) prevents it from increasing the taxpayer's ACE adjustment by the difference between the fair market value allowable in calculating the charitable

contribution deduction and the adjusted basis the IRS regards as deductible in computing earnings and profits.

(n46)Footnote 45. *IRC § 56(g)(4)(C)(iv)*. See also *IRC § 199(d)(6)* (providing that, in computing the amount of the deduction allowed by *IRC § 199* for AMTI purposes, none of the adjustments in *IRC §§ 56-58* are to be taken into account in calculating "qualified production activities income."

(n47)Footnote 46. *IRC § 56(g)(4)(A)(i)* (second sentence).

(n48)Footnote 47. See *IRC § 56(g)(A)(i) through (v)*.

(n49)Footnote 48. *IRC § 56(g)(4)(D)(i)*.

(n50)Footnote 49. *IRC § 56(g)(4)(D)(ii)*.

(n51)Footnote 50. See *Treas Reg § 1.56(g)-1(f)(2)*.

(n52)Footnote 51. Treasury regulations prescribe the methodology to be used for computing the LIFO recapture amount, *Treas Reg § 1.56(g)(f)(3)*, and also provide an optional "simplified" method of calculating the LIFO recapture amount in *Treas Reg § 1.56(g)-1(r)*.

(n53)Footnote 52. See *IRC § 56(g)(4)(D)(iv)* and compare *IRC § 312(n)(5)*.

(n54)Footnote 53. For example, if a corporate taxpayer makes a casual sale of property costing \$15 million for sales price of \$25 million, all of which is deferred until after the year of sale, its applicable percentage is 80 percent (\$25 million - \$5 million = \$20 million/\$25 million = 80 percent) and the eligible gain is therefore \$8 million (\$10 million x 80 percent = \$8 million). The taxpayer can defer recognition of the entire \$10 gain for regular and alternative minimum tax purposes, but only \$8 million of the gain is eligible for installment reporting in calculating adjusted current earnings. The remaining \$2 million of ineligible gain must be included in income in the year of sale for purposes of calculating the ACE adjustment.

(n55)Footnote 54. 499 US 554 (1991) .

(n56)Footnote 55. See § 1.02[3][a][i].

(n57)Footnote 56. *IRC § 56(g)(4)(F)(i)*.

(n58)Footnote 57. See *Treas Reg § 1.312-6(c)(1)*. See also *Santa Fe Pacific Gold Co and Subs v Comm'r*, 130 TC No 17 (2008) .

(n59)Footnote 58. However, no ACE adjustment is permitted under any ACE provision with respect to depletion of oil and gas wells determined under *IRC § 613A(c)* that is allowable to independent producers and royalty owners. *IRC § 56(g)(4)(F)(ii)*.

(n60)Footnote 59. *IRC § 56(a)(3)*. No adjustment is required, however, if the contract is a home construction contract as defined in *IRC § 460(e)(6)*.

(n61)Footnote 1. See *IRC § 56(b)(1)*.

(n62)Footnote 2. *IRC § 56(b)(1)(A)(i)*. For regular tax purposes, such miscellaneous itemized deductions are allowed only to the extent they exceed in the aggregate 2 percent of the taxpayer's AGI. *IRC § 67(a)*.

(n63)Footnote 3. Charitable contributions, casualty and theft losses, and expenses allocable to income in respect of a decedent are deductible in the same manner and subject to the same limitations for both regular income and AMTI

purposes. State and local taxes and medical expenses, although not considered miscellaneous itemized deductions (and therefore not subject to the 2 percent floor for regular tax purposes), are separately disallowed in whole or in part for AMTI purposes by other provisions of *IRC § 56(b)(1)* (see below).

(n64)Footnote 4. See *Commissioner v Banks*, 543 US 426 (2005) (contingent legal fees taken out of taxpayer's recovery in lawsuit were includible in gross income for regular and alternative minimum tax purposes, and as a miscellaneous itemized deduction such fees were not deductible from AGI for purposes of computing the taxpayer's AMTI); *Alexander v IRS*, 72 F3d 938, 946 (1st Cir 1995) (opining that including the taxpayer's damages recovery in income without allowing an AMTI deduction for the legal fees incurred in obtaining that income "smacks of injustice," but concluding nonetheless that equitable considerations cannot override the plain meaning of the statute).

(n65)Footnote 5. *IRC § 62(a)(1)*. However, with few exceptions, above-the line deductions are specifically not allowed for expenses incurred in connection with the trade or business of performing services as an employee, which expenses therefore fall into the category of "miscellaneous itemized deductions."

(n66)Footnote 6. By classifying these expenses as above-the-line deductions, Congress automatically exempts such expenses from both disallowance for purposes of the alternative minimum tax and the 2 percent of AGI floor which miscellaneous itemized deductions must exceed to be deductible under the regular income tax.

(n67)Footnote 7. *IRC § 62(a)(2)(A)*.

(n68)Footnote 8. *IRC §§ 62(a)(2)(B), (C), (D) and (E)*.

(n69)Footnote 9. *IRC § 62(a)(3)*.

(n70)Footnote 10. *IRC § 62(a)(4)*.

(n71)Footnote 11. *IRC § 62(a)(10))*.

(n72)Footnote 12. See *IRC § 56(e)*.

(n73)Footnote 13. See *IRC §§ 62(a)(20) and (21)*. The above-the-line deduction for legal fees may not exceed the amount of any settlement or other recovery included in the taxpayer's income for the taxable year.

(n74)Footnote 14. *IRC § 56(b)(1)(A)(ii)*. Neither is the taxpayer required to include refunds of those taxes in income for AMTI purposes. *IRC § 56(b)(1)(D)*.

(n75)Footnote 15. *IRC § 56(b)(1)(B)*. For purposes of calculating AMTI, the amount of deductible medical expenses, as well as the amount of any other item of income, exclusion or deduction computed with reference to AGI or modified AGI (e.g., the deduction for charitable contributions), the taxpayer is instructed to use AGI or modified AGI as determined for regular tax purposes. See *Treas Reg § 1.55-1(b)*.

(n76)Footnote 16. *IRC § 163(h)*.

(n77)Footnote 17. Compare *IRC § 163(h)(3)(C)* with *IRC §§ 56(b)(1)(C) and 56(e)*.

(n78)Footnote 18. *IRC § 56(b)(1)(E)*.

(n79)Footnote 19. *IRC § 55(b)(1)*. See discussion at § 2A.03.

(n80)Footnote 20. *IRC § 56(b)(1)(F)*.

(n81)Footnote 21. The depreciation method switches to straight-line when that produces a higher depreciation

deduction.

(n82)Footnote 22. For regular tax purposes, MACRS allows the use of a 200 percent declining balance method for personal property but, like the AMTI rule, requires the straight line method for depreciating real property. The result is that no AMTI adjustment should be required for real property placed in service on or after January 1, 1999, since depreciation on real property is computed the same way for regular tax and AMTI purposes.

(n83)Footnote 23. *IRC § 56(a)(1)(A)(i)*. AMTI depreciation rules applicable to property placed in service prior to January 1, 1987 are prescribed under a separate minimum tax provision, *IRC § 57(a)(6)*, which by now is of limited interest.

(n84)Footnote 24. The objective is to subject percentage depletion in excess of a property's cost to the adjusted minimum tax. Since the adjustment required by *IRC Section 57(a)(1)* is made on a property-by-property basis, the fact that the adjusted basis of one property exceeds the current year's depletion deduction taken in respect of that property does not allow the taxpayer to "carry over" the unused adjusted basis to offset the depletion deduction taken with respect to another separate property. *Treas Reg § 1.57-1(h)(1)*.

(n85)Footnote 25. *US v Hill, 506 US 546 (1993)* (holding that the adjusted basis of the property which the taxpayer is allowed to deduct from percentage depletion in respect of that property does not include the adjusted basis of such improvements, which are separately recovered through depreciation, not depletion deductions. See also *Santa Fe Pacific Gold Co and Subs v Comm'r, 130 TC No 17 (2008)*, in which the Tax Court, applying the reasoning of *Hill*, held *sua sponte* that unamortized mining exploration and development costs capitalized for AMTI purposes under *IRC § 56(a)(2)* (see discussion below) are similarly not includible in the adjusted basis of the "property" that is deducted from percentage depletion in calculating the *IRC § 57(a)(1)* adjustment. The Court nevertheless allowed the taxpayer to include mining exploration and development costs in adjusted basis because the Government had conceded that such costs were includible.

(n86)Footnote 26. See *IRC § 56(a)(2)*. A corporate taxpayer that elects to deduct mining exploration or development costs for regular tax purposes must reduce the deduction by an amount equal to 30 percent of such costs under the regular tax's own corporate preference tax rules, see *IRC § 291(b)(1)(B)*, and amortize that 30 percent over a 60 month period. *IRC § 291(b)(2)*. The AMTI tax treatment prescribed by *§ 56(a)(2)* requires 100 percent of exploration and development costs to be capitalized and amortized over 10 years, including the 30 percent that is not currently deductible for regular tax purposes because of *IRC § 291*.

(n87)Footnote 27. *IRC § 56(a)(2)(B)*.

(n88)Footnote 28. *IRC § 57(a)(2)*. The tax preference also applies to the separately computed difference between excess intangible drilling costs paid or incurred in connection with geothermal deposits over 65 percent of the taxpayer's net income from such deposits. *IRC § 57(a)(2)(D)*. However, the intangible drilling costs tax preference only fully applies to integrated oil companies as defined in *IRC § 291(b)(4)*. *IRC § 57(a)(2)(E)(1)*. Independent producers are exempt from the preference as long as the reduction in the alternative minimum tax resulting from such exemption does not exceed 40 percent of AMTI, computed without the exemption and without regard to any alternative tax net operating loss. *IRC § 57(a)(2)(E)(2)*.

(n89)Footnote 29. In this case, unlike the tax preference for mining exploration and development costs, in calculating the amount of the AMTI preference corporate taxpayers take into account the 30 percent reduction in the intangible drilling costs deduction required by *IRC § 291(b)*. See *IRC § 57(a)(2)(B)(i)* and compare *IRC § 56(a)(2)*.

(n90)Footnote 30. See *IRC § 57(a)(2)(B)(ii)* and *57(b)(1)*. Alternatively, the taxpayer may elect to use any other permissible cost depletion method. See *IRC § 57(b)(2)*.

(n91)Footnote 31. The amortizable basis of such facilities eligible for 60 month amortization is reduced by 20

percent for corporate taxpayers under *IRC* § 291(b)(4), which percentage may be depreciated under the normal MACRS rules. *IRC* § 169(g).

(n92)Footnote 32. AMTI depreciation applies to the entire basis of such facilities, including the 20 percent that *IRC* Section 291(a)(4) disqualifies from 60 month amortization for purposes of the regular tax. *IRC* § 56(a)(5). Pollution control facilities placed in service after December 31, 1986 but before January 1, 1999 must use the alternative system of depreciation under *IRC* § 168(g).

(n93)Footnote 33. *IRC* § 56(b)(2). The disallowance of the deduction for research and experimental expenditures does not apply to individuals who materially participate in the activity that gives rise to such expenditures. *IRC* § 56(b)(2)(D). And while corporations are not subject to this adjustment, they are required to capitalize circulation expenditures for purposes of calculating the ACE adjustment. See § 2A.02[2][d][ii].

(n94)Footnote 34. *IRC* § 56(b)(2)(A)(i) and (ii).

(n95)Footnote 35. *IRC* § 58(a)(1).

(n96)Footnote 36. *IRC* § 58(a)(2).

(n97)Footnote 1. See *IRC* §§ 56(a)(1) (depreciation of tangible real and personal property), 56(a)(2) (capitalization of mining exploration and development costs), 56(a)(5) (amortization of pollution control facilities), and 56(b)(2) (capitalization of circulation and research or experimental expenditures).

(n98)Footnote 2. The \$100 loss should be allowed in calculating AMTI even if the taxpayer did not pay alternative minimum tax in prior years, and so received the full benefit of faster regular tax depreciation in such years. Cf *IRC* § 1016(a)(2); *Breckridge Corp v Comm'r*, 45 BTA 131, *affd* 129 F2d 318 (2d Cir 1942).

(n99)Footnote 3. Under a special rule, the amount of passive activity losses disallowed under *IRC* § 469 is reduced for AMTI purposes by the amount (if any) by which the taxpayer is insolvent as of the close of the taxable year (i.e., the amount by which the taxpayer's liabilities exceed the fair market value of the taxpayer's assets.) *IRC* § 58(c)(1).

(n100)Footnote 4. See *IRC* §§ 56(a)(4), 56(d).

(n101)Footnote 5. *IRC* § 56(d)(2)(A).

(n102)Footnote 6. *IRC* § 56(d)(1)(A). ATNOLs that are not allowed in a particular taxable year because they exceed 90 percent of AMTI for the year may be carried over to other taxable years, in accordance with the rules of *IRC* § 172(b). See Staff of Joint Comm on Taxation, 99th Cong, General Explanation of the Tax Reform Act of 1986 (Comm Print 1987) ("Tax Reform Act of 1986 Blue Book") at 469, n 29.

(n103)Footnote 7. *IRC* §§ 56(d)(1), 172(b)(1)(A).

(n104)Footnote 8. If the taxpayer makes an *IRC* § 172(b)(3)(C) election to relinquish the carryback of an NOL, such election applies to both the regular NOL and any ATNOL for the year. See *Branum v Comm'r*, 17 F3d 805 (5th Cir 1994); *Plumb v Comm'r*, 97 TC 632 (1991); *Rev Rul* 87-44, 1987-1 CB 3.

(n105)Footnote 9. See Tax Reform Act of 1986 Blue Book at 469.



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CHAPTER 2A The Alternative Minimum Tax

1-2A Taxation of Securities Transactions § 2A.03

§ 2A.03 Calculating the Alternative Minimum Tax

Having made the adjustments to regular taxable income called for in *IRC Sections 56-58*, the taxpayer's next step is to deduct the "exemption amount" from the resulting AMTI. The statutorily prescribed exemption is \$45,000 in the case of a joint return or surviving spouse;ⁿ¹ \$33,750 in the case of an unmarried individual who is not a surviving spouse, and \$22,500 in the case of a married person filing separately, or an estate or trust.ⁿ² The exemption amount for corporations is \$40,000.ⁿ³ However, under a series of "patches," the exemption amounts for individuals have been increased, usually on a year-to-year basis, to provide some relief from the AMTI.

The last AMT patch was made by section 1012(a) of the American Recovery and Reinvestment Act of 2009, (ARRA of 2009).ⁿ⁴ The AMT exemptions for individuals in taxable years beginning in 2009 and thereafter are:

- (1) \$70,950 in the case of married individuals filing a joint return and returns filed by a surviving spouse;
- (2) \$46,700 in the case of other unmarried individuals;
- (3) \$35,475 in the case of married individuals filing separate returns (50 percent of exemption allowed to married couples filing jointly).ⁿ⁵

The stipulated exemption amounts are phased out for all taxpayers after certain income levels are reached. The exemption amount is reduced (but not below zero) by 25 percent of the amount by which the taxpayer's AMTI exceeds: \$150,000, in the case of corporations and individual taxpayers filing joint returns or a return filed by a surviving spouse; \$112,500, in the case of single and head of household taxpayers; and \$75,000, in the case of married taxpayers filing separate returns and returns filed by estates and trusts.ⁿ⁶ Married taxpayers filing separately are also required to increase alternative minimum taxable income by the lesser of (for taxable years beginning in 2009) (i) 25 percent of the amount by which AMTI exceeds \$216,900 or (ii) \$35,475.ⁿ⁷

AMTI remaining after the exemption amount (if any) is deducted, referred to in *IRC Section 55(b)(1)(ii)* as the "taxable excess," is then multiplied by the appropriate minimum tax rate. For individuals, the rate is 26 percent of the first \$175,000 and 28 percent of income in excess of that amount.ⁿ⁸ A special computation, prescribed by *IRC Section 55(b)(3)*, incorporates the preferential rates for net capital gains of individuals found in *IRC Section 1(h)*.ⁿ⁹ This means that an individual taxpayer who computes the regular tax for a taxable year utilizing the rate caps for net capital gains

will not be penalized when it comes to determining the alternative minimum tax for the year. A 20 percent tax rate is applied to the AMTI of corporations in excess of the exemption amount.ⁿ¹⁰

Both individuals and corporations are entitled to deduct an "alternative minimum tax foreign tax credit" (AMTFTC) from the minimum tax calculated above to arrive at their "tentative minimum tax."ⁿ¹¹ The AMTFTC is calculated in the same manner as the regular FTC, except that the limitation on the creditⁿ¹² must be calculated after applying the adjustments in *IRC Sections 56-58* both to income from sources outside the US and to total worldwide income. The resulting ratio of foreign source alternative minimum taxable income to total AMTI is then multiplied by the taxpayer's "pre-credit tentative minimum tax;" i.e., the tentative minimum tax before deducting the AMTFTC.ⁿ¹³

The alternative minimum tax imposed for the taxable year (in addition to the regular income tax imposed by *IRC Section 1* or *Section 11*) is the excess of the taxpayer's tentative minimum tax over the regular tax liability for the year.ⁿ¹⁴ Most credits against the regular tax, including nonrefundable personal credits, may also be credited against liability for any add-on alternative minimum tax due for the taxable year.ⁿ¹⁵ The rule regarding nonrefundable personal credits has been in effect for taxable years beginning in 2000 through 2009.ⁿ¹⁶ However, unless further extended by Congress, for taxable years beginning in 2010 nonrefundable personal credits cannot be deducted from the alternative minimum tax and cannot be used to reduce the taxpayer's regular tax liability below the taxpayer's tentative minimum tax for the year.ⁿ¹⁷

FOOTNOTES:

(n1)Footnote 1. A surviving spouse is a taxpayer whose spouse died in either of the two taxable years immediately preceding the taxable year in question and who maintains as his home a household that constitutes the principal abode of a child or stepchild for whom a personal exemption can be claimed. *IRC § 2(a)*.

(n2)Footnote 2. The exemption amount for a minor child subject to the "kiddie tax" of *IRC § 1(g)* cannot exceed the sum of the minor's earned income plus \$6,700. *IRC § 59(j)(1) Rev Proc 2009-50, 2009 IRB LEXIS 652*.

(n3)Footnote 3. *IRC § 55(d)(2)*.

(n4)Footnote 4. Pub L No 111-5, *123 Stat 115 (2009)*.

(n5)Footnote 5. *IRC § 55(d)(1)*.

(n6)Footnote 6. *IRC § 55(d)(3)*.

(n7)Footnote 7. See *IRC § 55(d)(3)*(flush language).

(n8)Footnote 8. *IRC § 55(b)(1)(A)*.

(n9)Footnote 9. A discussion of the preferential net capital gain rates can be found in § 2.06[2][a][i].

(n10)Footnote 10. *IRC § 55(b)(1)(B)(i)*. The maximum tax rate of 15 percent on the qualified timber gain of corporations set by *IRC § 1201(b)* also sets a limit on the alternative minimum tax on such gain. *IRC § 55(b)(4)*.

(n11)Footnote 11. *IRC §§ 55(b)(1)(A)(i), 55(b)(1)(B)(ii), 59(a)*.

(n12)Footnote 12. In general, the credit for foreign taxes is limited for regular tax purposes by a fraction, the numerator of which is taxable income from foreign sources and the denominator of which is taxable worldwide income, multiplied by the regular income tax liability of the taxpayer. See *IRC § 904(a)*.

(n13)Footnote 13. See *IRC § 59(a)*. A "simplified method" of calculating the limitation may be elected under which the taxpayer uses its regular taxable income from sources outside the US (but not in excess of the taxpayer's

entire AMTI) over AMTI as the limitation ratio. The election must be made in the first taxable year (beginning after December 31, 1997) in which the taxpayer claims an AMFTC, and, once made, may only be revoked with the consent of the Internal Revenue Service. See *IRC* § 59(a)(3).

(n14)Footnote 14. *IRC* § 55(a).

(n15)Footnote 15. *IRC* § 26(a)(2).

(n16)Footnote 16. The provision was most recently extended to 2009 by Section 1011(a) of ARRA of 2009.

(n17)Footnote 17. See *IRC* § 26(a)(1). Some specifically designated nonrefundable personal credits (*IRC* §§ 23, 24, 25A(i), 25B, 25D, 30, 30B and 30D) will remain exempt from this limitation, however.



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CHAPTER 2A The Alternative Minimum Tax

1-2A Taxation of Securities Transactions § 2A.04

§ 2A.04 The Minimum Tax Credit

The minimum tax credit was intended to correct a potential inequity in the working of the minimum tax involving timing or deferral adjustments.ⁿ¹ To take an extreme example of the problem, suppose a taxpayer made an expenditure of \$100 that it was allowed to expense for regular tax purposes but that the minimum tax required to be capitalized and amortized ratably over a 2-year life. If the taxpayer was subject to the alternative minimum tax in Year 1 (perhaps because of the expensing preference), it would be limited to a deduction of \$50 with respect to that expenditure. But if in Year 2 the taxpayer had no tax preferences and was no longer subject to the minimum tax, it would have no way of recovering the remaining \$50 since, for regular tax purposes, the item was fully expensed in the prior year. Thus, the taxpayer would be permanently deprived of any tax benefit for an expenditure that even under economic concepts of income should have been fully deductible over its useful life.

The minimum tax credit allows a credit against the taxpayer's regular tax liability equal to the "adjusted net minimum tax" imposed in all prior taxable years (after 1986) less any minimum tax credits previously allowed or allowable.ⁿ² The amount of adjusted net minimum tax that may be credited in any year may not exceed the difference between the taxpayer's regular tax liability and its tentative minimum tax for the year.ⁿ³

Consistent with the original goal of the credit, creditable "adjusted net minimum tax" generally excludes any minimum tax paid with respect to "exclusion preferences;" adjustments that restored to AMTI income that would otherwise have been permanently excluded from the tax base.ⁿ⁴ This requires individual taxpayers to recalculate their tentative minimum tax in prior years to determine what it would have been had only adjustments for "deferral preferences" been includible in AMTI. Corporations, however, are permitted to claim credits for the entire amount of alternative minimum tax paid in prior years, including minimum tax attributable to "exclusion preferences."ⁿ⁵ Since the exclusion preferences with respect to gain on the sale of small business stock and personal itemized deductions are not applicable to corporations, percentage depletion and tax-exempt interest are the only exclusion preferences on which corporations could be subject to minimum tax.

Taxpayers who incurred substantial minimum tax liabilities when they acquired high-priced stock through the exercise of incentive stock options in the late 1990s and 2000, at the height of a stock market bubble, faced a problem that the minimum tax credit couldn't solve when the market collapsed and the expected increase in their regular taxable income from selling the stock never materialized.ⁿ⁶ Congress responded by amending the minimum tax credit provisions in a manner that allows long unused minimum tax credits to be recovered through a special refundable minimum tax credit

over a period of two years.ⁿ⁷ Under this provision, a "long-term unused minimum tax credit" for any taxable year beginning before January 1, 2013 is turned into an "AMT refundable credit."ⁿ⁸ The taxpayer has a "long-term unused minimum tax credit" to the extent that a portion of uncredited minimum taxes for prior years is attributable to a year that precedes the current taxable year by more than three taxable years.ⁿ⁹ The "AMT refundable credit" available in these circumstances is equal to the greater of (1) 50 percent of the taxpayer's long-term unused minimum tax credits (as defined above) in the current taxable year or (2) the amount (if any) of the AMT refundable credit determined for the immediately preceding taxable year.ⁿ¹⁰

FOOTNOTES:

(n1)Footnote 1. See Staff of Joint Comm on Taxation, 99th Cong, General Explanation of the Tax Reform Act of 1986 (Comm Print 1987) ("Tax Reform Act of 1986 Blue Book") at 436-437.

(n2)Footnote 2. *IRC* §§ 53(a), (b). The credit is carried forward from year to year until completely used. Since the carryforward period is indefinite, there is no need to keep track of which taxable years' minimum taxes are included in the credit (unless the taxpayer has a long-term unused minimum tax credit under *IRC* § 53(e), discussed below.)

(n3)Footnote 3. *IRC* § 53(c). Returning to the facts of the hypothetical above, if the taxpayer had gross income of \$100 in both Years 1 and 2 for regular tax and alternative minimum tax purposes and no other expenses, its regular taxable income would be \$0 in Year 1 and \$100 in Year 2, while AMTI would be \$50 in each year. In Year 2, therefore, the taxpayer's regular taxable income would exceed AMTI by \$50, and the regular tax on this excess would absorb (and be reduced by) the credit for the minimum tax paid on the \$50 of income reported in Year 1. This fits the rationale of the limitation: a minimum tax credit should be allowed when income excluded from the regular tax base in earlier years as the result of a timing preference is brought back into the regular tax base in a subsequent year(s) when the beneficial effect of the timing preference is reversed.

(n4)Footnote 4. *IRC* § 53(d)(1)(B). These "exclusion preferences" consist of: the percentage depletion adjustment required by *IRC* § 57(a)(1); the tax-exempt interest adjustment required by *IRC* § 57(a)(3); the adjustment restoring the excluded gain from the sale of small business stock required by § 57(b)(5); and the disallowance of itemized deductions required by *IRC* § 56(b)(1). *IRC* § 53(d)(1)(B)(ii).

(n5)Footnote 5. *IRC* § 53(d)(1)(B)(iii).

(n6)Footnote 6. See § 2A.02[1][c].

(n7)Footnote 7. See *IRC* § 53(e).

(n8)Footnote 8. *IRC* § 53(e)(1). Not only does the limitation imposed by *IRC* § 53(c) not apply to such AMT refundable credits, but the taxpayer is entitled to a refund if the AMT refundable credit exceeds the taxpayer's tax liability for the year. *IRC* § 53(e)(4).

(n9)Footnote 9. *IRC* § 53(e)(3)(A). In making this determination, previously allowed credits are deemed to have been allowed on a first-in, first-out basis. *IRC* § 53(e)(3)(B).

(n10)Footnote 10. *IRC* § 53(e)(2). Finally, to provide relief for taxpayers who had not yet paid minimum taxes due or asserted by the Internal Revenue Service as the result of exercising incentive stock options in years ending before January 1, 2008, Congress abated all such taxes, plus interest and penalties, in *IRC* § 53(f)(1). See § 2A.02[1][c].



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CHAPTER 3 Forming the Corporation

1-3 Taxation of Securities Transactions 3.syn

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CHAPTER 3 Forming the Corporation

1-3 Taxation of Securities Transactions § 3.01

§ 3.01 Introduction

The transfer of property to a corporation in exchange for its stock is a disposition giving rise to the realization of gain or loss. Should, however, the transferor who retains a sufficient degree of control of the corporation, and who has, in effect, done little more than alter the form of his investment, be required to presently recognize that gain? The inequity of immediate recognition in the absence of any change in substance prompted Congress, in 1921, to enact the predecessor of *IRC Section 351*.ⁿ¹

This chapter will focus upon the conditions imposed by the Code for nonrecognition, the consequences of nonrecognition on the basis and holding period of the stock in the hands of the taxpayer, and the effect of the transfer on the transferee corporation. Also to be explored are the factors influencing the choice of corporate capital structure, i.e., whether the corporation should be financed through investment in equity capital or debt securities.

FOOTNOTES:

(n1)Footnote 1. Revenue Act of 1921, Ch 136, § 202(c)(3), *42 Stat* 230.

The provision does not apply to a transfer of property of a debtor while the debtor is under the jurisdiction of a court in a bankruptcy, receivership, foreclosure or similar case, to the extent that the stock or securities received in the exchange are used to satisfy the indebtedness of the debtor. *IRC § 351(e)(2)*.



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CHAPTER 3 Forming the Corporation

1-3 Taxation of Securities Transactions § 3.02

§ 3.02 The Requirements of Section 351

In brief, the Code provides for nonrecognition of gain or loss realized on incorporating transfers if three conditions are satisfied: (1) the transfer to the corporation consists of property, (2) the transfer is in exchange solely for stock of the transferee corporation, and (3) the transferors are in control of the corporation immediately after the exchange.ⁿ¹ The discussion that follows will consider each of these conditions in depth.

[1] Transfer of Property.

[a] Property Defined. The first requirement of *IRC Section 351* is that the transfer to the corporation be of "property." The section affords little help in ascertaining the meaning of the word "property" except to declare in *IRC Section 351(d)* that "stock issued for (1) services, (2) indebtedness of the transferee corporation which is not evidenced by a security, or (3) interest on indebtedness of the transferee corporation which accrued on or after the transferor's holding period for the debt, shall not be considered as issued in return for property." Does the absence of an affirmative definition imply that normal concepts of property should control in determining the content of the term? While this would seem to be a logical conclusion, it does not find complete support in administrative ruling. For example, the Internal Revenue Service originally ruled that a transfer of less than all substantial rights in a patent was not a transfer of property under *IRC Section 351*.ⁿ¹ It now concedes that the rights constitute property, but would continue to deny nonrecognition treatment on the ground that the transfer could not qualify as a sale or exchange for capital gain purposes. This reasoning was rejected by the Court of Claims in *E.I. du Pont de Nemours & Co. v. United States*,ⁿ² on the theory that the requirement of continuing control in *IRC Section 351* militates against the application of capital gain formulations which rest on the completeness of the disposition.

Given its normal meaning, money is property. However, in some instances, the Code provides that money is not property. Is it for purposes of *IRC Section 351*? The answer is of crucial importance. Although the transfer of money cannot itself result in the realization of gain or loss, the denial of property status to money could force persons transferring property other than money to recognize gain on the transfer, if such transferors were not, by virtue of their stock ownership, in control of the corporation immediately after the exchange. Reason and practicality dictate that money should be included within the definition of property, thereby permitting the contemporaneous transfer of money and other property without jeopardizing nonrecognition;ⁿ³ the Service has ruled that it is.

The express negation of services as property must here be considered. The disqualification does not attach to all services, but only to those which are rendered to or for the benefit of the issuing corporation.ⁿ⁴ Thus, assume A

transfers property to a corporation in exchange for its stock and, at the same time, directs the issuance of shares to *B* who previously rendered services to *A* having no relation to the business of the corporation or the assets transferred. The shares issued to *B* will not be considered shares issued in exchange for services. Rather, *A* will be deemed to have first received all of the shares in exchange for his transfer of property, and then to have transferred the shares to *B*. The transaction will still qualify for Section 351 treatment as long as *A* retains sufficient control after the transfer to *B*, or if not, as long as the incorporation transfer and the transfer to *B* were not independent steps.ⁿ⁵ *B* will realize ordinary income equal to the fair market value of the shares received by him as compensation for services to *A*. *A* will realize gain or loss on the difference between the fair market value of the shares transferred to *B* and *A*'s basis for such shares.ⁿ⁶

Ascertaining whether stock has been issued as consideration for services rendered or to be rendered to the issuing corporation, or in exchange for a property interest previously acquired as compensation for past services, or in satisfaction of a claim for services rendered to one of the transferors, is not always an easy task. *United States v. Frazell*ⁿ⁷ illustrates the difficulty that may be encountered. The taxpayer in *Frazell* performed services for a partnership for which he was to receive compensation in the form of salary, plus a specified interest in properties acquired by the partnership. However, by contract, it was agreed that the taxpayer would not be deemed to own any interest in the properties until the partners had fully recovered their costs and expenses. Prior to complete recovery of costs and expenses, the properties were transferred to a corporation. The taxpayer received 13 percent of the issued shares, but included no part of their value in his income for the year of receipt. The taxpayer contended that the shares were received in an exchange qualifying for nonrecognition under *IRC Section 351*. The Fifth Circuit had little difficulty in finding compensation income on either of two grounds:

- (1) The taxpayer had acquired a partnership interest which became possessory prior to the transfer to the corporation, and was therefore in receipt of ordinary income under the partnership rules.ⁿ⁸ The subsequent transfer of the partnership interest to the corporation could then qualify as a transfer of property.
- (2) The shares were given in substitution for the partnership interest originally contemplated, and, thus, the stock itself represented compensation for services.

Frazell indicates that at least one court has found a claim for services rendered to a third party by a cash basis taxpayer as falling without the definition of property. However, the first alternative ground may provide a sound basis for argument if the partnership interest became possessory in a year prior to the year in which the interest was transferred to the corporation.

A final consideration is the proper treatment of a transfer of property coupled with the performance of services for the transferee corporation. For example, suppose that a corporation issues 80 percent of its stock (worth \$20,000) in exchange for a transfer of property worth \$15,000 and in consideration of the performance of services valued at \$5,000. The property transfer qualifies for nonrecognition inasmuch as the transferor is in control of the corporation (owns 80 percent of the corporation's stock) after the exchange.ⁿ⁹ All of the stock received by the transferor, even the shares received in consideration of the services rendered to the corporation, may be counted in determining whether the control requirement of *IRC Section 351* has been met. However, nonrecognition does not extend to the stock issued for services. The taxpayer will realize ordinary income to the extent of the value of the stock received as compensation.ⁿ¹⁰

Caution should be exercised lest it be assumed that a taxpayer who renders services to a corporation for which he receives stock, an transfer any amount of property and still have all of the shares counted for control purposes. Under the Regulations:

"[S]tock or securities issued for property which is of relatively small value in comparison to the value of the stock and securities already owned (or to be received for services) by the person who

transferred such property, shall not be treated as having been issued in return for property if the primary purpose of the transfer is to qualify ... the exchanges of property by other persons transferring property."¹¹

Thus, if *A* were to transfer property worth \$30,000 and receive 75 percent of a new corporation's stock, and *B* were to render services worth \$10,000 and receive 25 percent of the stock, the transaction would not qualify under *IRC Section 351* since *A*, the only transferor of property, would not be in control of the corporation. The result would be no different if *B* transferred a relatively small amount of property, say \$200, to the corporation in an attempt to secure nonrecognition treatment for *A*.

[b] Assignment of Income and Related Problems.

We have just seen that the receipt of stock by a taxpayer in consideration of services rendered to the issuing corporation or to one of the transferors produces ordinary income for the taxpayer. We must now inquire whether the protective umbrella of *IRC Section 351* affords nonrecognition to all transfers of property, or whether considerations, such as the tax benefit rule or the doctrine of anticipatory assignment of income, override the provisions of *IRC Section 351* and require the transferor to report ordinary income when the transferred item is one which would generate ordinary income.¹²

[i] Section 351 and the Assignment of Income Doctrine. The underlying premise of the assignment of income doctrine is that income should be taxable to the person who earns it. It is obvious that if *IRC Section 351* permitted a taxpayer to transfer an item of potential income to a corporation without recognition of gain, a change in the taxable person could be achieved through the volitional act of the taxpayer. By relying on cases such as *Helvering v. Horst*¹³ and *Lucas v. Earl*,¹⁴ courts have generally been able to block attempts to shift the incidence of taxation through anticipatory assignments, even though the transfer meets the literal terms of *IRC Section 351*.¹⁵

However, the taxpayer has not always been on the losing side. The transfer of a carved-out oil payment to a corporation was held to be a transfer of property entitled to nonrecognition in *H.B. Zachry Co. v. Commissioner*.¹⁶ The Commissioner's contention that the carved-out oil payment was not property was founded on two arguments: The first, based on *Commissioner v. P.G. Lake, Inc.*,¹⁷ asserted that an assignment of a carved-out oil payment could never be made under a nonrecognition provision without immediate tax consequences. The Tax Court, in dismissing this argument, distinguished *Lake* on the ground that the issue in that case concerned the character of realized and recognized gain, and not the nonrecognition of gain. The second sought to deny property status to the transferred income on the theory that it was no more than a mere income right. The denial of this contention rested on the finding that even if it was a pure income right, local law treated the oil payment as an interest in land. And, because of this, the Tax Court was able to "view it as 'property' within the common law definition and within the intent of Section 351."¹⁸

By looking to local law to provide the definition of "property," the Tax Court effectively removed the assignment of income doctrine from consideration in *IRC Section 351* transfers. In so doing, the court overlooked the fact that the doctrine developed notwithstanding the characterization of the assigned item as property under local law. The correctness of the *Zachry* decision is, therefore, open to doubt.

One normally expects to see the Internal Revenue Service pressing for application of the assignment of income doctrine. A reversal of roles occurred in *Hempt Bros., Inc., v. United States*,¹⁹ where a transferee corporation sought to invoke the doctrine to make a cash basis transferor taxable on income generated by the collection of transferred accounts receivable. The Third Circuit held otherwise, reasoning that if the transferor were taxed on the transfer of the receivables, the specific congressional intent reflected in *IRC Section 351* would be frustrated if an ongoing business could not be incorporated tax free. An essential ingredient of the *Hempt Bros.* result is the finding that the transfer of the accounts receivable served a valid business purpose.²⁰ Where a tax avoidance purpose is evident, the Service will

continue to argue for taxation of the transferor.ⁿ²¹

[ii] Section 351 and the Tax Benefit Rule. It is well settled that if a taxpayer using the reserve method of accounting for bad debts no longer needs to maintain the reserve, the amount of such reserve becomes an item of gross income.ⁿ²² This result is dictated by the tax benefit rule--creation of the reserve produced a deduction; its cancellation should properly produce income. Should, however, the rule apply if the taxpayer's need for the reserve ends because of an incorporating transfer of the accounts receivable to which the reserve applies?

The question produced conflicting answers. The Internal Revenue Service,ⁿ²³ the Fifth Circuit,ⁿ²⁴ and the Tax Courtⁿ²⁵ all held that elimination of the reserve caused income to be realized under the tax benefit rule, even though the transfer of the receivables qualified for nonrecognition treatment under *IRC Section 351*. The reasoning of the Tax Court was simply "that the taxpayer, by disposing of the accounts receivable, will never sustain a bad debt in respect thereof, and the deduction which he has previously taken for such anticipated loss must therefore be restored to income."ⁿ²⁶

The contrary result was reached by the Ninth Circuit in *Estate of Schmidt v. Commissioner*.ⁿ²⁷ The receivables were there transferred to the corporation subject to the reserve. In fixing the net value of the transferred assets, and, therefore, the amount of stock to be issued, the reserve was deducted from the face amount of the receivables. The court, in holding that the economic realities of the situation prevented any realization of income, stated:

"It is quite true that the taxpayer no longer 'needed' the reserve, but it is certainly not true, in any economic sense, that he has recovered its value. What he has recovered, in relation to the receivables, is pieces of paper--stock certificates--representing their net value, not their gross value."ⁿ²⁸

The Supreme Court's decision in *Nash v. United States*ⁿ²⁹ resolved the conflict in favor of the taxpayer. The nonrecognition provisions of *IRC Section 351* prevailed, and no income was realized because of the elimination of the bad debt reserve.ⁿ³⁰ The result in *Nash* is of diminishing importance because of the repeal, in 1986, of the reserve method of deducting bad debts.ⁿ³¹

[iii] Section 351 and the Clear Reflection of Income Doctrine. A third weapon available to the Commissioner in his battle against midstream transfers of potential income is his ability to require clear reflection of a taxpayer's income, either through a change in accounting method under *IRC Section 446(b)*, or an allocation of income and deductions between taxpayers under *IRC Section 482*.ⁿ³² Use of the former section is illustrated by *Palmer v. Commissioner*,ⁿ³³ where a taxpayer, reporting income on the completed contract method, transferred assets to a corporation in return for all of its stock prior to completion of a major contract. Consistent with the completed contract method, the taxpayer did not report any pretransfer payments received under the contract as income.ⁿ³⁴ At the same time, the transferee corporation was able to offset the profits from the venture against existing losses. The Commissioner's attempt to charge the transferor with a proportionate share of the income earned under the contract, by requiring adoption of the percentage of completion method,ⁿ³⁵ met with Ninth Circuit approval.

The fact situation in *Rooney v. United States*,ⁿ³⁶ is typical of those in which the Commissioner seeks to invoke the clear reflection provision of *IRC Section 482*. The transferors incurred all of the expenses necessary for the production of income prior to the date of transfer. By deducting these expenses on their individual returns for the year of transfer, they suffered a net operating loss which they attempted to carry back to prior years in order to secure a refund. All of the income earned was reported by the corporation. The Government reallocated the expenses to the corporation, an action considered by the court to be in keeping with the purpose of *IRC Section 482*, namely, to prevent the avoidance of tax or the distortion of income by shifting profits from one trade or business to another one under common control. The taxpayers' argument, that *IRC Section 482* had to give way when *IRC Section 351* applied, was met with the statement that "section 482 ... will control when it conflicts with section 351 ... as long as the discretion of the Commissioner in reallocating is not abused."ⁿ³⁷ The holding of the Ninth Circuit in this regard has found fairly

uniform application.ⁿ³⁸

IRC Section 269A provides the Service with another weapon to attack the formation or use of corporations to achieve a tax avoidance purpose. If (1) substantially all of the services of a personal service corporationⁿ³⁹ are performed for or on behalf of one other corporation, partnership, or other entity, and (2) the principal purpose for the formation or use of the corporation is the avoidance or evasion of federal income tax by reducing the income of, or securing the benefit of any deduction, credit, exclusion, or other allowance for any employee-ownerⁿ⁴⁰ that would not otherwise be available, the Commissioner can allocate the income, deductions, credits, exclusions, or allowances between the corporation and its employee-owners if necessary to prevent tax avoidance or evasion, or clearly reflect income.

[iv] Section 351 and the Business Purpose Doctrine. Must a transfer meeting the literal terms of *IRC Section 351* be granted nonrecognition if the transfer serves no purpose other than tax avoidance? A recurring theme in cases involving transfers made to secure tax advantages is that only those transactions having a legitimate business purpose in addition to the lessening of tax impact will be recognized for tax purposes.ⁿ⁴¹ If the taxpayer is unable to establish an independent purpose for the transfer, it will be disregarded and the true nature of the transaction given effect. The rationale for giving effect to the business purpose doctrine in other nonrecognition situations should apply with equal force to *IRC Section 351* transfers,ⁿ⁴² and thereby afford another means of attacking attempts at tax-free incorporation of potential income.

[2] Solely in Exchange for Stock.

The second requisite of *IRC Section 351* is that the consideration flowing from the corporation to the transferors consist solely of "stock in such corporation."ⁿ¹ However, for transfers before October 3, 1989 (July 12, 1989 for a transferor corporation that became the common parent of the transferee in an affiliated group), the permitted consideration could also take the form of securities of the transferee corporation.ⁿ² Excepting the question whether stock warrants or stock rights constitute stock,ⁿ³ or whether a certificate of contingent interest is the equivalent of stock,ⁿ⁴ there has been little litigation concerned with the meaning of stock. The bulk of the problems focused on the meaning of, "securities."

The task of classifying an instrument as one which does or does not constitute a security abounds in confusion. The difficulties that exist can in large part be traced to the opinion in *Pinellas Ice & Cold Storage Co. v. Commissioner*,ⁿ⁵ wherein the Supreme Court held a transfer of property in exchange for cash and short-term notes one which could not qualify as a reorganization. In arriving at this result, the Court said:

"These notes--mere evidence of obligation to pay the purchase price--were not securities within the intentment of the act and were properly regarded as the equivalent of cash. It would require clear language to lead us to conclude that Congress intended to grant exemption to one who sells property and for the purchase price accepts well-secured, short-term notes (all payable within four months), when another who makes a like sale and receives cash certainly would be taxed."ⁿ⁶

The Court concluded "that to be within the exemption the seller must acquire an interest more definite than that incident to ownership of its short-term purchase-money notes."ⁿ⁷

The last statement marked the Supreme Court's adoption of the continuity of interest doctrine developed shortly before by the Second Circuit in *Cortland Specialty Co. v. Commissioner*.ⁿ⁸ According to that doctrine, a transaction falls without the realm of reorganization unless the transferors retain a continuing proprietary interest in the transferred property. Once it had been determined that short-term notes did not provide the necessary continuity, and, therefore, that the transaction was not a reorganization, there was no need for the Court to decide more. It no longer mattered whether the instruments received were securities or something else. Taxability of the transaction had been decreed by lack of continuity of interest.

The additional determination, that short-term notes did not constitute securities, caused the subsequent confusion.ⁿ⁹ Courts seized upon length of time to maturity as the most important classification criterion. Indicative of the post-*Pinellas* approach is the following language of the Tax Court:

"[The term securities] denotes an obligation of a character giving the creditor some assured participation in the business of the debtor, or, in other words, an investment in the business, and that term does not include evidences of indebtedness for short-term loans representing temporary advances for current corporate needs."ⁿ¹⁰

What length of time did the courts think necessary to turn an obligation into an investment in the business of the debtor? It became generally assumed that an instrument having a term of ten years or more could qualify as a security,ⁿ¹¹ while one with a term of five years or less could not.ⁿ¹² But the existence of other criteria may outweigh an adverse "time" factor. The Tax Court has held unsecured notes maturing five to nine years after issuance to be securities when their payment was subject to the complete liquidation of a substantial prior loan.ⁿ¹³ Similar reliance on additional factors resulted in a Service ruling that bonds secured by a mortgage on the issuer's property were securities, even though the shortest time to maturity was three years, and the average time, six and one half years.ⁿ¹⁴ According to the Tax Court, the determination involved an over-all evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purpose of the advances, etc.ⁿ¹⁵ In other words, no hard and fast rule mechanically choosing which instruments are securities is possible; the evaluation must proceed on a case-by-case basis. Indeed, such an approach led the Fifth Circuit to find a one-year note a security.ⁿ¹⁶

Under *IRC Section 351(g)(1)(A)*, the receipt of only nonqualified preferred stock eliminates nonrecognition treatment. This means that both gain or loss can be recognized on the transfer. However, if the taxpayer receives stock other than nonqualified stock in addition, the nonqualified stock is treated as "boot" and gain is recognized only to the extent of the value of the boot;ⁿ¹⁷ loss in such case cannot be recognized.ⁿ¹⁸ The nonqualified preferred stock still qualifies as stock in the determination of control of the corporation.ⁿ¹⁹

The provision applies to preferred stock (stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent), where (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock, (2) the issuer or a related party is required to purchase the stock, (3) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that the right will be exercised, or (4) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.ⁿ²⁰ The rules of (1), (2), and (3) apply only if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency that, as of the issue date, makes remote the likelihood of the redemption or purchase.ⁿ²¹ Moreover, a right or obligation is disregarded if it may be exercised only upon the death, disability, or mental incompetency of the holder, or, in the case of stock transferred in connection with the performance of services, it may be exercised only upon the holder's separation from service.ⁿ²²

[a] The Receipt of "Boot."

Suppose the consideration received by the taxpayer in exchange for his transfer of property consists not only of stock, but also of other property.ⁿ²³ Clearly, the transfer is not "solely in exchange for stock." However, the failure to meet this condition of *IRC Section 351(a)* does not completely negate nonrecognition treatment. In the first place, any loss realized on a transfer falling within *IRC Section 351* will continue to go unrecognized in full, notwithstanding the receipt of "boot."ⁿ²⁴ In the second, the amount of gain to be recognized as a result of the receipt of "boot" is a product of two functions: (1) the amount of gain realized, and (2) the value of the property received.ⁿ²⁵

Example:

Assume a taxpayer transfers property which has an adjusted basis of \$50,000 and a value at the time of transfer of \$75,000 to a corporation in exchange for stock of the corporation worth \$60,000, cash of \$10,000, and other property having a value of \$5,000. Assuming further that the control requirement of *IRC Section 351(a)* is met, the realized gain of \$25,000 will be recognized only to the extent of \$15,000, the amount of money received plus the value of the other property received.

Since the receipt of "boot" affects the recognition of gain only, an interesting problem is posed when the property transferred consists of more than one asset. To illustrate, suppose a taxpayer transfers two assets, one with an adjusted basis of \$40,000 and a fair market value of \$25,000, and the other with a basis of \$10,000 and a value of \$50,000 in exchange for stock worth \$45,000 and cash of \$30,000. Using an aggregate approach, the taxpayer's net gain is \$25,000, all of which is recognized. Using a fragmented approach, the result is a loss of \$15,000 on the first asset and a gain of \$40,000 on the second. The latter method accords more with precedent and probably is the one to be employed.ⁿ²⁶ Since the quantum of realized gain or loss is determined on an asset-by-asset basis, the consideration received must be allocated between the two assets in order to determine the extent of recognized gain. Using a method of allocation based on relative fair market values, two-thirds ($\$50,000/\$75,000$) of the total consideration, and, thus \$20,000 of the cash is attributed to the "gain" producing asset, giving rise to recognized gain of \$20,000.ⁿ²⁷ No loss is recognized even though \$10,000 of the cash is allocable to the transfer of the "loss" property.ⁿ²⁸

[i] Character of the Recognized Gain. Once gain is recognized to any degree, the character of the gain--capital or ordinary--becomes an important consideration. Since the exchange requirement of a capital transaction is clearly present, capital gain will ensue if the transferred property is a capital asset. Whether the gain is long- or short-term will obviously depend on the length of time the property was held by the transferor.

The Code contains a number of exceptions to capital gain treatment. These special provisions are generally triggered when the transfer is of a specific type of property, although the relationship of the transferor is sometimes crucial. The sections to consider are listed below.

(1) *IRC Section 1245*, requiring recapture of depreciation taken after 1961 on dispositions of specified types of property.ⁿ²⁹ The normal overriding effect of *IRC Section 1245*, namely, that it applies notwithstanding any contrary provision of the Code, is modified by *IRC Section 1245(b)(3)* to require recapture only in the event gain must be recognized under *IRC Section 351(b)*. In other words, *IRC Section 1245* does not mandate independent recognition of gain in an *IRC Section 351* transfer.ⁿ³⁰ Furthermore, the amount of post-1961 depreciation that *IRC Section 1245* causes to be recaptured cannot exceed the amount of the otherwise recognized gain. To illustrate, assume a taxpayer realizes a gain of \$10,000 on the transfer of depreciable personal property to a corporation in exchange for its stock and \$5,000 in cash. The gain recognized on the transfer cannot exceed \$5,000, the cash received.ⁿ³¹ The amount of depreciation recapture also cannot exceed that sum.

(2) *IRC Section 1250*, which decrees recapture of certain post-1963 depreciation when the disposition is of real property not specified in *IRC Section 1245*. The extent to which *IRC Section 1250* applies in a transaction falling within *IRC Section 351* is limited in the same manner as *IRC Section 1245*.ⁿ³²

(3) *IRC Section 1239*, which eliminates from capital gain treatment any gain recognized on the transfer of depreciable property if more than 50 percent in value of the outstanding stock of the transferee corporation is owned (directly or indirectly) by or for the transferor.ⁿ³³ The statute calls for the application of the rules of *IRC Section 267(c)* to determine the extent of the transferor's ownership interest.ⁿ³⁴

(4) *IRC Section 1248*, which may turn the gain realized on dispositions of stock in controlled foreign corporations into dividend income.ⁿ³⁵

[ii] Assumption of the Transferor's Liability. Previous mention has been made of the rule that an assumption of liability by the purchaser or transferee results in an increase in the amount realized by the transferor.ⁿ³⁶ This should logically lead to the conclusion that when liabilities are assumed as part of an incorporating transfer, the transferor is in receipt of "boot." And this is exactly how the Supreme Court ruled in *United States v. Hendler*.ⁿ³⁷ However, through specific statutory enactment, now *IRC Section 357(a)*, no "boot" is deemed received by the transferor when the transferee corporation assumes a liability.ⁿ³⁸ Thus, if a taxpayer transfers property with a basis of \$25,000 and a value of \$50,000 to a corporation in exchange for stock of \$40,000 and the corporation's assumption of an existing encumbrance of \$10,000, the taxpayer realizes a gain of \$25,000, but because of *IRC Section 357(a)*, recognizes none of that gain.

Prior to 1999, *IRC Section 357(a)* applied if the transferee corporation acquired property subject to a liability. Legislation enacted in that year limits the application of the provision to liabilities that are assumed. For this purpose, a recourse liability is treated as having been assumed if, on the basis of all facts and circumstances, the transferee has agreed to, and is expected to, satisfy the liability, whether or not the transferor has been relieved of the liability.ⁿ³⁹ A nonrecourse liability is treated as having been assumed by the transferee of any asset subject to the liability, but the amount of the liability must be reduced by the lesser of (1) the amount of the liability that the owner of assets not transferred to the transferee corporation and also subject to the liability has agreed with the transferee to, and is expected to, satisfy; or (2) the fair market value of the other assets subject to the liability.ⁿ⁴⁰

The possibility that *IRC Section 357(a)* might lead a taxpayer to borrow money, pledge the property as security, and then immediately transfer the property to a corporation which would assume the liability or take the property subject to it, prompted Congress to enact *IRC Section 357(b)*.ⁿ⁴¹ The effect of the provision, invoked whenever it appears that the principal purpose of the taxpayer is either a purpose to avoid federal income tax on the exchange or one which is not a bona fide business purpose,ⁿ⁴² is to treat the assumption as money received on the exchange (in other words, "boot"). Furthermore, if one of the improper purposes is found to exist with respect to the assumption of any liability, then all liabilities assumed pursuant to the exchange are treated as "boot."ⁿ⁴³

The determination of principal purpose requires inquiry into the nature of the liability as well as the circumstances surrounding the arrangement for the assumption. Thus, where the taxpayer first expressed eagerness in mortgaging properties "to the limit" before transferring them to a corporation, and then used the proceeds to purchase tax-exempt securities, the transfer resulted in the recognition of gain.ⁿ⁴⁴ In like manner, a taxpayer who borrowed against property in order to secure funds to pay a personal tax liability, was held to have run afoul of *IRC Section 357(b)* when his transfer of the property to a corporation three days later was accompanied by an assumption of the liabilities by the transferee, and the transferor could not show a valid purpose for the transfer and assumption.ⁿ⁴⁵ However, it is important to note that the bona fide business purpose need not be a corporate purpose. In *Easson v. Commissioner*,ⁿ⁴⁶ the taxpayer sought to place himself in a liquid position to take advantage of a business downturn which he believed would soon occur. Finding himself unable to obtain a buyer for his property, the only way to achieve liquidity was by mortgaging the property. The transfer to the corporation was motivated by the desire for limited liability and convenience of management. The business purpose for transferring the property without first removing the encumbrance was the taxpayer's desire to remain liquid during an expected business recession. This the Ninth Circuit found to be a good business purpose, for:

"[*IRC Section 357(b)*] says nothing about the origin of an encumbrance. ... Nor is there anything in the section which deals with the reasons for the encumbrance, or the manner in which the mortgage proceeds are used. If there is a good business purpose for transferring the property without first removing the encumbrance, the requirements of [*IRC Section 357(b)*] are satisfied."ⁿ⁴⁷

A further exception to the general rule of *IRC Section 357(a)* comes into play whenever the liabilities assumed exceed the total adjusted basis of all properties transferred to the corporation by the taxpayer.ⁿ⁴⁸ Under *Section 357(c)(1)*, the excess is considered a gain from the exchange of the property.ⁿ⁴⁹ Thus, if an individual transfers two assets, each having a basis of \$20,000, but one of which is encumbered by a liability of \$35,000, assumption of the liability by the transferee corporation will not result in the receipt of "boot" since the aggregate basis of the transferred property is greater than the liability assumed. If, however, the basis of each asset is only \$15,000, the taxpayer now has a gain of \$5,000. This result will obtain in all events, that is, whether or not gain is realized on the transaction as a whole. While the express language of *IRC Section 357(c)(1)* appears to classify the nature of the gain solely by reference to the character of the transferred property,ⁿ⁵⁰ the question whether the gain is capital gain or ordinary income should probably be resolved by reference to all of the rules affecting character.ⁿ⁵¹

How does one determine the character of the gain if more than one asset is transferred to the corporation? Consider an incorporating transfer consisting of the following assets:

Asset	Basis	Value	Liability
Capital	\$5,000	\$20,000	\$40,000
Noncapital	30,000	10,000	-0-
	\$35,000	\$30,000	\$40,000

Although the transaction produces a loss, *IRC Section 357(c)* requires the recognition of \$5,000 in gain because the \$40,000 liability encumbering the capital asset exceeds the aggregate basis of the transferred assets. According to *Regulations Section 1.357-2(b)*, a portion of the gain must be allocated to each asset in accordance with its fair market value in order to determine the character of the gain. Therefore, under the regulation, two-thirds of the gain must be allocated to the capital asset and one-third to the noncapital asset. Not only does this mean that a portion of the gain must be characterized as ordinary income, but that characterization stems from an asset that, if sold, would engender a loss. This result has been called absurd.ⁿ⁵²

IRC Section 357(c) once posed a trap for the unwary cash basis taxpayer who incorporated a going business which listed accounts receivable among its assets and accounts payable among its liabilities. The accounts receivable of a proprietorship operated on a cash basis method of accounting have a basis of zero.ⁿ⁵³ Thus, if the books and records of the business showed the following assets and liabilities:

Assets

Cash	\$2,000
Accounts receivable	78,000
Equipment (net of depreciation)	10,000
	\$90,000

Liabilities

Accounts Payable	\$50,000

the aggregate basis of the transferred assets would be less than the liability represented by the accounts payable.

IRC Section 357(c)(3) prevents this result by excluding from the amount of liabilities assumed any liability whose payment would produce a deduction (e.g., interest and taxes which relate to the transferred trade or business),ⁿ⁵⁴ or any liability that would be payable to a partner under *IRC Section 736(a)*.ⁿ⁵⁵ Not covered by the subsection is any liability

to the extent its incurrence resulted in the creation of, or an increase in, the basis of any property.

[3] Control.

[a] Control Defined. The final condition of *IRC Section 351* requires the transferors to be in control of the corporation immediately after the exchange.ⁿ¹ The requisite degree of control is met if the transferors own stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.ⁿ²

A threshold problem raised by the definition of control focuses on the question of voting power. Suppose a corporation issues preferred stock which has voting rights only when dividends are in arrears. Is such stock to be counted when determining the total combined voting power of all classes of stock entitled to vote? The answer is not entirely free from doubt, although it would seem that only stock having presently vested voting rights should be considered since the statute looks to control immediately after the transfer, and at that moment in time, contingent-voting-right stock has no effect on control.ⁿ³

A second problem is presented whenever a corporation has more than one class of nonvoting stock outstanding. Assume a taxpayer transfers property to a corporation in return for at least 80 percent of the voting common stock of the corporation, 90 percent of the corporation's nonvoting preferred stock, and 75 percent of its nonvoting common stock. If the number of outstanding shares of each class of nonvoting stock is the same, it is clear that the transferor owns more than 80 percent of the total of all other classes. However, is he in control of the corporation? If the second ownership requirement is tested on an aggregate basis, the answer is yes; if class-by-class, it is no. The question has been considered on only one occasion, and then by the Service. It denies control unless the persons claiming control own at least 80 percent of each class of stock.ⁿ⁴

[b] Control Immediately After the Exchange. The extent of stock ownership is not the only criterion of control under *IRC Section 351*. Also imposed is a time test, namely, that the requisite degree of control exist "immediately after the exchange." Use of the word "immediately" suggests that mere momentary control is enough. However, despite some early cases holding that retention of control for an instant satisfied the statute,ⁿ⁵ the courts now are of the view that momentary control is not sufficient, if the loss of control results from a subsequent transfer made pursuant to prior agreement, and the transfer is an interrelated step in the incorporating transaction.ⁿ⁶

The difference between a subsequent transfer which is an integral part of the entire transaction, and one which is independent can be illustrated by comparing the facts in two cases. In the first, *S. Klein on the Square, Inc. v. Commissioner*,ⁿ⁷ a third party made an offer to the eventual transferors either to purchase the assets of an unincorporated business which he would then transfer to a corporation, or to buy the stock of a corporation to be formed by the transferors. Following an agreement in which the second approach was adopted, the corporation was formed, the assets transferred to it in return for stock, and the stock distributed to the purchaser. The Tax Court, in holding that the transaction fell outside the scope of the predecessor of *IRC Section 351* because the transferors lacked control, found:

"The steps of the plan, at least to the point where the shares went out of the ownership of [the transferors], were so inseparable and interdependent that the acceptance of the bid and the agreement would have been vacuous had the ownership stopped there. The transfer of the shares by [the transferors to the purchaser] was not an independent transaction as to which [the transferors] had any further choice."ⁿ⁸

The second case, *American Bantam Car Co. v. Commissioner*,ⁿ⁹ involved a plan calling for a transfer in exchange for 300,000 shares of common stock (all of the corporation's outstanding stock immediately after the exchange), to be followed by an offering to the public of preferred stock of the corporation. Under the contemplated plan, the underwriters of the issue of preferred stock were to receive certain amounts of common stock as compensation for services. The incorporating transfer, including the receipt of the 300,000 shares by the transferors, occurred on June 3,

1936. The agreement with the underwriters was formalized five days later. In October, 1937, the public offering of preferred stock ceased and the underwriters received the almost 88,000 shares of common stock to which they had become entitled. The Tax Court found the original exchange of assets for stock and the subsequent transfer to the underwriters to be independent steps which could not be considered part of the same transaction in order to deprive the original transferors of control immediately after the exchange. The court looked to three factors to justify its conclusion:

- (1) There was no written agreement prior to the exchange binding the transferors to transfer stock to the underwriters.
- (2) The underwriters did not have an absolute right to ownership of the common stock, but would become entitled thereto only as and if certain percentages of preferred stock were sold.
- (3) The necessity of placing the common shares in escrow pending completion of the public offering was indicative of complete ownership in the transferor.

According to the Tax Court:

"The understanding with the underwriters, for disposing of the preferred stock, however important, was not a *sine qua non* in the general plan, without which no other step would have been taken. While the incorporation and exchange of assets would have been purposeless, yet both would have been carried out even though the contemplated method of marketing the preferred stock might fail."¹⁰

Perhaps this latter ground, and not technical distinctions such as whether an agreement is in writing or not, better explains the rationale of *American Bantam Car*. While financing was crucial, proceeding via the sale of preferred stock was not. Another means of raising funds could have been pursued had the public offering been abandoned. Viewed in this light, the original exchange could stand alone.

Although the two cases mentioned both occurred in the commercial sphere, the same test of interdependence is employed where the transfer is gratuitous. Control immediately after the exchange will be present unless the transferor is under a legal obligation to dispose of the shares.¹¹

One instance in which control is not lost by a subsequent transfer of the stock received by the transferor is provided by *IRC Section 351(c)(1)*. The fact that a corporate transferor distributes all or part of the stock which it receives in the exchange to its shareholders is not taken into account in determining control.¹²

[c] The Problem of Multiple Transferors. *IRC Section 351(a)* expressly permits transfers by more than one person to qualify for nonrecognition treatment provided that "immediately after the exchange such ... persons are in control ... of the corporation." By this provision, control following a multiple transferor exchange is tested by looking to the transferors as a group.¹³ Thus, it is possible for control to exist even though each of the transferors does not receive shares of each class of stock issued as part of the exchange. However, a pre-October 3, 1989 exchange in which some of the transferors received only stock while others received only securities is one which can qualify only in part. To illustrate:

Example:

In 1988, *A*, *B*, *C*, and *D* transferred property of equal value to a newly formed corporation. *A*, *B*, and *C*, received all of the outstanding stock of the corporation while *D* received debt securities. *A*, *B*, and *C* met the requirements for nonrecognition; they transferred property in exchange for a controlling stock interest. *D*, on the other hand, engaged in a taxable transaction since he is not part of the control group. He is merely a creditor of the corporation.¹⁴

The foregoing result should be contrasted with the situation in which all of the stock of an existing corporation is owned by A, B, C, and D, each of whom transferred property to the corporation solely in exchange for securities. The transaction met the conditions imposed by *IRC Section 351*. Each of the four individuals transferred property and received a security in return. Together they controlled the corporation immediately after the exchange.ⁿ¹⁵

Control can exist "immediately after the exchange" even if the transfers take place at different times. The Regulations explicitly negate any requirement of simultaneous exchanges by two or more persons if the rights of the parties have been previously defined by agreement and the terms of the agreement are carried out expeditiously.ⁿ¹⁶ This provision is of extreme importance if the property to be transferred by one person is, say, the subject of litigation. An agreement between the parties to transfer the property upon termination of the litigation, and actual transfer at that time, will make all transfers part of one transaction qualifying for *IRC Section 351* treatment.

The present Code does not require, as did the 1939 Code, that the stock received by each transferor be substantially in proportion to the fair market value of the property transferred by each. Notwithstanding elimination of this requirement, consideration must be given to any exchange in which stock is received in disproportion to the recipient's interest in the transferred property. The Regulations call for an inquiry into the realities of the situation and for the entire transaction to be given tax effect in accordance with the true nature of the transaction.ⁿ¹⁷ They go on to say that, in appropriate cases, the transaction may be treated as if the stock had first been received in proportion to the interests transferred and then used to make gifts, to pay compensation, or to satisfy obligations of the transferor.ⁿ¹⁸

[4] The "Investment Company" Exception.

The underlying purpose of an "exchange fund" or "swap fund" is to provide a degree of diversification of investment not otherwise practicable or possible for the individual investor. Typically, a swap fund exchange involves transfers of appreciated securities (usually publicly-listed companies) by a group of investors in exchange for stock of the transferee fund. If the investors individually sold their stocks and securities and used the proceeds of sale to acquire shares in the mutual fund, they would be required to pay tax on the appreciation in the value of the stocks and securities sold. Structured as a section 351 exchange, however, the members of the group hope to achieve diversification while avoiding recognition of gain.

Should such an exchange be tax-free? Literally, there has been a transfer of property in return for stock, with the transferors in control of the corporation after the exchange. But, does the transaction accord with the rationale for nonrecognition, namely, that the exchange has not produced a substantial change in the transferor's economic position, but rather a change in the form of investment only? In the early days of swap funds, the Service apparently thought such exchanges fit the mold of nonrecognition transfers for it ruled privately on a number of occasions that the exchanges were tax-free. However, the Service announced a no-ruling policy with respect to swap fund transactions in *Rev Proc 62-32*,ⁿ¹ and in 1966 the Treasury issued proposed regulations which sought to tax "swap fund" exchanges. Shortly thereafter, Congress created an exception to *IRC Section 351*'s nonrecognition rule when the corporation to which controlling shareholders transfer property is an "investment company."ⁿ² Congress subsequently required recognition of gain on transfers of property to investment company partnershipsⁿ³ and trustsⁿ⁴ as well, and extended the denial of tax-free treatment to asset transfers in which a previously undiversified investment company is able, through an otherwise tax-free reorganization, to diversify its investment portfolio.ⁿ⁵

As Congress did not define the term "investment company," the Treasury and Internal Revenue Service were left with the task of administratively defining that term as well as other parameters of the investment company exception. The regulations define an investment company as either (1) a regulated investment company, (2) a real estate investment trust, or (3) a corporation more than 80 percent of the value of whose assets are held for investmentⁿ⁶ and consist of readily marketable stocks and securities, or interests in regulated investment companies or real estate investment trusts.ⁿ⁷ In 1997, Congress, concerned that exchange funds were evading the investment company exception by adding

high quality investments other than readily marketable stocks and securities to their portfolios, expanded the list of assets which result in designation as an investment company for purposes of *IRC Section 351(e)*.ⁿ⁸ As amended, *IRC Section 351(e)(1)* requires that all stock and securities be taken into account for purposes of the 80 percent test, whether or not they are readily marketable.ⁿ⁹ Also treated as "stock and securities" for purposes of the 80 percent test are money,ⁿ¹⁰ any equity interest in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts or derivatives, foreign currency, and interests in precious metals unless used or held in the active conduct of a trade or business.ⁿ¹¹

The regulations provide that, in applying the 80 percent test, stock and securities in subsidiary corporations (*i.e.*, those in which the parent owns 50 percent or more of the voting power or total value of the outstanding shares) are disregarded and the parent is deemed to own directly its ratable share of the subsidiaries' assets.ⁿ¹² Subject to and without overriding this provision, the 1997 amendments added other operating rules to be used in determining whether a transferee meets the 80 percent test:

- (1) If substantially all the assets of any entity consists of stock and securities or assets treated as stocks and securities by *IRC Section 351(e)(1)(B)*, any interest in the entity itself is treated as "stock and securities."ⁿ¹³
- (2) If any entity owns stock and securities (including assets treated as stock and securities by *IRC Section 351(e)(1)(B)*), but such stock and securities constitute less than substantially all of its assets, an interest in such entity is treated as "stock and securities" to the extent the value of such interest is attributable to the entity's "stock and securities."ⁿ¹⁴
- (3) An interest in any noncorporate entity is considered "stock and securities" if, pursuant to its terms or any other arrangement, it is convertible into, or exchangeable for, any asset that either is or is treated as "stock and securities" under *IRC Section 351(e)(1)*.ⁿ¹⁵

Significantly, the regulations do not treat every transfer of property to an "investment company" (including a corporation meeting the 80 percent test) as taxable.ⁿ¹⁶ To fall within the investment company exception, two or more persons must transfer nonidentical assets to an investment company, and the transfer must result, directly or indirectly, in a diversification of the interests of at least one of the transferors.ⁿ¹⁷ A transfer to a newly organized corporation by a single transferor, or transfers by two or more persons each of whom transfers assets identical to those transferred by the others, do not come within the investment company exception.ⁿ¹⁸ Thus, if each of several transferors transfer a diversified portfolio of stocks and securities to a corporation, none achieves diversification by reason of the transfers, the investment company exception does not apply, and no gain or loss is recognized.ⁿ¹⁹ A transferor is deemed to have transferred a diversified portfolio of stocks and securities if not more than 25 percent of the value of her portfolio is invested in the stock and securities of any one issuer and not more than 50 percent of the value of her portfolio is invested in stock and securities of 5 or fewer issuers.ⁿ²⁰ For purposes of calculating the 25 and 50-percent tests, Government securities are included in the denominator but not the numerator of the fractions, unless they were acquired to meet the 25 and 50-percent tests.

[5] The Bankruptcy Exception.

Gain must be recognized if, pursuant to a plan, property of a debtor subject to the jurisdiction of a court in a "title 11 or similar case" is transferred to a controlled corporation, but only to the extent that the stock received on the exchange is used to satisfy the indebtedness of the transferor.ⁿ¹ A "title 11 or similar case" is defined as a case under title 11 of the United States Code, or a receivership, foreclosure, or similar proceeding in a federal or state court.ⁿ²

[6] Forming the Foreign Corporation.

If the transferor is a U.S. person and the transferee corporation is a foreign corporation, an additional Code provision must be considered. *IRC Section 367(a)(1)* provides that in determining the extent to which gain is recognized on an *IRC Section 351* exchange, "a foreign corporation shall not ... be considered to be a corporation."ⁿ¹ The effect of this provision is to remove the exchange from the ambit of *IRC Section 351*,ⁿ² unless one of the stated exceptions applies.

The first exception prevents the application of *IRC Section 367(a)(1)* to the transfer of stock or securities of a foreign corporation which is a party to the exchange.ⁿ³ The second makes the provision inapplicable if the transferee corporation will use the transferred property in the active conduct of a trade or business outside the United States.ⁿ⁴ However, certain assets are tainted and ineligible for the active trade or business requirement, namely: (1) stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of business; (2) copyrights and similar property as defined in *IRC Section 1221(a)(3)*; (3) installments obligations, accounts receivable, or similar property; (4) foreign currency or other property denominated as foreign currency; and (5) property leased by the transferor to anyone other than the transferee.ⁿ⁵

Intangible assets, as defined by *IRC Section 936(h)(3)(B)*,ⁿ⁶ are generally treated as tainted assets for purposes of *IRC Section 367(a)(1)*, but not when the exchange is governed by *IRC Section 351*.ⁿ⁷ Instead, the U.S. person transferring the property is treated as having sold the property in exchange for payments that are contingent upon the productivity, use, or disposition of the property, i.e., royalty income, and as receiving amounts that reasonably reflect what would have been received (i) annually, or (ii) in the case of a disposition following the transfer (whether direct or indirect), at the time of disposition over the useful life of the property.ⁿ⁸ The earnings and profits of the foreign corporation to which the intangible property was transferred are reduced by the amount required to be included in income by the transferor.ⁿ⁹

Regulations make *IRC Section 367(a)(1)* inapplicable if a United States person transfers foreign stock or securities to a foreign corporation and, after the transfer the transferor owns less than 5 percent of both the total voting power and the total value of the stock of the transferee foreign corporation, or the United States transferor receives a 5-percent or greater interest in the transferee foreign corporation and enters into a prescribed five-year gain recognition agreement.ⁿ¹⁰ *IRC Section 367(a)(1)* also is inapplicable to a transfer by a United States person of stock or securities in a domestic corporation (target corporation) to a foreign corporation if the target corporation complies with the reporting requirements of *Regulations Section 1.367(a)-3(c)(6)* and each of the following conditions are met:ⁿ¹¹

- (1) No more than 50 percent of both the total voting power and the total value of the stock of the transferee foreign corporation is received in the transaction, in the aggregate, by United States shareholders.ⁿ¹²
- (2) No more than 50 percent of each of the total voting power and the total value of the stock of the transferee foreign corporation is owned, in the aggregate, immediately after the transfer, by United States persons who are either officers or directors of the domestic target corporation or who are 5-percent shareholders (own at least 5 percent of either the total voting power or total value of the domestic target corporation). Any stock of the transferee foreign corporation owned by a United States person immediately after the transfer will be taken into account, whether or not it was received in exchange for the stock or securities of the domestic target corporation.
- (3) The transferee foreign corporation or an affiliate (qualified subsidiary or qualified partnership) has been engaged in the active conduct of a trade or business outside the United States for the entire 36-month period preceding the date of transfer.ⁿ¹³ In addition, at the time of the transfer, neither the transferors nor the transferee (and, if applicable, the qualified subsidiary or qualified partnership engaged in the active trade or business) have an intention to substantially dispose of or discontinue the trade or business. Finally, the fair market value of the transferee foreign corporation must be at least equal to the fair market value of the domestic target corporation.

- (4) Either (a) the United States transferor is not a 5-percent transferee shareholder (owns at least 5 percent of either the total voting power or total value of the stock of the transferee foreign corporation immediately after the transfer); or (b) the United States transferor is a 5-percent transferee shareholder and enters into a five-year gain recognition agreement with respect to the domestic target company stock or securities transferred to the transferee foreign corporation.

Gain recognition is required under a gain recognition agreement ("GRA") if a "gain recognition event" listed in *Treasury Regulation Section 1.367(a)-8(j)*, that is not within any of the exceptions provided in *Treasury Regulation Section 1.367(a)-8(k)*, occurs during the GRA term.ⁿ¹⁴ The GRA term is approximately five-years, beginning on the date of the initial transfer of stock or securities to the transferee foreign corporation and ending as of the close of the fifth full taxable year (not less than 60 months) following the close of the taxable year in which the initial transfer occurred.ⁿ¹⁵ In general, a non-expected gain recognition event occurring during this period triggers taxation of the gain that was realized but not recognized by the US transferor on the initial transfer of stock or securities to the transferee foreign corporation.ⁿ¹⁶ The US transferor must report the gain on an amended return for the taxable year in which the initial transfer took place and pay any additional tax due plus interest, from the due date prescribed for filing the return for that year to the date the tax is paid.ⁿ¹⁷ Once the gain is reported, the US transferor gets a step-up in the basis of stock in the transferee foreign corporation received in the exchange equal to the amount of gain recognized, and the transferee gets a step-up in the basis of the stock or securities it received from the US transferor in the same amount.ⁿ¹⁸

A common "gain recognition event" is the complete or partial disposition of the stock or securities initially transferred to the foreign corporation.ⁿ¹⁹ A disposition, for purposes of this and all other provisions of the GRA regulations, includes any transfer that would constitute a disposition for any purpose under the Internal Revenue Code.ⁿ²⁰ Other transactions which may trigger gain recognition include: a disposition of substantially all of the assets of the transferred corporation;ⁿ²¹ complete or partial disposition of a partnership interest if the if the initial transfer occurred by reason of the transfer of such partnership interest;ⁿ²² complete or partial disposition of the stock of the transferee foreign corporation received in the initial exchange by the US transferor;ⁿ²³ a US corporate transferor leaves a consolidated group or joins a new consolidated group;ⁿ²⁴ a US individual transferor dies, or a US transferor that is a trust or estate ceases to exist.ⁿ²⁵ Gain recognition may also be triggered if a US transferor fails to comply in any material respect with the terms and requirements of the GRA and the GRA regulations.ⁿ²⁶

Treasury Regulation Section 1.367(a)-8(k) provides exceptions that prevent many transactions classified as "gain recognition events" from becoming "triggering events" that actually require recognition of the gain realized on the initial transfer. A general catch-all exception covers any disposition in which: (i) the disposition qualifies as a nonrecognition transaction, (ii) after which the US transferor retains an interest in the transferred stock or securities or the assets of the transferred corporation, and (iii) the US transferor enters into a new gain recognition agreement.ⁿ²⁷ For this purpose, "nonrecognition transaction" has the same meaning as in *IRC Section 7701(a)(45)*:--"any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A"--and also includes an exchange described in *IRC Sections 351(b)* or *356* even if all gain realized in the exchange is recognized.ⁿ²⁸ Transferred stock or securities" refers both to the stock or securities originally transferred to the foreign corporation and any stock or securities of the transferred corporation having a basis determined in whole or in part by reference to the basis of the stock or securities originally transferred.ⁿ²⁹ The "transferred corporation" is the corporation whose stock or securities were the subject of the initial transfer from the US transferor to the transferee foreign corporation.ⁿ³⁰ The catch-all exception additionally requires that if as a result of a disposition in a nonrecognition transaction any foreign corporation acquires either the transferred stock or securities or substantially all the assets of the transferred corporation, the US transferor must own at least five percent (applying the attribution rules of section 318 as modified by *IRC Section 958(b)*) of the total voting power and the total value of the outstanding stock of such foreign corporation.ⁿ³¹

Treasury Regulation Section 1.367(a)-8(k) also contains a list of more specific circumstances under which a US

transferor may avoid gain recognition notwithstanding the occurrence of a gain recognition event:

Death of individual US transferor. The death of an individual US transferor is not a triggering event if the person winding up the affairs of the US transferor: (i) retains sufficient assets to satisfy any possible Federal tax liability of the US transferor under the GRA for the duration of the extended period of limitations under the GRA; (ii) provides security for the payment of such tax liability if required to do so by the IRSⁿ³² (security generally required only if the transferred stock or securities are a principal asset of the US transferor and the IRS has reason to believe that a disposition of such stock or securities may be contemplated); or (iii) obtains a ruling from the IRS providing for one or more successors to the US transferor under the GRA.ⁿ³³

Liquidation of corporate US transferor. If a US transferor distributes stock in the transferee foreign corporation that it received in exchange for the initial transfer of stock or securities, the disposition will not be a triggering event if the distribution is pursuant to a complete liquidation of the US transferor under *IRC Section 332*, and the distributee (as defined in *IRC Section 334(b)(2)*) is a domestic corporation, provided the distributee enters a new GRA in which it is designated as the US transferor.ⁿ³⁴

Consolidation or deconsolidation of US transferor. A deconsolidation of the US transferor, or its consolidation with a new group, will not be considered a triggering event if the US transferor enters into a new GRA.ⁿ³⁵ An exception is also available if stock in the transferee foreign corporation is transferred to another member of the US transferor's consolidated group in a transaction governed by the intercompany transaction rules in *Treasury Regulation Section 1.1502-13*.ⁿ³⁶

Transfers of transferred stock or securities to a corporation or partnership. A disposition of transferred stock or securities to a corporation or partnership in an exchange to which *IRC Sections 351, 354* (but only in connection with a "B" reorganization) or *IRC Section 721* applies will not constitute a triggering event if the US transferor enters into a new GRA which includes as additional triggering events (i) any disposition of the stock, securities or partnership interests received in exchange for the transferred stock or securities, and (ii) any other event "inconsistent with the principles of [*Treasury Regulation Section 1.367(a)-8(k)*], including the indirect disposition of the transferred stock or securities."ⁿ³⁷

Transfers of substantially all the assets of the transferred corporation. A disposition of substantially all the assets of the transferred corporation pursuant to an exchange to which *IRC Sections 351, 354* (but only in connection with a "B" organization) or *IRC Section 721* applies will not be a triggering event if the US transferor agrees to enter a new GRA which provides that any disposition of the stock, securities or partnership interest (as applicable) received in the exchange will constitute a triggering event for purposes of the new GRA.ⁿ³⁸

The regulations also include a procedure by which a US transferor can request relief from the consequences of a failure to make a timely filing or to comply in any material respect with any requirement of the GRA regulations, provided such failure is shown to have been due to reasonable cause and not willful neglect.ⁿ³⁹ Requests will be considered only if an amended return is filed for the taxable year to which the failure relates that includes the information that should have been included with the original return or otherwise complies with the rules and that includes a written statement explaining the reasons for the failure to file timely or otherwise to comply with the regulations. If the year is currently under examination by the IRS the amended return must be delivered to the IRS personnel conducting the examination; otherwise, the amended return is filed with the Director having jurisdiction over the original return.ⁿ⁴⁰

IRC Section 367(b)(1) provides that in the case of an incorporating exchange (as well as any exchange governed by *IRC Section 332, 354, 355, 356 or 361*) in which there is no transfer of property described in *IRC Section 367(a)(1)*, a foreign corporation will be considered to be a corporation except to the extent provided in regulations. The covered

exchange (described in the regulations as a Section 367(b) exchange) is any exchange described above in which the status of a foreign corporation as a corporation is relevant for determining the extent to which income shall be recognized or for determining the effect of the transaction on earnings and profits, basis of stock or securities, basis of assets, or other relevant tax attributes.ⁿ⁴¹

A notice requirement is imposed on certain shareholders, the determination based on the nature of the transaction.ⁿ⁴² The notice must be attached to the person's timely filed tax return for the year in which income is realized in the Section 367(b) exchange.ⁿ⁴³

Every U.S. person who transfers property in an exchange falling within *IRC Section 351* must furnish to the Service information that will be prescribed in regulations.ⁿ⁴⁴ Failure to do so results in a penalty equal to 10 percent of the fair market value at the time of the exchange unless the failure is due to reasonable cause and not to willful neglect.ⁿ⁴⁵ The penalty with respect to any one exchange cannot exceed \$100,000 unless the failure to furnish the information is due to intentional disregard.ⁿ⁴⁶

FOOTNOTES:

(n1)Footnote 1. *IRC § 351(a)*. A transfer of property by a corporation to its wholly owned subsidiary in exchange for the latter's stock was followed by a transfer of the same property to a wholly owned subsidiary of the transferee in exchange for stock. Since each transaction qualified for nonrecognition treatment under *IRC § 351*, the entire transaction did so as well. *Rev Rul 77-449, 1977-2 CB 110* . The same result obtained in *Rev Rul 83-156, 1983-2 CB 66* , and *Rev Rul 83-84, 1983-1 CB 79* .

Rev Rul 84-111, 1984-2 CB 88 , sets forth the tax consequences of a transfer to a newly formed corporation of (i) partnership assets and liabilities, (ii) partnership assets and liabilities by partners after the liquidation of the partnership, and (iii) partnership interests.

If an unincorporated state law entity that is classified as a partnership for federal tax purposes converts into a state law corporation under a state law formless conversion statute, the following is deemed to occur: the partnership contributes all its assets and liabilities to the corporation in exchange for stock in the corporation, and immediately thereafter, the partnership liquidates distributing the stock of the corporation to its partners. *Rev Rul 2004-59, 2004-1 CB 1050* .

See generally North, "Organizing the Closely Held Corporation," 32 *NYU Inst on Fed Tax* 697 (1974); Henkel, "Corporate Organizational Problems: A Checklist of Actions, Elections and Considerations," 31 *NYU Inst on Fed Tax* 255 (1973); Burke, "Section 351: The Beginning of Life in Subchapter C," 24 *SW LJ* 742 (1970).

A checklist of the information to be included in a request for a ruling under Section 351 is contained in *Rev Proc 83-59, 1983-2 CB 575* , reprinted in App A.

(n2)Footnote 1. *Rev Rul 69-156, 1969-1 CB 101* . The rationale of the ruling is that the transfer would not qualify for capital gain or loss treatment under *IRC § 1235*. One may question whether the Service's reliance on a provision concerned with the character of gain or loss is warranted.

A transfer to a new corporation of a certificate of registration of a corporate name, all rights to use the name in a foreign country, and all goodwill associated with the name was a transfer of property for purposes of *IRC § 351*. The transfer of a name that has no goodwill value is not a transfer of property. *Rev Rul 79-288, 1979-2 CB 139* . The distinction is important when the transfer is to a foreign corporation. See § 3.02[5].

(n3)Footnote 2. 471 *F2d* 1211 (*Ct Cl* 1973) .

(n4)Footnote 3. *Rev Rul 69-357, 1969-1 CB 101* ; *Halliburton v Commr*, 78 *F2d* 265 (9th *Cir* 1935) .

(n5)Footnote 4. *Treas Reg § 1.351-1(a)(1)(i)*. The issuance of shares in exchange for property previously received by the taxpayer as compensation for services rendered will qualify as an issuance for property. *IDI Management, Inc v Commr, TC Memo 1977-369*.

(n6)Footnote 5. See § 3.03.

(n7)Footnote 6. *Treas Reg § 1.351-1(b)(1), (2)*.

(n8)Footnote 7. *335 F2d 487 (5th Cir 1964)*.

(n9)Footnote 8. *Treas Reg § 1.721-1(b)(1)*.

(n10)Footnote 9. *Treas Reg § 1.351-1(a)(2), Ex (3)*.

(n11)Footnote 10. *Id*; *Rev Rul 64-56, 1964-1 CB 133*.

(n12)Footnote 11. *Treas Reg § 1.351-1(a)(1)(ii)*. For an example of an attempt by one transferor to qualify a transfer by another, see *Rev Rul 68-349, 1968-2 CB 143*; *Kamborian v Commr, 56 TC 847 (1971)*, *aff'd*, *469 F2d 219 (1st Cir 1972)*. When the transaction is designed to serve a business purpose and not be a vehicle for qualifying transfers by others, nonrecognition treatment should ensue. See, eg, *Rev Rul 76-123, 1976-1 CB 94*, where the purpose of the transfer was reincorporation in another state.

For ruling purposes, the property transferred will not be considered to be of relatively small value if its fair market value is at least 10 percent of the value of the stock and securities already owned (or to be received for services) by the transferor. *Rev Proc 77-37, 1977-2 CB 568*.

(n13)Footnote 12. See generally, Biblin, "Assignments of Income in Connection With Incorporating and Liquidating Corporations," 1969 *So Calif Tax Inst* 383; Note, "Section 351 of the Internal Revenue Code and 'Mid-Stream' Incorporations," 38 *U Cinc L Rev* 96 (1969).

(n14)Footnote 13. *311 US 112 (1940)*.

(n15)Footnote 14. *281 US 111 (1930)*.

(n16)Footnote 15. *Commr v Fender Sales, Inc, 338 F2d 924 (9th Cir 1964)* (extinguishing claim for salaries owed by corporation in consideration of the issuance of additional shares); *Brown v Commr, 115 F2d 337 (2d Cir 1940)* (assignment of claim for compensation; transferor taxed when amount due collected); *Findley v Commr, TC Memo 1991-339* (assignment of future liquidation proceeds already earned or due to taxpayer).

(n17)Footnote 16. *49 TC 73 (1967)*.

(n18)Footnote 17. *356 US 260 (1958)*.

(n19)Footnote 18. *HB Zachry Co v Commr, 49 TC 73, 80 (1967)*.

(n20)Footnote 19. *490 F2d 1172 (3d Cir 1974)*, *cert denied 419 US 826*.

(n21)Footnote 20. The Service followed *Hempt Bros* in *Rev Rul 80-198, 1980-2 CB 113*.

(n22)Footnote 21. *Rev Rul 80-198, 1980-2 CB 113*.

(n23)Footnote 22. *Peabody Coal Co v Commr, 18 BTA 1081 (1930)*, *aff'd*, *55 F2d 7 (7th Cir)*, *cert denied 287 US 605*; *S Rossin & Sons v Commr, 113 F2d 652 (2d Cir 1940)*.

(n24)Footnote 23. *Rev Rul 62-128, 1962-2 CB 139* . The ruling was revoked by *Rev Rul 78-280, 1978-2 CB 139* .

(n25)Footnote 24. *Nash v US, 414 F2d 627 (5th Cir 1969)* , *rev'd 398 US 1 (1970)* .

(n26)Footnote 25. *Schuster v Commr, 50 TC 98 (1968)* .

(n27)Footnote 26. *Id at 101* .

(n28)Footnote 27. *355 F2d 111 (9th Cir 1966)* .

(n29)Footnote 28. *Id at 113* .

(n30)Footnote 29. *398 US 1 (1970)* . The Court's decision led to short opinions in cases pending in lower courts. See, eg, *Rowe v US, 428 F2d 874 (6th Cir 1970)* .

(n31)Footnote 30. The transferor's basis in the accounts receivable is deemed to be equal to the net value of the receivables. *Rev Rul 78-280, 1978-2 CB 139* .

(n32)Footnote 31. The reserve method is still available to banks and certain other special categories of taxpayers. See, eg, *IRC §§ 585, 586, and 593*.

(n33)Footnote 32. The provisions may be relied upon to treat a transfer of property to a corporation closely followed by a sale as a sale by the transferor. See, eg, *Ltr Rul 9016001* and cases cited therein.

(n34)Footnote 33. *267 F2d 434 (9th Cir 1959)* , *cert denied 361 US 821* .

The Commissioner's use of *IRC § 446(b)* was disapproved in *Mathis v US, 430 F2d 158 (7th Cir 1970)* . The transferring proprietorship had exercised an election to be taxed as a corporation, making the tax the same no matter who reported the income.

(n35)Footnote 34. *Treas Reg § 1.460-4(d)*.

(n36)Footnote 35. *Treas Reg § 1.460-4(e)*.

(n37)Footnote 36. *305 F2d 681 (9th Cir 1962)* .

(n38)Footnote 37. *Id at 686* .

(n39)Footnote 38. *National Sec Corp v Commr, 137 F2d 600 (3d Cir 1943)* , *cert denied 320 US 794* ; *Aiken Drive-In Theatre Corp v US, 281 F2d 7 (4th Cir 1960)* ; *Estate of Walling v Commr, 373 F2d 190 (3d Cir 1967)* . The Regulations reflect this view. *Treas Reg § 1.482-1(d)(5) (1968)*; see also *Central Cuba Sugar Co v Commr, 198 F2d 214 (2d Cir 1952)* , *cert denied 344 US 874* .

(n40)Footnote 39. A personal service corporation is one whose principal activity is the performance of personal services substantially by employee-owners.

(n41)Footnote 40. An employee-owner is any employee who owns, on any day during the taxable year, more than 10 percent of the outstanding stock of the personal service corporation. The attribution rules of *IRC § 318* apply, except that attribution from a corporation to a shareholder is permitted when the shareholder owns as little as 5 percent of the stock of the corporation.

(n42)Footnote 41. Eg, *Gregory v Helvering, 293 US 465 (1935)* .

(n43)Footnote 42. *Rev Rul 60-331, 1960-2 CB 189* ; contra, *Cukor v Commr, TC Memo 1968-17* .

The fact that certain acquisitive transactions fail to meet the requirements for tax-free organization treatment does not preclude application of *IRC* § 351 to transfers that are a part of a larger transaction, but meet the requirements of that section either alone or in conjunction with other transfers. *Rev Rul 84-71, 1984-1 CB 106*.

(n44)Footnote 1. An actual distribution of stock to the transferors may not be required. See, eg, *Ltr Rul 9719030*, where equal shareholders transferred additional property that they owned equally to the corporation.

(n45)Footnote 2. Securities become "boot" if received in a transfer occurring after Oct 2, 1989.

(n46)Footnote 3. In *Helvering v Southwest Consol Corp*, 315 US 194 (1942), stock warrants were held not to be voting stock for purposes of *IRC* § 368(a)(1)(B). The Regulations go even further in providing that for purposes of *IRC* § 351, stock rights and warrants are not treated as stock. *Treas Reg* § 1.351-1(a)(1) (ii). This Regulation has been criticized insofar as it denies "stock" status to stock warrants for any purpose other than to determine whether the transferors are in control of the corporation immediately after the exchange. Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* 3-16 (6th ed 1998).

(n47)Footnote 4. *Carlberg v US*, 281 F2d 507 (8th Cir 1960).

(n48)Footnote 5. 287 US 462 (1933).

(n49)Footnote 6. *Id* at 468-469.

(n50)Footnote 7. *Id* at 470.

(n51)Footnote 8. 60 F2d 937 (2d Cir 1932).

(n52)Footnote 9. One commentator has suggested that the language about securities may have been nothing more than another way of stating the continuity of interest test, the Court intending to show that the notes in question were not the kind of securities as meet the continuity of interest requirement. Griswold, " 'Securities' and 'Continuity of Interest'," 58 *Harv L Rev* 705 (1945). The House of Representatives version of the 1954 Code contained a statutory definition of "security." The Senate considered the inclusion of a fixed definition unwise. S Rep No 1622, 83d Cong, 2d Sess 42 (1954). The Senate view obviously prevailed.

(n53)Footnote 10. *Wellington Fund, Inc v Commr*, 4 TC 185, 189 (1944).

(n54)Footnote 11. *Neville Coke & Chem Co v Commr*, 148 F2d 599 (3d Cir 1945) (three-, four-, and five-year notes); *Lloyd-Smith v Commr*, 116 F2d 642 (2d Cir 1941) (two-year notes); *Commr v Sisto Fin Corp*, 139 F2d 253 (2d Cir 1943) (demand notes); *Wellington Fund, Inc*, 4 TC 185 (1944) (12-month notes); but cf *US v Mills*, 399 F2d 944 (5th Cir 1968) (one-year note a security).

In *Lovell & Hart, Inc v Commr*, TC Memo 1970-335, *aff'd*, 456 F2d 145 (6th Cir 1972), the Tax Court held that the taxpayer recognized gain on the receipt of 13-month notes. The taxpayer did not argue, nor did the Tax Court consider, whether the notes constituted "securities"; the issue before the court was whether the notes had been issued as consideration for the transfer of property to the corporation.

(n55)Footnote 12. *Burnham v Commr*, 86 F2d 776 (7th Cir 1936).

(n56)Footnote 13. *Camp Wolters Enterprises, Inc v Commr*, 22 TC 737 (1954), *aff'd*, 230 F2d 555 (5th Cir 1956), *cert denied* 352 US 826.

(n57)Footnote 14. *Rev Rul 59-98, 1959-1 CB 76*.

(n58)Footnote 15. *Camp Wolters Enters, Inc v Commr*, 22 TC 737, 751 (1954) , *aff'd*, 230 F2d 555 (5th Cir 1956) . The Tax Court applied the quoted language in *Lagerquist v Commr*, TC Memo 1987-185 , to find that notes with consecutive terms of four to five years were securities.

(n59)Footnote 16. *US v Mills*, 399 F2d 944 (5th Cir 1968) . See also *US v Hertwig*, 398 F2d 452 (5th Cir 1968) , in which security status was granted to a note payable in 150 installments.

Hertwig was distinguished in *Bradshaw v US*, 683 F2d 365 (Ct Cl 1982) , a case involving a transfer of property to a wholly owned corporation in exchange for five installment notes due more than 10 years after the transfer, on the ground that the degree of risk in *Bradshaw* was insubstantial in contrast to the risk involved in *Hertwig*. This resulted in a holding that the transaction in *Bradshaw* was a sale.

(n60)Footnote 17. Options to acquire nonqualified preferred stock are also boot. *Treas Reg* § 1.356-6.

(n61)Footnote 18. *IRC* § 351(g)(1)(B).

(n62)Footnote 19. HR Rep No 2014, 105th Cong, 1st Sess 242 (1997).

(n63)Footnote 20. *IRC* § 351(g)(2)(A), (3)(A). Stock will not be treated as participating in corporate growth to any significant extent unless there is a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation. If there is not a real and meaningful likelihood that dividends beyond any limitation or preference will actually be paid, the possibility of such payments will be disregarded in determining whether stock is limited and preferred as to dividends.

A person is treated as related to another person if they bear a relationship to such other person described in *IRC* §§ 267(b) or 707(b). *IRC* § 351(g)(3)(B).

(n64)Footnote 21. *IRC* § 351(g)(2)(B).

(n65)Footnote 22. *IRC* § 351(g)(2)(C)(i). The death, disability, or mental incompetency exception does not apply if the stock surrendered or the stock received in an exchange is stock of a corporation any class of stock of which (or of a related corporation) is publicly traded. *IRC* § 351(g)(2)(C)(ii). This rule will normally come into play in divisive reorganizations, acquisitive reorganizations, and stock-for-stock exchanges.

Preferred stock containing one of the first three rights or obligations described in *IRC* § 351(g)(2)(B) that is exercisable only upon the holder's separation from service from the issuer or a related person will be treated as transferred in connection with the performance of services, if the stock is received in exchange for, or in a distribution with respect to, existing stock containing a similar right or obligation that was issued in exchange for services. In applying the rules relating to nonqualified preferred stock, the preferred stock received will continue to be treated as transferred in connection with the performance of services in subsequent transactions involving the stock. *Treas Reg* § 1.356-7(c).

(n66)Footnote 23. An open-account debt from corporation to shareholder will constitute "boot" if the parties to the transaction intend to create the debt as part of the incorporating transfer. The absence of such intent led to nonrecognition in *R Shisler Farms, Inc v Commr*, TC Memo 1974-141 , and *Taub v Commr*, TC Memo 1971-155 .

The Service has held that an intracompany account payable becomes "other property" when a corporation transfers all of the assets of one division of the company to a newly formed corporation in exchange for all of the stock of the new entity. *Rev Rul* 80-228, 1980-2 CB 115 . According to the Service, the intracompany account does not give rise to a debtor-creditor relationship prior to the incorporation, but afterwards becomes a liability of the subsidiary and an asset of the parent. In so ruling, the Service refused to follow a contrary decision in *Wham Constr Co v US*, 600 F2d 1052

(4th Cir 1979) .

(n67)Footnote 24. *IRC § 351(b)(2)*. It should be noted that if the transfer were to a corporation in which the taxpayer owned, directly or indirectly, 50 percent in value of the outstanding stock, any loss realized would be disallowed by *IRC § 267(a)(1)*. The immediate effect is the same--no loss deduction. However, the tax consequences of a later sale of the stock may be different due to the provisions of *IRC § 267(d)*. See § 2.07[4][c]. It would seem that *IRC § 351(b)(1)* should control the effect of loss since that decrees nonrecognition, rather than disallowance which assumes prior recognition.

(n68)Footnote 25. *IRC § 351(b)(1)* provides that:

"[G]ain (if any) ... shall be recognized, but not in excess of--
 "(A) the amount of money received, plus,
 "(B) the fair market value of ... other property received ... "

(n69)Footnote 26. *Watson v Commr*, 345 US 544 (1953) ; *Williams v McGowan*, 152 F2d 570 (2d Cir 1945) ; *Rev Rul 67-192*, 1967-2 CB 140 ; *Rev Rul 68-55*, 1968-1 CB 140 , amplified by *Rev Rul 85-164*, 1985-2 CB 117 . An excellent article dealing with boot allocation is Rabinovitz, "Allocating Boot in Section 351 Exchanges," 24 *Tax L Rev* 337 (1969). A more recent discussion of the issue of boot allocation can be found in Cohen & Whitney, "Revisiting the Allocation of Boot in Section 351 Exchanges," 48 *Tax Lawyer* 959 (1995).

(n70)Footnote 27. Two-thirds (\$50,000/\$75,000) of the total amount received will be allocated to the gain property. Thus, \$30,000 in value of the stock and \$20,000 in cash will be deemed the consideration received in exchange for the transfer of the gain property.

(n71)Footnote 28. *IRC § 351(b)(2)*.

(n72)Footnote 29. *IRC § 1245(a)*. The subject property is set forth in *IRC § 1245(a)(3)*.

(n73)Footnote 30. *Rev Rul 71-569*, 1971-2 CB 314 .

(n74)Footnote 31. *IRC § 351(b)(1)*.

(n75)Footnote 32. *IRC § 1250(d)(3)*.

(n76)Footnote 33. *IRC § 1239(b)(1)*, (c)(1)(A). A person can come within the scope of *IRC § 1239* even though he does not own more than 50 percent of the number of shares of stock outstanding. The test is whether he owns more than 50 percent *in value* of the outstanding stock. *US v Parker*, 376 F2d 402 (5th Cir 1967) ; *Rev Rul 69-339*, 1969-1 CB 203 . The Court of Claims held, in *Robertshaw v US*, 616 F2d 507 (Ct Cl 1980) , that the taxpayer's stock is to be valued prior to the transaction.

(n77)Footnote 34. *IRC § 1239(c)(2)*. *IRC § 267(c)(3)*, which treats an individual owning stock in a corporation as owning the stock owned directly or indirectly by or for his partner, is inapplicable here. The constructive ownership rules of *IRC § 267(c)* are discussed in § 2.07[4][a].

(n78)Footnote 35. *Rev Rul 75-143*, 1975-1 CB 275 . The operation of the provision is the subject of § 20.04[4].

(n79)Footnote 36. See § 1.04[2][b].

(n80)Footnote 37. 303 US 564 (1938) .

(n81)Footnote 38. Under the authority of *IRC § 357(a)*, an agreement by the transferee corporation to pay the

transferor's expenses does not constitute "boot." *Rev Rul 74-477, 1974-2 CB 116* .

A corporation's assumption of a shareholder's obligation to deliver replacement securities to close out a short sale constitutes an assumption of a liability for purposes of *IRC § 357*. The amount of the liability assumed equals the proceeds of the original short sale. *Rev Rul 95-45, 1995-1 CB 53* .

(n82)Footnote 39. *IRC § 357(d)(1)(A)*.

(n83)Footnote 40. *IRC § 357(d)(1)(B), 357(d)(2)*. Fair market value is determined without regard to *IRC § 7701(g)*, the provision that treats property subject to a nonrecourse liability as having a value not less than the amount of the debt.

(n84)Footnote 41. It is interesting to note that the Government urged passage of this legislation. This position was prompted by the realization that taxpayers who had made transfers prior to the decision in *Hendler* would be able to reap benefits, such as a stepped-up basis, without shouldering any burdens.

(n85)Footnote 42. *IRC § 357(b)(1)(A), (B)*. The presence of a valid business purpose will prevent application of *IRC § 357(b)* even though the borrowing immediately precedes the transfer to the corporation. See, eg, *ISC Indus Inc v Commr, TC Memo 1971-283* ; *Rev Rul 79-258, 1979-2 CB 143* .

(n86)Footnote 43. *Treas Reg § 1.357-1(c)*.

(n87)Footnote 44. *Drybrough v Commr, 376 F2d 350 (6th Cir 1967)* .

(n88)Footnote 45. *Campbell v Wheeler, 342 F2d 837 (5th Cir 1965)* ; see also *Thompson v Campbell, 353 F2d 787 (5th Cir 1965)* , *aff'g per curiam 353 F2d 787* (transfer subject to liability one day after liability incurred).

(n89)Footnote 46. *294 F2d 653 (9th Cir 1961)* .

(n90)Footnote 47. *294 F2d 653, 659 (9th Cir 1961)* .

(n91)Footnote 48. The taxpayer in *Doe v Commr, TC Memo 1993-543* , argued that *IRC § 357(c)* should not apply if the transferee corporation does not assume any debt. The Tax Court held that, for purposes of *IRC § 357(c)*, it is sufficient that the property received by the corporation is subject to the debt.

The Service has held that contingent environmental liabilities assumed as part of a transfer to a controlled corporation are not liabilities for purposes of *IRC § 357(c)*. *Rev Rul 95-74, 1995-2 CB 36* .

(n92)Footnote 49. The Service takes the position that a taxpayer cannot avoid the application of *IRC § 357(c)(1)* by issuing a note for the difference between the basis of the transferred property and the liability assumed by the transferee; the basis of the note to the transferor is zero. The Tax Court agrees. *Alderman v Commr, 55 TC 662 (1971)* ; *Rev Rul 68-629, 1968-2 CB 154* . However, in *Lessinger v Commr, 872 F2d 519 (2d Cir 1989)* , *rev'g 85 TC 824 (1985)* , the Second Circuit held that *IRC § 357(c)* could be avoided if the shareholder, as part of the incorporating transfer, promises to pay the excess debt. For a discussion of *Lessinger*, see Cummings, "Zero Basis Hoax or Contingent Debt and Failure of Proof? Sorting Out the Issues in the *Lessinger* Case," *2 Fla Tax Rev 283 (1994)*; Fleming, "A Second Look at the Zero Basis Hoax," *64 Tax Notes 811(1994)*; Brewer, "The Zero Basis Hoax," *63 Tax Notes 457 (1994)*.

The court, in *Peracchi v Commr, 143 F3d 487 (9th Cir 1998)* , held that an unsecured note that an individual contributed to his wholly owned corporation constituted genuine indebtedness with a basis equal to the face amount of the debt. This meant that the taxpayer did not have to recognize gain on the transfer of real property encumbered by liabilities exceeding the basis of the property.

The taxpayers, in *Seggerman Farms, Inc v Commr*, TC Memo 2001-99 , *aff'd*, 308 F3d 803 (7th Cir 2002) , argued that their personal guaranties of corporate indebtedness were the equivalent of loans receivable or personal notes, so that *Lessinger* and *Peracchi* should apply. The Tax Court rejected the argument on the ground that a guaranty is a mere promise to pay in the future and not an economic outlay.

If both *IRC* §§ 357(b)(1) and 357(c)(1) apply to an exchange, the former will control, treating as boot the total amount of assumed liabilities. *IRC* § 357(c)(2)(A).

IRC § 357(c)(1) will apply to a transaction coming within its terms even though the transfer does not relieve the transferor of liability, *Rosen v Commr*, 62 TC 11 (1974) .

IRC § 357(c)(1) does not apply to transactions that qualify as reorganizations under *IRC* §§ 368(a)(1)(A) or (C), or under (D) or (G) (provided the requirements of *IRC* § 354(b)(1) are met), regardless of whether *IRC* § 351 applies. *Rev Rul* 2007-8, 2007-1 CB 469 .

When partnership interests are transferred for stock, the partners recognize gain to the extent that each partner's share of partnership liabilities exceeds the adjusted basis of the transferred interest. Where none of the partners has any personal liability with respect to a partnership liability, the liability is allocated to each partner in the same proportion as the partner's interest in partnership profits. *Rev Rul* 80-323, 1980-2 CB 124 . See also *Smith v Commr*, 84 TC 889 (1985) .

(n93)Footnote 50. The statute considers the excess of liabilities over basis "as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be."

(n94)Footnote 51. *Rev Rul* 60-302, 1960-2 CB 223 , which held *IRC* § 357(c) gain to be ordinary income because of the application of *IRC* § 1239.

(n95)Footnote 52. Fredericks, "The Character of Section 357(c) Gain: Why the Underlying Regulation Is Capable of Producing Absurd Results," 48 *Tax Lawyer* 167 (1994).

The Tax Court (using what the author of the cited article describes as an intuitive approach) has not followed the regulation in two reported decisions. The cases are *Rosen v Commr*, 62 TC 11 (1974) , and *Raich v Commr*, 46 TC 604 (1966) .

(n96)Footnote 53. *Raich v Commr*, 46 TC 604 (1966) .

(n97)Footnote 54. A liability falls within *IRC* § 357(c)(3) if the transferor would have been entitled to a deduction had the transferor paid the liability and the transfer not taken place. *Black & Decker Corp v US*, 436 F3d 431,436 (4th Cir 2006) . Further, even though the legislative history of *IRC* § 357(c)(3) makes clear that Congress had in mind the trap for the unwary described above when liabilities are transferred to a corporation along with the assets of an incorporated trade or business, two courts of appeal have determined that the plain language of *IRC* § 357(c)(3) is not limited to this paradigm case but is applicable to any assumption of liabilities by a corporation in exchange for its stock; there is no requirement that the assets associated with those liabilities must likewise be transferred to the corporation. *Coltec Indus, Inc v US*, 454 F3d 1340, 1349 (Fed Cir 2006) ; *Black & Decker Corp v US*, 436 F3d 431 436-437 (4th Cir 2006) .

(n98)Footnote 55. A discussion of *IRC* § 736(a) can be found in § 14.04[1][a][ii].

(n99)Footnote 1. Only stock issued to transferors of property can be counted for control. Stock issued to one who just renders services to the corporation does not qualify, but the mere fact that stock is issued for services will not prevent use of *IRC* § 351 by other, if they transfer property and can themselves achieve the necessary control.

1-3 Taxation of Securities Transactions § 3.02

(n100)Footnote 2. *IRC § 368(c)*. An outstanding issue of stock may not have to be counted as a class of stock if it in fact does not represent an equity interest. *Rev Rul 66-333, 1966-2 CB 114* (shares of special preferred stock issued to Federal Housing Administration in compliance with the requirements of law not treated as a class of stock).

An attempt to use the attribution rules to boost a transferor's ownership to the required 80 percent level failed in *Yamamoto v Commr, TC Memo 1986-316*.

(n101)Footnote 3. *Cf Rev Rul 66-339, 1966-2 CB 274*, holding that shareholders' voting agreements, stockwarrants, options, rights, convertible debentures and similar rights to purchase stock are not voting securities for the purpose of *IRC § 351(b)*.

(n102)Footnote 4. *Rev Rul 59-259, 1959-2 CB 115*.

(n103)Footnote 5. *Portland Oil Co v Commr, 109 F2d 479 (1st Cir), cert denied 310 US 650 (1940)*; *America Compress & Warehouse Co v Bender, 70 F2d 655 (5th Cir 1934)*.

(n104)Footnote 6. An incorporating transfer followed by a prearranged exchange of the acquired stock for stock of a public corporation has been treated as a sale of the transferred property rather than a *IRC § 351* transaction and a stock for stock reorganization. The original transfer could not fit within *IRC § 351* because of the lack of control in the transferors immediately after the exchange. *Rev Rul 70-140, 1970-1 CB 73*; *Rodman v Commr, 57 TC 113 (1971)*, *acq 1972-1 CB 2*. The opposite result was reached in *Vest v Commr, 57 TC 128 (1971)*, *rev'd in part, aff'd in part on other grounds 481 F2d 238 (5th Cir 1973)*. The incorporation there served a valid business purpose and was not merely a transitory step in the acquisition of the property by the publicly held corporation.

A shift of ownership pursuant to an agreement to sell is not automatically fatal. If the sale is to persons who themselves are transferors, and the stock received directly by them for property is not of relatively small value in relation to the value of the purchased stock, the control requirement is satisfied. *Rev Rul 79-194, 1979-1 CB 145*.

A transfer of assets to a corporation (first corporation) in exchange for an amount of stock in that corporation constituting control satisfies the control requirement even if, pursuant to a binding agreement entered into by the transferor with a third party prior to the exchange, the transferor transfers the stock of the first corporation to a second corporation simultaneously with the transfer of assets by the third party to the second corporation, and immediately after the transfer the transferor and third party are in control of the second corporation. *Rev Rul 2003-51, 2003-1 CB 938*.

(n105)Footnote 7. *14 TC 786 (1950)*, *aff'd, 188 F2d 127 (2d Cir 1951)*, *cert denied 342 US 824*.

(n106)Footnote 8. *14 TC at 790*.

(n107)Footnote 9. *11 TC 397 (1948)*, *aff'd, 177 F2d 513 (3d Cir 1949)*, *cert denied 339 US 920*.

(n108)Footnote 10. *11 TC at 406-407*.

(n109)Footnote 11. *Wilgard Realty Co v Commr, 127 F2d 514 (2d Cir 1942)*, *cert denied 317 US 655*.

(n110)Footnote 12. If the transfer is part of a divisive reorganization that qualifies for nonrecognition treatment in whole or in part, then, solely for purposes of determining the tax treatment of the transfers of property to the controlled corporation by the distributing corporation, the fact that the shareholders of the distributing corporation dispose of part or all of the distributed stock, or the fact that the corporation whose stock was distributed issues additional stock, shall not be taken into account in determining control for purposes of *IRC § 351*. *IRC § 351(c)(2)*.

(n111)Footnote 13. This, of course, assumes that the recipients are transferors of property and that the transfer does not run afoul of *Treas Reg § 1.351-1(a)(1)(ii)*, which provides that stock issued for property which has relatively little

value in comparison to the value of stock already owned is not stock issued for property, and therefore stock which can be counted for recipients are transferors of property, control, if the primary purpose of the transfer is to qualify transfers by others.

The owner of a noncorporate business and an underwriter transferred property to a corporation in exchange for all of its stock. Because the transfer by the underwriter was pursuant to a firm-commitment underwriting under which the underwriter had to retain any shares that could not be sold to the public, the underwriter was considered a transferor for control purposes. *Rev Rul 78-294, 1978-2 CB 141* .

One of two transactions forming part of an overall plan involved a forward subsidiary merger in which shareholders of the merged corporation received stock of the surviving corporation's parent. In the other transaction, a second corporation transferred part (but not substantially all) of its assets to the parent corporation in exchange for its stock. After both transactions, the shares held by the second corporation and by the former shareholders of the merged corporation were sufficient to constitute control, but since there was no transfer of property by those former shareholders, their shares could not be counted towards control. *Rev Rul 84-44, 1984-1 CB 105* .

(n112)Footnote 14. *Rev Rul 73-472, 1973-2 , CB 114*.

(n113)Footnote 15. *Rev Rul 73-473, 1973-2 CB 115* .

(n114)Footnote 16. *Treas Reg § 1.351-1(a)(1)*. The assets of a noncorporate business were transferred to a new corporation in exchange for one half of the authorized shares. The balance of the stock was sold to the public by an underwriter within the next two weeks. Held, the transferor of the assets and the public were treated as transferors for purposes of *IRC § 351*. *Rev Rul 78-294, 1978-2 CB 141* .

For purposes of *IRC § 351*, if a person acquires stock of a corporation from an underwriter in exchange for cash in a qualified underwriting transaction, the person is treated as transferring cash to the corporation in exchange for the stock and the underwriter is ignored. A qualified underwriting transaction is one in which a corporation issues stock for cash in an underwriting under which either the underwriter is an agent of the corporation or the underwriter's ownership of the stock is transitory. *Treas Reg § 1.351-1(a)(3)*.

(n115)Footnote 17. *Treas Reg § 1.351-1(b)(1)*.

(n116)Footnote 18. *Treas Reg § 1.351-1(b)(1)*. The exchange itself remains tax-free. The tax consequences which flow from the "reapportionment" depend on the reasons therefor. *Treas Reg § 1.351-2(b)(2)*, Ex (1).

(n117)Footnote 1. *1962-2 CB 527* .

(n118)Footnote 2. See *IRC § 351(e)*, the predecessor of which was added to the Code by the Foreign Investors Tax Act of 1966. See S Rep No 1707, 89th Cong, 2d Sess 61 (1966).

(n119)Footnote 3. See *IRC § 721(b)*. Whether or not a contribution of property to a partnership is denied tax-free status depends on whether the partnership would have been treated as an investment company within the meaning of *IRC § 351* if it had been incorporated. Unlike *IRC § 351*, however, while gain is recognized in a transfer of property to an investment company partnership, loss is not recognized.

(n120)Footnote 4. See *IRC § 683(a)*. As in *IRC § 721(b)*, whether or not a contribution of property to a trust is denied tax-free status depends on whether the trust would have been treated as an investment company within the meaning of *IRC § 351* if the trust were a corporation. Further, only gain, not loss, is recognized in a transfer of property to an investment company trust.

(n121)Footnote 5. See *IRC § 368(a)(2)(F)*. This provision was intended to foreclose a possible end run around *IRC*

§ 351(e). While two or more investors could not combine their undiversified portfolios tax-free by contributing them to a single corporation, each investor might instead contribute his undiversified portfolio to a wholly owned corporation and, after a time, merge the corporations in a tax-free reorganization, thereby creating a single surviving corporation with a diversified portfolio. *IRC* § 368(a)(2)(F) precludes this result by imposing tax on the transfers from the individual nondiversified "investment company" transferors to the surviving entity notwithstanding the reorganization provisions. See Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 (HR 10612, 94th Cong, Pub L 94-455) (1976), 662-667. See also Ch 8, § 8.07[5].

(n122)Footnote 6. Stocks and securities are considered held for investment unless they are (i) held primarily for sale to customers in the ordinary course of business, or (ii) used in the trade or business of banking, insurance, brokerage, or a similar trade or business. *Treas Reg* § 1.351-1(c)(3).

(n123)Footnote 7. *Treas Reg* § 1.351-1(c)(1)(ii).

(n124)Footnote 8. See *IRC* § 351(e)(1), as amended by Section 1002 of the Taxpayer Relief Act of 1997 (Pub L 105-34). As noted above, the investment company exception for partnerships and trusts references the provisions of section 351 (see fns 3 and 4, *supra*), so any amendment to section 351 or the regulations thereunder applies, *mutatis mutandis*, to asset transfers to partnerships and trusts under *IRC* §§ 721(b) and 683(a). Other than expanding the types of assets to be taken into account in applying the 80 percent test, Congress did not intend the 1997 amendments to override the provisions of the existing regulations defining the investment company exception. See Staff of Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in 1997" (Dec 17, 1997) (hereafter, "1997 Bluebook"), at 184. Thus, no asset is included in the numerator of the 80 percent test unless it is actually held for investment as required by *Treas Reg* § 1.351-1(c)(3) (see fn 6). 1997 Bluebook, at 184. See also *IRC* § 351(e)(1)(B)(v) (investment requirement made explicit in case of an interest in precious metals).

(n125)Footnote 9. *IRC* § 351(e)(1)(A).

(n126)Footnote 10. The regulations provide that while the determination of whether the 80 percent test is met is ordinarily made by reference to the circumstances existing immediately after the property-for-stock exchange, a subsequent change in circumstances will be taken into account if it occurs as the result of a plan in existence at the time of the transfer. *Treas Reg* § 1.351-1(c)(2). Citing this regulation, the Joint Committee on Taxation's explanation of the 1997 amendment states that cash contributed to the transferee will not be treated as "stocks and securities" if, pursuant to a plan in existence at the time of the transfer, the contributed cash is subsequently used to purchase assets other than "stocks and securities" as defined in *IRC* § 351(e)(1), or the transferee uses the cash to make expenditures not resulting in the acquisition of an asset (eg, for payment of salaries). 1997 Bluebook, at 184.

(n127)Footnote 11. *IRC* § 351(e)(1)(B).

(n128)Footnote 12. *Treas Reg* § 1.351-1(c)(4).

(n129)Footnote 13. *IRC* § 351(e)(1)(B)(vi).

(n130)Footnote 14. *IRC* § 351(e)(1)(B)(vii).

(n131)Footnote 15. *IRC* § 351(e)(1)(B)(iv).

(n132)Footnote 16. See *Treas Reg* § 1.351-1(c)(1)(i).

(n133)Footnote 17. *Treas Reg* § 1.351-1(c)(5). A *de minimis* exception protects the nontaxable status of transfers in which only an insignificant portion of the total value of assets transferred is not identical. For example, if A and B each transfers \$10,000 worth of the only class of stock of Corporation X for 50 shares each of Investment Company X's stock, and C transfers \$200 worth of Corporation Y's stock (less than 1 percent of the total value of all assets transferred

to X) for 1 share of Investment Company X, C's participation in the transfer will be disregarded in determining whether the diversification requirement is met. Therefore, the transfers will not be considered as resulting in the diversification of the transferors' interests, and neither A, B, nor C will be required to recognize gain on the transfers under the investment company exception. *Treas Reg § 1.351-1(c)(7)* (Example 1). Compare *Rev Rul 87-9, 1987-1 CB 133* (contribution of nonidentical assets by one of the transferors that represented 11 percent of the total value of assets contributed was not "insignificant").

(n134)Footnote 18. If a transfer of identical assets is part of a plan to achieve diversification without recognition of gain, such as a plan which contemplates a subsequent transfer, however delayed, of the corporate assets (or of the stock or securities received in the earlier exchange) to an investment company in a transaction purporting to qualify for nonrecognition treatment, the original transfer will be treated as resulting in diversification. See *Treas Reg § 1.351-1(c)(5)*. This "look-back" provision is not applicable if the transferee corporation plans to dispose of all or a portion of the contributed identical stock and securities through taxable sales and to use the proceeds to purchase a diversified portfolio of stock and securities, for such a plan does not contemplate a subsequent nontaxable transfer. See *Rev Rul 88-32, 1988-1 CB 113*.

(n135)Footnote 19. *Treas Reg § 1.351-1(c)(6)*. The IRS has ruled privately that the result is the same if, as part of the transaction, one or more transferors contribute cash rather than a diversified portfolio of stock and securities to the investment company; the transferors who contribute diversified portfolios of stock and securities do not recognize gain or loss. See *PLR 200934013 (2009)*; *PLR 200931042 (2009)*. On the other hand, in a transaction in which a transferor contributes stock of a single issuer to a newly organized corporation and another transferor contributes cash, the transferor contributing stock will be deemed to have diversified his investment and the stock transfer will be taxable under the investment company exception since the transferors have contributed nonidentical assets and neither has contributed a diversified portfolio of stock and securities. See *Rev Rul 87-9, 1987-1 CB 133*.

(n136)Footnote 20. The diversification test is borrowed from *IRC § 368(a)(2)(F)(ii)*, which sets out requirements that must be met to avoid recognition of gain under *IRC § 368 (a)(2)(F)* with respect to transfers of stock and securities pursuant to a diversifying reorganization. See fn 5, *supra*.

(n137)Footnote 1. *IRC § 351(e)(2)*.

(n138)Footnote 2. *IRC § 368(a)(3)(A)*.

(n139)Footnote 1. A transfer of property to a foreign corporation as a contribution to the capital of the corporation by persons who, immediately after the transfer, own 80 percent of the voting stock of the corporation is treated as an exchange of property for stock equal in value to the value of the property transferred. *IRC § 367(c)(2)*. The attribution rules of *IRC § 318* apply in determining ownership.

No difficulty is encountered unless gain is realized on the exchange. *Rev Rul 68-43, 1968-1 CB 146*. However, the determination of gain or loss on an asset-by-asset approach can produce recognized gain and unrecognized loss. *Rev Rul 67-192, 1967-2 CB 140*. Although the rulings applied prior law, the positions taken therein are probably still valid.

In *Abegg v Commr, 50 TC 145 (1968)*, *aff'd on other grounds 429 F2d 1209 (2d Cir 1970)*, *cert denied 400 US 1008*, a shareholder transferred securities to his wholly owned foreign corporation, but received nothing in return. The transfer was viewed as a contribution to capital and not as an *IRC § 351* exchange, with the result that *IRC § 367* was held to be inapplicable. *IRC § 367* will also not apply where the transaction is an exchange, but the conditions of *IRC § 351* are not met. *Rev Rul 70-522, 1970-2 CB 81*.

The Tax Court overruled *Abegg* to the extent that it held that no exchange had taken place, and determined in *Lessinger v Commr, 85 TC 824 (1985)*, *rev'd on other grounds 872 F2d 519 (2d Cir 1989)*, that a transfer of assets to an already existing corporation by the sole shareholder of the corporation was an exchange within *IRC § 351* even

though the shareholder did not receive any additional stock.

In the case of a transfer by a US person to a foreign corporation as paid-in surplus or as a contribution to capital in a transaction not otherwise covered by *IRC* § 367 (eg, a contribution to capital by a nonshareholder), regulatory authority is granted under *IRC* § 367 to treat the transaction as a sale or exchange at fair market value, requiring gain recognition. *IRC* § 367(f).

(n140)Footnote 2. *IRC* § 367(a)(1) applies as well to exchanges described in *IRC* §§ 332, 351, 354, 356, and 361, and to distributions described in *IRC* §§ 332 and 355 if made to a foreign corporation. *IRC* § 367(e).

If, pursuant to *IRC* § 304(a)(1), a US person is treated as transferring stock of a domestic or foreign corporation to a foreign corporation in exchange for stock of the transferee corporation in a transaction to which *IRC* § 351(a) applies, the deemed *IRC* § 351 exchange is not a transfer to a foreign corporation subject to *IRC* § 367(a). *Treas Reg* § 1.367(a)-3(a). The same holds true if, pursuant to *IRC* § 304(a)(1), a foreign acquiring corporation is treated as acquiring the stock of a foreign acquired corporation in a transaction to which *IRC* § 351(a) applies. *Treas Reg* § 1.367(b)-4(a). A discussion of *IRC* § 304(a)(1) can be found in § 5.04[1].

(n141)Footnote 3. *IRC* § 367(a)(2). The exception also applies if the foreign corporation is a party to a reorganization.

(n142)Footnote 4. *IRC* § 367(a)(3)(A). For the exception to apply, the US transferor also must comply with the reporting requirements of *IRC* § 6038B. *Temp Treas Reg* § 1.367(a)-2T(a)(2).

The active trade or business exception does not apply if the foreign corporation transfers the property to another person. A subsequent transfer within six months of the initial transfer is considered to be part of the same transaction; a subsequent transfer more than six months after the initial transfer may be considered part of the same transaction under step-transaction principles. *Temp Treas Reg* 1.367(a)-2T(c)(1). Subsequent transfers will not preclude application of the active trade or business exception if (1) the initial transfer is followed by one or more subsequent transfers granted nonrecognition treatment under either *IRC* § 351 or *IRC* § 721; (2) each subsequent transferee is either a partnership in which the preceding transferor is a general partner or a corporation in which the preceding transferor owns common stock; and (3) the ultimate transferee uses the property in the active conduct of a trade or business outside the US. *Temp Treas Reg* § 1.367(a)-2T(c)(2).

Transfers of assets by a foreign branch of a US person to a foreign corporation produce gain to the extent that the sum of losses incurred by the branch before the transfer for which a deduction was allowed exceeds the amount of those losses recaptured as US income. The amount so recognized is treated as foreign source income. *IRC* § 367(a)(3)(C).

A transfer of a partnership interest is treated as a transfer of the partner's pro rata share of the partnership assets. *IRC* § 367(a)(4).

(n143)Footnote 5. *IRC* § 367(a)(3)(B). *IRC* § 367(a)(1) applies to the transfer of installment obligations, accounts receivable, or similar property only to the extent that the principal amount of any such obligation has not previously been included in income by the taxpayer. *Temp Treas Reg* § 1.367(a)-5T(c).

Foreign currency includes installment obligations, futures contracts, accounts receivable, or any other obligation entitling its payee to receive payment in a currency other than US dollars. *Temp Treas Reg* § 1.367(a)-5T(d)(1). However, if transferred property denominated in a foreign currency is denominated in the currency of the country in which the transferee foreign corporation is organized, and was acquired in the ordinary course of business of the transferor that will be carried on by the transferee foreign corporation, then *IRC* § 367(a)(1) applies to the transfer only to the extent that gain is required to be recognized with respect to previously realized gain reflected in installment obligations subject to *Temp Treas Reg* § 1.367(a)-5T(c). *Temp Treas Reg* § 1.367(a)-5T(d)(2).

(n144)Footnote 6. Intangible property is defined as any: (1) patent, invention, formula, process, design, pattern, or know-how; (2) copyright, literary, musical, or artistic composition; (3) trademark, trade name, or brand name; (4) franchise, license, or contract; (5) method, program system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (6) any similar item, which has substantial value independent of the services of any individual.

(n145)Footnote 7. *IRC § 367(d)(1)*.

(n146)Footnote 8. *IRC § 367(d)(2)*. The amount taken into account must be commensurate with the income attributable to the intangible. The income is treated as ordinary income. *IRC § 367(d)(2)(C)*. Prior to 1997, the income was treated as US source income. The Taxpayer Relief Act of 1997 repealed the US-source treatment of the income. This should mean that the income will be governed by the source rules for royalties contained in *IRC §§ 861(a)(4)* and *862(a)(4)*. Thus, if the intangible property is used outside the US, the income will be foreign-source income.

For purposes of applying *IRC § 904(d)* (discussed in § 20.02[4][e][iii]), the amount is treated as if it were a royalty.

(n147)Footnote 9. *IRC § 367(d)(2)(B)*.

(n148)Footnote 10. *Treas Reg § 1.367(a)-3(b)(1)*. The agreement must be attached to, and filed by the due date (including extensions) of, the transferor's income tax return for the year of transfer. *Treas Reg § 1.367(a)-8(d)*. The information required in the agreement is set forth in *Treas Reg § 1.367(a)-8(a)(2)* and (3). The transferor also must file a waiver of the period of limitation on assessment of tax on the gain realized on the transfer. *Treas Reg § 1.367(a)-8(f)*.

Annual certifications that the transferred property has not been disposed of are required throughout the five-year period. *Treas Reg § 1.367(a)-8(g)*.

(n149)Footnote 11. *Treas Reg § 1.367(a)-3(c)*.

(n150)Footnote 12. Persons who transfer stock or securities in the domestic target corporation in exchange for stock in the transferee foreign corporation are presumed to be US persons. *Treas Reg § 1.367(a)-3(c)(2)*. The presumption can be rebutted by the domestic target corporation obtaining ownership statements from a sufficient number of transferors who are not US persons to demonstrate that the 50% threshold is not exceeded. *Treas Reg § 1.367(a)-3(c)(7)*.

Stock of the transferee foreign corporation owned directly or indirectly (applying the attribution rules of *IRC § 267(c)(1)* and (5)) by the domestic target corporation is not taken into account in determining whether the 50% threshold is exceeded or whether a control group exists. *Treas Reg § 1.367(a)-3(c)(4)(iii)*.

The attribution rules of *IRC § 318*, as modified by *IRC § 958(b)*, apply in determining the ownership of stock. *Treas Reg § 1.367(a)-3(c)(4)(iv)*. Options (or similar interests) are treated as exercised and counted as stock for purposes of determining whether the 50% threshold is exceeded or whether control exists if a principal purpose of the issuance or acquisition of the option (or other interest) was the avoidance of the general rule of *IRC § 367(a)(1)*. *Treas Reg § 1.367(a)-3(c)(4)(ii)*.

(n151)Footnote 13. A qualified subsidiary is a foreign corporation whose stock is at least 80% owned (by total voting power and total value), directly or indirectly, by the transferee foreign corporation. *Treas Reg § 1.367(a)-3(c)(5)(vii)*. However, a corporation will not be treated as a qualified subsidiary if it was affiliated with the domestic target corporation at any time during the 36-month period preceding the transfer, or if it was acquired by the transferee foreign corporation at any time during that period for the principal purpose of satisfying the active trade or business test.

A qualified partnership is a partnership in which the transferee foreign corporation has active and substantial

management functions as a partner with respect to the partnership business, or has at least a 25% interest in the partnership's capital and profits. *Treas Reg § 1.367(a)-3(c)(5)(viii)*. A partnership is not a qualified partnership if the domestic target company or any of its affiliates held a 5% or greater interest in the partnership's capital and profits during the 36-month period prior to the transfer, or if the transferee foreign corporation's interest was acquired during that period for the principal purpose of satisfying the active trade or business test.

(n152)Footnote 14. *Treas Reg § 1.367(a)-8(c)(1)*.

(n153)Footnote 15. *Id.*

(n154)Footnote 16. *Id.*

(n155)Footnote 17. *Treas Reg § 1.367(a)-8(c)(1)(iii)(A)*. The US transferor may file an election with the GRA to report the unrealized gain in the year the gain recognition event occurs rather than in an amended return for the year in which the initial transfer took place. *Treas Reg § 1.367(a)-8(c)(iii)(B)*. In either case, however, interest must be paid on the additional tax attributable to the previously unreported gain, calculated from the due date of the return for the year of the initial transfer. *Treas Reg § 1.367(a)-8(c)(1)(v)*.

(n156)Footnote 18. *Treas Reg § 1.367(a)-8(c)(4)*.

(n157)Footnote 19. *Treas Reg § 1.367(a)-8(j)(1)*. If there is only a partial disposition, only a proportionate amount of the gain realized but unrecognized on the initial transfer need be reported under the GRA. Such portion is determined by the ratio that the fair market value of stock or securities disposed of bears to the fair market value of the stock or securities initially transferred, with both values determined as of the date of the partial disposition. The total amount of gain subject to the GRA is reduced by the amount of the partially recognized gain. *Treas Reg § 1.367(a)-8(c)(1)*.

(n158)Footnote 20. *Treas Reg § 1.367(a)-8(b)(1)(iii)*. A disposition by installment sale is treated as made in the year of sale. *Id.*

(n159)Footnote 21. *Treas Reg § 1.367(a)-8(j)(2)*.

(n160)Footnote 22. *Treas Reg § 1.367(a)-8(j)(3)*.

(n161)Footnote 23. *Treas Reg § 1.367(a)-8(j)(4)*. For purposes of this provision, an individual US transferor that loses US citizenship or ceases to be a lawful US permanent resident is treated as having disposed of all the stock of the transferee foreign corporation as of the date before the loss of such status. *Id.*

(n162)Footnote 24. *Treas Reg § 1.367(a)-8(j)(5) and (6)*. A deconsolidation that occurs by reason of the acquisition of the assets of the US transferor in a transaction to which *IRC § 381(a)* applies (in general, a nontaxable liquidation or a reorganization) or by reason of the US transferor joining another consolidated group as part of the same transaction, is not treated as a gain recognition event. *Id.*

(n163)Footnote 25. *Treas Reg § 1.367(a)-8(j)(7)*.

(n164)Footnote 26. *Treas Reg § 1.367(a)-8(j)(8)*.

(n165)Footnote 27. *Treas Reg § 1.367(a)-8(k)(14)*.

(n166)Footnote 28. *Treas Reg § 1.367(a)-8(b)(2)(iii)*.

(n167)Footnote 29. *Treas Reg § 1.367(a)-8(b)(1)(viii)*.

(n168)Footnote 30. *Treas Reg § 1.367(a)-8(b)(1)(xii)*.

(n169)Footnote 31. *Treas Reg § 1.367(a)-8(k)(14)(ii)*.

(n170)Footnote 32. See *Treas Reg § 1.367(a)-8(h)*.

(n171)Footnote 33. *Treas Reg § 1.367(a)-8(k)(9)*.

(n172)Footnote 34. *Treas Reg § 1.367(a)-8(k)(2)*.

(n173)Footnote 35. *Treas Reg § 1.367(a)-8(k)(10)* and *(11)*. If the US transferor becomes a member of a new consolidated group and is not the common parent of the group, the common parent must file the GRA as agent for the US transferor. *Treas Reg § 1.367(a)-8(d)(3)*.

(n174)Footnote 36. *Treas Reg § 1.367(a)-8(k)(12)*.

(n175)Footnote 37. *Treas Reg § 1.367(a)-8(k)(3)*.

(n176)Footnote 38. *Treas Reg § 1.367(a)-8(k)(4)*.

(n177)Footnote 39. See *Treas Reg § 1.367(a)-8(p)(1)*.

(n178)Footnote 40. *Treas Reg § 1.367(a)-8(p)(2)*.

(n179)Footnote 41. *IRC § 367(b)(2)*; *Treas Reg § 1.367(b)-1(a)*. Nothing in the *IRC § 367(b)* regulations can permit the nonrecognition of income that would otherwise be required to be recognized, or the recognition of a loss or deduction that would otherwise not be recognized, under another provision of the Internal Revenue Code or regulations. *Treas Reg § 1.367(b)-1(b)(1)(ii)*.

The Service will not ordinarily rule whether a foreign corporation is considered a corporation for purposes of any nonrecognition provision listed in *IRC § 367(b)*, and related issues, unless the ruling presents a significant legal issue or Subchapter C rulings are requested in the context of reorganizations or liquidations involving foreign corporations. *Rev Proc 2010-7, 2010-1 IRB 231 (§ 4.01(2))*.

(n180)Footnote 42. *Treas Reg § 1.367(b)-1(c)(1), (2)*. The information required is set forth in *Treas Reg § 1.367(b)-1(c)(4)*. An abbreviated notice is permitted in the case of a foreign acquired corporation that never had any earnings and profits that would result in a shareholder having an all earnings and profits amount. *Treas Reg § 1.367(b)-1(c)(5)*.

(n181)Footnote 43. *Treas Reg § 1.367(b)-1(c)(3)*.

(n182)Footnote 44. *IRC § 6038B(a)*; *Treas Reg § 1.6038B-1*.

(n183)Footnote 45. *IRC § 6038B(c)(1), (2)*.

(n184)Footnote 46. *IRC § 6038B(c)(3)*.



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Taxation of Securities Transactions

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CHAPTER 3 Forming the Corporation

1-3 Taxation of Securities Transactions § 3.03

§ 3.03 The Transferor's Basis

Consistent with the theory that a transfer to a controlled corporation works only a change in form, *IRC Section 358* prescribes a set of substituted basis rules. Where the transferor receives only nonrecognition property (stock, or stock and securities in a pre-October 3, 1989 transfer), the basis of such property is exactly the same as the basis of the property given up in the exchange. If the transferor receives more than one class of stock (or stock and securities in a pre-October 3, 1989 transfer), an allocation of the preserved basis becomes necessary.ⁿ¹ Under the Regulations, the allocation is to be in proportion to the fair market values of each class of nonrecognition property.ⁿ² Therefore, if the basis of the transferred property was \$8,000, and the transferor received Class A stock worth \$12,000 and Class B stock having a value of \$4,000, the basis of the Class A stock would be \$6,000, and the basis of the Class B stock, \$2,000.ⁿ³

When "boot" (including securities received in a post-October 2, 1989 transfer) is part of the consideration received by the transferor, a number of additional factors enter into the determination of basis. The first is the basis of the "other property," and *IRC Section 358(a)(2)* provides, simply, that it is the fair market value of such property. The second is the effect of "boot" on the basis of the nonrecognition property received on the exchange. The starting point here is the same as if "boot" had not been received, namely, the transferor's basis for the transferred property. Only now the original basis must be decreased by the amount of money and the fair market value of any other "boot" received by the taxpayer, and increased by the amount of gain recognized on the exchange.ⁿ⁴

Example:

Assume a transfer of property with a basis of \$10,000 in exchange for stock worth \$12,000, other property worth \$2,000 and cash of \$1,000. The gain realized by the transferor would be \$5,000; the gain recognized, \$3,000 (the "boot" received). The basis of the other property would be its fair market value, \$2,000; the basis of the stock, \$10,000. The last figure is the transferor's original basis of \$10,000, decreased by the amount of money (\$1,000) and the fair market value of other property (\$2,000) received on the exchange, and increased by the amount of gain recognized (\$3,000).

It was indicated in § 3.02[2] that the asset-by-asset approach is the preferred means of determining the amount of realized and recognized gain in the case of multiple-asset transfers. An unanswered question is whether the fragmented approach must also be employed in allocating "boot" for basis purposes.ⁿ⁵ The problem is posed by the transfer of two assets, one with a basis of \$500 and a value of \$1,000, and the other with a basis of \$700 and a value of \$1,000, in exchange for 100 shares of stock worth \$1,500 and \$500 cash. Using the comminuted approach, and allocating in

proportion to fair market value, the consideration deemed received for each asset is \$1,000, consisting of fifty shares of stock worth \$750 and \$250 in cash. The realized gain of \$500 on the first asset (the one with the \$500 basis) is recognized to the extent of \$250, the amount of "boot". The realized gain of \$300 on the other asset is similarly recognized only to the extent of \$250. If the asset-by-asset approach must be carried through to the determination of basis, the fifty shares received for the first asset would assume a basis of \$500 (\$500 original basis, less \$250 money received, plus \$250 recognized gain), while the basis of the remaining fifty shares would be \$700 (\$700 original basis, less \$250, money received, plus \$250 gain recognized). It is true that in this case (but not in every case) the total basis of the 100 share of stock would be the same under the aggregate approach, so that a sale of all of the shares at one time would produce the same gain or loss no matter which method was used to compute basis. However, a sale of less than all the shares would produce different results, since the per-share basis determined under the aggregate approach would be \$12 (\$1,200 divided by one hundred shares), while under the asset-by-asset approach, fifty of the shares would have a per-share basis of \$10 (\$500 divided by fifty shares) and the other fifty, a per-share basis of \$14 (\$700 divided by fifty shares).ⁿ⁶

Although the assumption of a liability by the transferee corporation does not result in the receipt of "boot" by the transferor, except in limited situations,ⁿ⁷ such assumption or acquisition generally invokes a basis adjustment. *IRC Section 358(d)* decrees that, for basis purposes, the amount of liability assumed must be considered money received on the exchange, thus decreasing the transferor's original basis by that amount.ⁿ⁸ The only exception to this rule relates to certain accounts payable which are not treated as liabilities by virtue of *IRC Section 357(c)(3)*.ⁿ⁹

If the basis of stock received by the transferor exceeds its fair market value, the basis must be reduced (but not below fair market value) by the amount of any liability assumed by another person as part of the exchange for the stock that did not otherwise reduce basis.ⁿ¹⁰ Except as provided by the Service, this rule does not apply to any liability if (a) the trade or business with which the liability is associated is transferred to the transferee corporation as part of the exchange, or (b) substantially all of the assets with which the liability is associated is transferred to the transferee corporation as part of the exchange.ⁿ¹¹

FOOTNOTES:

(n1)Footnote 1. *IRC § 358(b)(1)*.

(n2)Footnote 2. *Treas Reg § 1.358-2(b)(2)*. The transferor cannot determine the bases and holding periods of each class of stock by designating specific property to be exchanged for particular stock. Rather, the aggregate basis of the transferred property is allocated among the classes of stock received in proportion to the fair market value of each class. *Rev Rul 85-164, 1985-2 CB 117*.

(n3)Footnote 3. On the basis of the given facts, 12/16 (\$12,000/\$16,000) of the old basis is allocated to the Class A stock and 4/16 (\$4,000/\$16,000) to the Class B stock.

(n4)Footnote 4. *IRC § 358(a)(1)*.

(n5)Footnote 5. The regulations appear to suggest an aggregate approach. *Treas Reg § 1.358-2(b)(2)*.

(n6)Footnote 6. The existence of a different basis for each fifty share lot requires a consideration of the identification rules discussed in § 1.05[7]. See also Cohen & Whitney, "Revisiting the Allocation of Boot in Section 351 Exchanges," 48 *Tax Lawyer* 959 (1995), and Rabinovitz, "Allocating Boot in Section 351 Exchanges," 24 *Tax L Rev* 337 (1969).

(n7)Footnote 7. See § 3.02[2][b][ii].

(n8)Footnote 8. Prior to 1999, a liability to which property acquired was subject was considered money received on the exchange as well. Legislation enacted in that year limits the rule to liabilities that are assumed. See §

3.02[2][a][ii].

The assumption by the corporation of a shareholder's obligation to deliver securities to close a short sale is treated as an assumption of a liability for purposes of *IRC* § 358. The amount of the liability assumed equals the proceeds of the original short sale. *Rev Rul 95-45, 1995-1 CB 53* .

The Service has held that contingent environmental liabilities assumed as part of a transfer to a controlled corporation are not liabilities for purposes of *IRC* § 357(c), and, thus, are not to be treated as money received in determining the transferor's basis. *Rev Rul 95-74, 1995-2 CB 36* .

(n9)Footnote 9. *IRC* § 358(d)(2). § 3.02[2][b][ii] for a discussion of *IRC* § 357(c)(3). Two courts have concluded that if a liability is excluded by *IRC* § 357(c)(3) standing alone, then the exception contained in *IRC* § 357(d)(2) applies, whether or not the anti-abuse provision of *IRC* § 357(b)(1) overrides the application of *IRC* § 357(c)(3) for gain recognition purposes. *Coltec Indus, Inc v US, 454 F3d 1340, 1351 (Fed Cir 2006)* ; *Black & Decker Corp v US, 436 F3d 431, 438-439 (4th Cir 2006)* . However, the Federal Circuit, in *Coltec* held that lack of economic substance in a transaction can override the literal application of the Code in a case in which *IRC* §§ 357(c)(3) and 358(d)(2) would otherwise control.

(n10)Footnote 10. *IRC* § 358(h)(1). The amount of the liability is determined as of the date of the exchange.

For this purpose, the term "liability" includes any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of income taxation. *IRC* § 358(h)(3).

(n11)Footnote 11. *IRC* § 358(h)(2). *Treas Reg* § 1.358-5 removes the second exception ("substantially all of the assets") for exchanges occurring on or after May 9, 2008.



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CHAPTER 3 Forming the Corporation

1-3 Taxation of Securities Transactions § 3.04

§ 3.04 The Transferor's Holding Period

Since the basis of stock received in an *IRC Section 351* exchange is determined in accordance with substituted basis rules, the holding period of the stock includes the period during which the transferred property was held by the transferor, provided such property was either a capital asset or *IRC Section 1231* property.ⁿ¹ If the property exchanged consists not only of capital assets or Section 1231 property, but of noncapital assets as well, the result will be a split holding period for each share of stock. In such case, the extent to which the stock takes a tacked holding period or one which commences with the exchange, will depend on the relative values of the "tacking" property and the noncapital assets.

FOOTNOTES:

(n1)Footnote 1. *IRC § 1223(1)*; see *§ 2.05[2][b][ii]*.



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CHAPTER 3 Forming the Corporation

1-3 Taxation of Securities Transactions § 3.05

§ 3.05 Effect on the Transferee Corporation

[1] Gain or Loss on the Issuance of Stock.

Pursuant to *IRC Section 1032*, a corporation does not recognize any gain or loss realized on the issuance of its stock, including treasury stock, in exchange for money or other property. Although the language of the statute seems to preclude nonrecognition when stock is issued as compensation for services, the Regulations consider such a transfer "as a disposition by the corporation of such shares for money or other property."¹

What is stock for the purpose of *IRC Section 1032*? Neither the statute nor the Regulations gives any clue as to the meaning of the term. And in only a few cases has the result turned on the issue of whether the corporation issued stock.² From the decisions in these cases, and the silence of the Code and Regulations, it is fairly safe to assume that whenever the item issued lacks too many of the ordinary attributes of stock, i.e., the right to dividends, the right to share to some extent in the assets upon dissolution, and the right to participate in profits and management, the corporation will be called upon to recognize income.

[2] Basis of Acquired Property.

Just as nonrecognition of gain or loss dictates a substituted basis for the transferor, so it does for the transferee corporation. *IRC Section 362(a)* provides that the basis of the property received "shall be the same as it was in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer."¹ It should be noted that, contrary to the general rule, the assumption of liability by the transferee will have no effect on basis, unless the assumption triggers the recognition of gain under *IRC Section 357(b)*, or *IRC Section 357(c)*.

Is the basis of each asset transferred to be kept the same, or can the transferee effect a realignment of basis by allocating the aggregate basis of the entire property among the various assets in proportion to their fair market values? A related concern is the manner in which any increase resulting from the recognition of gain by the transferor should be allocated. The Code and Regulations say nothing with respect to either of these issues. Case law provides an answer to the first, namely, that the basis of each asset must be carried over without reallocation.² However, no answer has been forthcoming on the second. Four allocation methods suggest themselves. The first would apportion the gain to all of the transferred assets by reference to fair market values. A second would allocate gain only to those assets which produced gain in the proportion that the increase in value of each asset bore to the total appreciation in all of the assets. Another would look to the relative bases of the transferred property to provide the proper proportion. The last would call for an

equal percentage increase in all assets, the percentage being determined by comparing the total recognized gain with the total original basis. The differences in result can be striking.

Example:

A taxpayer transfers land with a basis of \$50,000 and a net value of \$200,000, and a building with a basis of \$750,000 and a net value of \$800,000, to a corporation in exchange for stock of the transferee corporation and the latter's assumption of an \$850,000 mortgage on the entire property. Because the assumed liability exceeds the basis of the property transferred, the transferor is required to recognize gain of \$50,000.ⁿ³ If gain is allocated to assets producing gain on the basis of the relative amounts of gain inherent in each asset, \$37,500 of the gain would be allocated to the land and \$12,500 to the building. If the allocation proceeds on the basis of relative fair market values, \$37,500 would be allocated to the building and \$12,500 to the land; the same result would obtain if the gain was allocated on an equal percentage basis. Using the relative bases of the assets would yield an increase of \$3,125 to the basis of the land and \$46,875 to the basis of the building.

If a net built-in loss is imported into the United States in a tax-free corporate organization, *IRC Section 362(e)(1)* causes the basis of the property transferred to the corporation to be its fair market value if (i) gain or loss with respect to the property is not subject to federal income tax in the hands of the transferor immediately before the transfer, and (ii) gain or loss with respect to the property is subject to federal income tax in the hands of the transferee immediately after the transfer.ⁿ⁴ There is an importation of a net-built-in loss in a transaction if the transferee's aggregate bases of the transferred property would exceed the fair market value of the property after the transaction.ⁿ⁵

If, in connection with a tax-free corporate organization, there is a transfer of built-in loss that is not governed by *IRC Section 362(e)(1)*, and the transferee's aggregate adjusted bases of the property transferred exceed the fair market value of the property immediately after the transaction, then the transferee's aggregate adjusted bases of the transferred property cannot exceed the fair market value of the property immediately after the transaction.ⁿ⁶ Any basis reduction required because of the foregoing rule is allocated among the transferred property in proportion to their respective built-in losses immediately before the transaction.ⁿ⁷ However, in lieu of limiting the basis of the transferred assets, the parties to the transaction can elect to limit the basis of the stock received by the transferor to the aggregate fair market value of the transferred property.ⁿ⁸

[3] Holding Period of Acquired Property.

Since the corporation's basis for the property received on the exchange is determined by reference to its basis in the hands of the transferor, the corporation can tack the transferor's holding period to its own.ⁿ¹ Here there is no requirement that the asset have been a capital asset or Section 1231 property when held by the transferor. It is sufficient that the property partake of that nature when it enters the hands of the transferee.

[4] Transfers of Property by the Transferee Corporation.

IRC Section 351(f) treats a transfer of property by the transferee corporation as a distribution governed by *IRC Section 311*, if the transferor did not recognize gain or loss (in whole or in part) under *IRC Section 351* and the original transfer was not part of a plan of reorganization. This means that the transferee will recognize gain on its transfer of the property.ⁿ¹

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.1032-1(a)*. The corporation may also be entitled to a deduction under *IRC § 162(a)*. Non-recognition of gain under *IRC § 1032* has no effect on deductibility. *Duncan Inds, Inc v Commr*, 73 TC 266 (1979); *Rev Rul 62-217*, 1962-2 CB 59.

(n2)Footnote 2. *Affiliated Govt Employees' Distrib Co v Commr*, 322 F2d 872 (9th Cir 1963) , cert denied 376 US

950 ; *Community TV Assn v US*, 203 F Supp 270 (D Mont 1962) .

(n3)Footnote 1. In no event can the basis of property be increased above the fair market value of the property, determined without regard to *IRC § 7701(g)* (fair market value of property subject to a nonrecourse liability treated as not less than the amount of the debt). *IRC § 362(d)(1)*. If gain is recognized to the transferor as a result of an assumption of a nonrecourse liability that is also secured by assets that are not transferred to the transferee, and no person is subject to tax on the gain, the basis can be increased only by the ratable portion of the liability determined according to the relative fair market values of all assets subject to the liability. *IRC § 362(d)(2)*.

The term "recognized" has been construed to mean "should have been recognized" so that the failure of the transferor to recognize gain will not prevent an upward adjustment of basis by the corporation. *Fahs v Florida Mach & Foundry Co*, 168 F2d 957 (5th Cir 1948) . See generally Burford, "Basis of Property After Erroneous Treatment of a Prior Transaction," 12 *Tax L Rev* 365 (1957).

One corporation transferred its treasury stock to another in exchange for 80 percent of the stock of the acquiring corporation. The Service originally ruled that the transferor's basis in the transferee corporation's stock received in the exchange was determined under *IRC § 362(a)* and that both the treasury stock received by the transferee and the stock acquired by the transferor have a basis of zero. *Rev Rul 74-503*, 1974-2 CB 117 . The Service now takes the position that *IRC § 362(a)* does not apply to the transaction; the zero basis ruling is under study. *Rev Rul 2006-2*, 2006-1 CB 261. *Rev Rul 74-503* has been revoked, but the Service will not challenge a position taken prior to Dec 20, 2005, with respect to a transaction occurring before that date.

(n4)Footnote 2. *PA Birren & Son, Inc v Commr* 116 F2d 718 (7th Cir 1940) ; *Gunn v Commr*, 25 TC 424 (1955) , *aff'd per curiam* 244 F2d 408 (10th Cir) , *cert denied* 355 US 830 . This view is also reflected in administrative decision. Thus a corporation was required to assume a zero basis for inventory items, that basis arising from the prior deduction of the cost of the items by a cash basis transferor. *Rev Rul 69-117*, 1969-1 CB 12 .

(n5)Footnote 3. *IRC § 357(c)*.

(n6)Footnote 4. If the transferor is a partnership, the provision is applied by treating each partner as holding the partner's proportionate share of the property of the partnership.

(n7)Footnote 5. *IRC § 362(e)(1)(C)*.

(n8)Footnote 6. *IRC § 362(e)(2)(A)*. Generally, *IRC § 362(e)(2)* does not apply to intercompany transactions occurring after September 17, 2008. *Treas Reg §§ 1.362-4(a)(2)* and *1.1502-80(h)*.

(n9)Footnote 7. *IRC § 362(e)(2)(B)*.

(n10)Footnote 8. *IRC § 362(e)(2)(C)(ii)*. The election is made at the time and in the form and manner as prescribed by the Service, and is irrevocable.

(n11)Footnote 1. *IRC § 1223(2)*.

(n12)Footnote 1. A discussion of *IRC § 311* can be found in § 4.07[1].



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CHAPTER 3 Forming the Corporation

1-3 Taxation of Securities Transactions § 3.06

§ 3.06 Financing the Corporation--The Choice Between Debt and Equity

The organizers of a corporation have wide latitude in choosing the capital structure of the newly formed enterprise. The entity may be financed solely through the issuance of stock, in which case the "owners" become shareholders only, or through the use of stock and debt securities, in which case they become both stockholders and creditors. State corporation laws have little effect on the ultimate choice, for if they even prescribe a minimum capital requirement, the amount is generally nominal.ⁿ¹

Why, then, be concerned with the manner in which the corporation is financed? The answer is simple--the tax consequences that flow from the choice.ⁿ² And those most concerned with these tax consequences are persons involved with closely held corporations.ⁿ³

[1] Impact of the Choice.

The choice between debt and stock creates no special problems at the time of the initial incorporating transfer. If the nonequity instruments received rise to the status of "securities," and the remaining conditions of *IRC Section 351* are met, the receipt of debt securities will not require the recognition of any gain or loss realized by the transferor.ⁿ¹ The impact of the choice comes later.

[a] On Distributions.

[i] Dividend vs. Interest. A principal consequence of the choice between debt and equity lies with the treatment of corporate distributions. Interest received by a creditor is always includable in gross income. On the other hand, the extent to which dividends form a part of ordinary income depends on the existence of corporate earnings and profits. Lack of sufficient earnings and profits will remove part of the distribution from ordinary income, and result, first, in a reduction of the shareholder's basis for his stock, and, then, in the realization of capital gain.ⁿ² Furthermore, even if the corporation's earnings and profits are of such magnitude as to cover the entire distribution, partial tax relief is afforded, and to corporations by way of the dividends received deductions provided by *IRC Sections 243, 244, and 245*.ⁿ³

The treatment of the distribution also differs from the standpoint of the distributing corporation. A dividend distribution gives the corporation no deduction; it only reduces earnings and profits.ⁿ⁴ The payment of interest gives rise to a deduction,ⁿ⁵ provided, of course, that a true indebtedness exists.ⁿ⁶ Manifestly, then, the existence of a bona fide debt, and the resulting interest deduction, eliminates the double taxation which attends dividend distributions.

[ii] Redemption vs. Retirement. Any amount received on the retirement of a debt security is deemed to have been received in exchange therefor, thus qualifying the gain or loss for capital treatment if the instrument is a capital asset in the hands of the holder.ⁿ⁷ No income can result to the holder of a debt security unless the amount received in retirement exceeds his basis in the security.

The gain or loss characteristics of a redemption of stock are subject to a more complex set of rules. Gain or loss will be capital in nature only if (1) the redemption is not essentially equivalent to a dividend; (2) the redemption is substantially disproportionate with respect to the shareholder; (3) the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder; or (4) the distribution is a partial liquidation.ⁿ⁸ In addition, capital gain or loss will result to a limited extent if the redemption is from an estate, and the value of all of the stock of the corporation included in the gross estate or the net estate.ⁿ⁹ If the redemption cannot qualify for capital treatment, the distribution will fall under *IRC Section 301*,ⁿ¹⁰ raising the specter of dividend income.ⁿ¹¹

The foregoing illustrates that, other factors being equal, the taxpayer intent upon a quick withdrawal of capital from the corporation should opt for debt rather than equity.

[b] On Dispositions. As a general rule, an instrument, whether classed as debt or equity, will be considered a capital asset whose sale or exchange produces capital gain or loss.ⁿ¹² Noncapital treatment will result even where stock is a capital asset, if the corporation is found to be a collapsible corporation under *IRC Section 341*,ⁿ¹³ if a loss is incurred and the stock qualifies as small business corporation stock under *IRC Section 1244*,ⁿ¹⁴ or if a loss is incurred on stock in a small business investment company.ⁿ¹⁵ Gain on the disposition of a debt security held for more than six months may be excluded from capital treatment if the bond was issued or purchased at a discount.ⁿ¹⁶

[c] Other Tax Consequences.

[i] Worthless Stock or Securities. Losses sustained by reason of stock becoming worthless are treated as capital losses as long as the stock constitutes a capital asset in the hands of the stockholder.ⁿ¹⁷ The same holds true for debt securities only if they bear interest coupons or are in registered form.ⁿ¹⁸ If an evidence of indebtedness is issued without interest coupons and is not in registered form, the tax consequences of worthlessness are tested by *IRC Section 166* (dealing with bad debts), a business bad debt giving rise to an ordinary loss, and a nonbusiness bad debt, to a short-term capital loss.ⁿ¹⁹

[ii] Accumulated Earnings Tax. The Code imposes a penalty tax on any corporation which unreasonably accumulates earnings and profits in order to avoid the tax which its shareholders would have to pay if the profits were distributed in the form of dividends.ⁿ²⁰ No tax is imposed to the extent that earnings and profits for the taxable year are retained for the reasonable needs of the business.ⁿ²¹ The existence of debt as opposed to equity can play a significant part in determining whether the penalty tax will be imposed.

For example, assume that a corporation decides to accumulate surplus for the purpose of retiring the interest of one of its owners. If the interest is a stock interest, it is more than likely that the accumulation will be held to be for a purpose unconnected with the reasonable needs of the business, and the tax imposed on the accumulation. This is especially true if the redeemed shareholder occupies a position of control;ⁿ²² an accumulation to buy out a minority shareholder or to resolve a deadlock is more likely to pass muster.ⁿ²³ The difference in result reflects the judicial attitude that a redemption of the interest of a majority stockholder primarily benefits the shareholder without furthering the corporation's business, while a redemption which eliminates dissidence, or promotes continuity of management through the retention of key personnel,ⁿ²⁴ serves a business purpose.

By statutory mandate, an accumulation to redeem the stock of a decedent is permitted to the extent to which the redemption qualifies for capital gains treatment under *IRC Section 303*.ⁿ²⁵ Were such accumulations considered to be unreasonable, they "would substantially interfere with the purpose of [the redemption provision]."ⁿ²⁶

An accumulation to pay off an existing debt has a better chance of meeting with approval. This is certainly true if the purpose of the indebtedness can be connected to the operation of the business,ⁿ²⁷ and if the lender is an unrelated party.ⁿ²⁸ While courts have been less prone to sanction accumulations where the creditor is a shareholder as well,ⁿ²⁹ they have not closed the door to such accumulations. Thus, where the equity of the corporation is of sufficient size to permit the court to call the indebtedness bona fide and not a substitute for equity, the accumulation will not be subject to the special tax.ⁿ³⁰ It appears, then, that once a sufficient level of equity financing is reached, a more beneficial accumulated earnings tax result can be achieved through the issuance of debt.

[iii] Qualifying for Subchapter S Status. Subchapter S of the Code provides special tax treatment for certain small business corporations and their shareholders.ⁿ³¹ One of the conditions for entry into Subchapter S status is that the corporation have only a single class of stock.ⁿ³² Early regulations sought to convert any debt which was in fact equity into a disqualifying second class of stock. These were found invalid for the reason that they attempted to apply automatically and arbitrarily to all misdesignated debt.ⁿ³³ Amended regulations placed purported debt obligations held by shareholders in substantially the same proportion as their stock interests in the category of contributions to capital rather than second class of stock. The Tax Court again decreed invalidity when it could not agree that the fact that debt characterized as equity was disproportionate to stock ownership controlled the decision as to the existence of more than one class of stock.ⁿ³⁴

If purported debt is not automatically a second class of stock, whether held in proportion to stock interest or not, are traditional debt-equity classification criteria suitable in determining that the recharacterized debt constitutes a different class of stock? The courts that have considered the question have concluded that the thrust of the criteria--limiting improper tax avoidance--prevents them from being the sole determinant of the second class of stock question.ⁿ³⁵ Indeed, it has been suggested that when the decisional process takes into account factors peculiar to the Subchapter S corporation and its one class of stock requirement, the consequence "will be that debt which for other purposes or in the instances of a non-subchapter S corporation might be recharacterized as stock will not be a second class of stock for purposes of [Subchapter S]" and "to cause the existence of what might be termed 'non-stock equity.'" ⁿ³⁶

[2] Classifying Debt and Equity.

What is debt and what is equity? A simple question is posed, but there is no simple answer. One thing is certain:

"There is no dearth of cases in this province of tax law. So large is their number and disparate their facts, that for every parallel found, a qualification hides in the thicket. At most they offer tentative clues to what is debt and what is equity for tax purposes; but in the final analysis each case must rest and be decided upon its own unique factual flavor, dissimilar from all others, for the intention to create a debt is a compound of many diverse external elements pointing in the end to what is essentially a subjective conclusion."ⁿ¹

Thus, the classification of an interest as debt or equity calls for the resolution of a question of fact in which all the facts and circumstances relative to the relationship between corporation and owner are weighed.ⁿ² In this regard, it should be noted that little weight is given to local law labels or characterizations.ⁿ³ The relationship, and the interest it creates, are viewed solely from a tax law standpoint.ⁿ⁴

[a] The Relevant Factors.

[i] Formal Indicia. While form alone is not determinative of the issue of debt versus equity, lack of formal indicia of debt may swing the balance in favor of equity.ⁿ⁵ Likewise, the failure to cloak a purported equity instrument with the characteristics of equity may lead a court to find the existence of debt. Generally, a debt instrument is thought of as one which contains an obligation to pay a sum certain at a reasonably close fixed maturity date, or, perhaps, at some accelerated date if a default occurs; bears a fixed rate of interest; is not subordinated in priority to general or unsecured

creditors; is readily transferable; and does not grant the holder the right to vote except in limited circumstances, eg, on default.ⁿ⁶ Equity, on the other hand, lacks a maturity date, normally gives the holder the right to vote or participate in management, gives the holder the right to share in the profits of the enterprise, and is subordinate to the claims of creditors.ⁿ⁷

Suppose an instrument contains indicia of both equity and debt. Is the instrument to be characterized as debt or as equity? When faced with the question of classifying such a hybrid security, the Supreme Court concluded:

"[N]o one characteristic ... can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts. So-called stock certificates may be authorized by corporations which are really debts, and promises to pay may be executed which have incidents of stock."ⁿ⁸

By so finding, the Court was forced to relegate the classification process to the trier of fact, its determination to be regarded as conclusive unless found to be clearly erroneous. A hybrid security may, therefore, be either debt or equity. The absence of certainty does not permit a more definitive answer.

[ii] "Thin" Capitalization--The Debt-Equity Ratio Problem. Suppose a corporation's capital structure consists of \$20,000 in stock and \$200,000 in debt. Can the entire amount of debt pass the characterization test, or does the existence of such a thin capitalization make the debt a prime candidate for classification as equity? Language contained in the Supreme Court's opinion in *John Kelley Co. v. Commissioner*,ⁿ⁹ might lead one to believe that an excessive debt-equity ratio is itself sufficient to transform debt into equity. However, not only is there "no magic debt-equity ratio which is appropriate for all corporations in all circumstances,"ⁿ¹⁰ but thin capitalization is only one factor to consider in determining whether a specified interest is debt or equity.ⁿ¹¹ Thus, equity has been found where the debt-equity ratio was 5 to 1,ⁿ¹² and debt found where the ratio was 700 to 1.ⁿ¹³ The seeming disparity in result is simply explained. The low debt-equity ratio in the first case was overridden by the presence of a sufficient number of other factors to permit the court to constitute the interest equity rather than debt.ⁿ¹⁴ On the other hand, the very thin capitalization of the second case was saved from equity classification by the existence of factors which the court considered so significant that it was able to find a bona fide debtor-creditor relationship.ⁿ¹⁵

It should be noted that the taxpayer contemplating the use of excessive debt will "go it on his own." The Internal Revenue Service will not ordinarily rule whether an "indebtedness" is to be classified as debt or equity because such determinations are factual.ⁿ¹⁶

[iii] Holding Debt in Proportion to Stock. Although not alone determinative of the issue of debt versus equity, the pro rata holding of debt and stock is often taken as evidence that a purported debt interest is, in reality, equity.ⁿ¹⁷ Conversely, the lack of identity between debt holders and stockholders provides a strong argument that a true indebtedness exists.ⁿ¹⁸ However, the mere fact that holdings are disproportionate will not support a finding of debt if all of the relevant facts and circumstances indicate an equity interest.ⁿ¹⁹

[iv] Advances Made to Initiate the Business or to Purchase

Essential Assets. Courts are quite prone to characterize purported debt instruments as equity where the advances provide the capital needed to commence business operations or to purchase essential assets.ⁿ²⁰ In addition, the issuance of debt securities in exchange for "key" assets is often looked upon with a jaundiced eye, and the debt held not bona fide.ⁿ²¹ Even an attempt to cast the transaction in the form of a sale might not pass muster. Thus, a transfer of land to a closely held corporation in exchange for its promissory note was held by the Seventh Circuit to be a contribution to capital, and not a sale as characterized by the parties to the transaction.ⁿ²² In the court's opinion:

"When the payment to the transferors is dependent on the success of an untried undercapitalized business with uncertain prospects, a strong inference arises that the transfer is an equity contribution."ⁿ²³

Once the corporation becomes successful and well-established, so that loans are not subject to the same risks as investment capital and payments of principal and interest become more secure, the court is more likely to view the advance as a loan. Indeed, the fact that the business was successful helped the taxpayer in *Baker Commodities, Inc. v. Commissioner*,ⁿ²⁴ overcome the normal equity inference which arises from a debt-equity ratio of 700 to 1.

[v] Intention of the Parties. A crucial inquiry is whether the shareholder and the corporation intended to enter into a debtor-creditor relationship with respect to the advance in question, that is, whether the lender entertained any reasonable expectation of repayment.ⁿ²⁵ Relevant to the determination of intent are such objective criteria as the existence of written evidence of the debt,ⁿ²⁶ whether outside lenders would have made such a loan,ⁿ²⁷ the extent to which the loan is subordinated to general creditors,ⁿ²⁸ the presence or absence of formal indicia of a debt, the thinness of the capitalization, and, finally, the use to which the advance is put. Put simply, the issue is whether the shareholder intended to risk his capital in the hope of reaping a profit, or merely to temporarily lend additional support to the venture.

[3] Debt-Equity Classification and the Tax Reform Act of 1969.

The difficulties inherent in the attempt to draw a distinction between debt and equity finally led Congress, in 1969, to enact legislation authorizing the promulgation of "such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness."ⁿ¹ Additional authority was granted in 1989 to permit regulations covering interests that "are in part stock and in part indebtedness." The debt-equity guidelines are required to set forth the factors to be taken into account in determining whether a specific interest qualifies as debt or equity, including among others:

"(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,

"(2) whether there is subordination to or preference over any indebtedness of the corporation,

"(3) the ratio of debt to equity of the corporation,

"(4) whether there is convertibility into the stock of the corporation, and

"(5) the relationship between holdings of stock in the corporation and holdings of the interest in question."ⁿ²

It took some 13 years for the Treasury to issue regulations.ⁿ³ Although final regulations were issued, their effective date was postponed repeatedly until they and proposed revisions were withdrawn on the ground that the rules did not fully reflect the Treasury or Service position on debt-equity matters.ⁿ⁴

FOOTNOTES:

(n1)Footnote 1. Eg, *NY Bus Corp Law § 504* (McKinney 1963) requires only that the consideration paid for par value stock be at least equal to par, and that the amount paid for no par value stock not be less than the stated value of such stock.

(n2)Footnote 2. A major nontax consideration is the ability of shareholder-creditors to share equally with trade creditors in the event of insolvency.

(n3)Footnote 3. Stone, "Debt-Equity Distinctions in the Tax Treatment of the Corporation and its Shareholders," *42 Tul L Rev* 251, 253 (1968). An exhaustive treatment of the debt-equity problem can be found in Plumb, "The Federal

Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 *Tax L Rev* 369 (1971).

(n4)Footnote 1. See § 3.02[2][a].

(n5)Footnote 2. See §§ 4.03[3] and 4.04[3].

(n6)Footnote 3. § 4.04[2][a].

(n7)Footnote 4. § 4.07[2].

(n8)Footnote 5. *IRC* § 163.

(n9)Footnote 6. See, eg, *Rev Rul* 69-333, 1969-1 *CB* 98 .

(n10)Footnote 7. *IRC* § 1271(a)(1). The provision applies to evidences of indebtedness issued before Jan 1, 1955, only if issued with interest coupons or registered form, or to those in such form on Mar 1, 1954.

(n11)Footnote 8. *IRC* § 302(b). Redemptions are discussed in Ch 5.

(n12)Footnote 9. *IRC* § 303.

(n13)Footnote 10. See Ch 4.

(n14)Footnote 11. Dividend income will result only if the corporation has earnings and profits. *IRC* § 301(c)(1).

(n15)Footnote 12. *IRC* §§ 1221, 1222.

(n16)Footnote 13. § 6.06.

(n17)Footnote 14. § 2.07[2][c].

(n18)Footnote 15. *IRC* § 1242; § 2.07[2][a].

(n19)Footnote 16. See Ch 17.

(n20)Footnote 17. *IRC* § 165(g)(1). See, eg, *Cutler v Commr*, *TC Memo* 1994-90 .

(n21)Footnote 18. *IRC* § 165(g)(2)(C).

(n22)Footnote 19. *IRC* § 166(a), (d).

(n23)Footnote 20. *IRC* §§ 531, 532.

(n24)Footnote 21. *IRC* § 535(a), (c)(1).

(n25)Footnote 22. *Pelton Steel Casting Co v Commr*, 28 *TC* 153 (1957) , *aff'd*, 251 *F2d* 278 (7th Cir 1958) , *cert denied* 356 *US* 958 ; *J Gordon Turnbull, Inc v Commr*, 41 *TC* 358 (1963) , *aff'd* 373 *F2d* 87 (5th Cir 1967) , *cert denied* 389 *US* 842 ; see generally Herwitz, "Stock Redemptions and the Accumulated Earnings Tax," 74 *Harv L Rev* 866 (1961).

(n26)Footnote 23. *Gazette Publishing Co v Self*, 103 *F Supp* 779 (D Ark 1952) ; *Penn Needle Art Co v Commr*, *TC Memo* 1958-99 ; contra, *Hedburg-Friedheim Contracting Co v Commr*, *TC Memo* 1956-275 , *aff'd* 251 *F2d* 839 (8th Cir 1958) , where the deadlock concerned the payment of dividends.

(n27)Footnote 24. *Ted Bates & Co v Commr*, *TC Memo* 1965-251 .

(n28)Footnote 25. *IRC § 537(a)(2), (b)(1)*. However, the amount paid on the redemption is not treated as a dividend for purposes of computing the amount subject to the accumulated earnings tax. *Rev Rul 70-642, 1970-2 CB 131* .

(n29)Footnote 26. *S Rep No 91-552, 91st Cong, 2d Sess, 280 (1969)*.

(n30)Footnote 27. *Jacob Sincoff, Inc v Commr, 20 TC 288 (1953)* , *aff'd, 209 F2d 569 (2d Cir 1953)* ; *KOMA, Inc v Commr, 8 TCM 1064 (1949)* , *aff'd, 189 F2d 390 (10th Cir 1951)* ; *Treas Reg § 1.537-2(b)(3) (1959)*.

(N31)Footnote 28. *Carlen Realty Co v Tomlinson, 345 F2d 998 (5th Cir 1965)* ; *Lion Clothing Co v Commr, 8 TC 1181 (1947)* , *acq, 1947-2 CB 3* .

(n32)Footnote 29. *Eg, Kirlin Corp v Commr, 23 TCM 1580 (1964)* , *aff'd per curiam 361 F2d 818 (6th Cir 1966)* .

(n33)Footnote 30. *Gazette Telegraph Co v Commr, 19 TC 692 (1953)* , *acq 1954-2 CB 4* , *aff'd, 209 F2d 926 (10th Cir 1954)* .

(n34)Footnote 31. See Ch 15.

(n35)Footnote 32. *IRC § 1361(b)(1)(D)*.

(n36)Footnote 33. *Gamman v Commr, 46 TC 1 (1966)* .

(n37)Footnote 34. *Stinnett v Commr, 54 TC 221 (1970)* .

(n38)Footnote 35. *Portage Plastics Co v US, 486 F2d 632 (7th Cir 1973)* ; *Amory Cotton Oil Co v US, 468 F2d 1046 (5th Cir 1972)* ; *Shores Realty Co v US, 468 F2d 572 (5th Cir 1972)* .

(n39)Footnote 36. *Amory Cotton Oil Co v US, 486 F2d 1046, 1051 (5th Cir 1972)* . Query, whether nonstock equity in the hands of persons other than shareholders makes them shareholders for purposes of determining the maximum number of shareholders and the consent to election required of shareholders? This question was not raised in *Portage Plastics, 486 F2d 632 (7th Cir 1973)* , where the persons advancing the funds to the corporation were not shareholders at the time the loans were made.

(n40)Footnote 1. *American Processing & Sales Co v US, 371 F2d 842, 848 (Ct Cl 1967)* .

(n41)Footnote 2. *Tomlinson v 1661 Corp, 377 F2d 291 (5th Cir 1967)* ; *Jewell Ridge Coal Corp v Commr, 318 F2d 695 (4th Cir 1963)* ; *Fellinger v US, 363 F2d 826 (6th Cir 1966)* ; Note, "Classification of Advances to Close Corporations by Shareholder--Debt or Equity," 1964 *Wis L Rev* 331 (1964). A few courts have viewed the issue as a mixed question of law and fact. *JS Birtz Constr Co v Commr, 387 F2d 451 (8th Cir 1967)* , or as a question of law. *US v Snyder Bros Co, 367 F2d 980 (5th Cir 1966)* , *cert denied, 386 US 956* .

The Service has announced that it will scrutinize and challenge transactions involving the issuance of instruments designed to be treated as debt for federal income tax purposes, but as equity for regulatory, rating agency, or financial accounting purposes. *Notice 94-48, 1994-19 IRB 10* ; *Notice 94-47, 1994-19 IRB 9* .

(n42)Footnote 3. *WO Covey, Inc v Commr, TC Memo 1969-273* .

(n43)Footnote 4. *US v Snyder Bros Co, 367 F2d 980 (5th Cir 1966)* .

(n44)Footnote 5. But see *Est of Mixon v US, 464 F2d 394 (5th Cir 1972)* , where the intention of the parties overcame the absence of usual indicia of legitimate debt, and *Turner Tire Co v US, 344 F Supp 634 (MD La 1972)* , where extensive repayment produced a finding of debt even though the transaction was marked by informality.

The Service has ruled that adjustable rate convertible notes (ARCNs) are equity, not debt. *Rev Rul 83-98, 1983-2 CB 40* . A typical ARCN bears interest at a rate that is tied to the current dividend yield on the issuer's common stock, is callable by the issuer, and generally is redeemable at the time of issuance of the stock into which the ARCN is convertible. In the ruling, the ARCNs under consideration were offered at a price of \$1,000 and were redeemable at maturity in 20 years for cash of \$600 or 50 shares of stock. Since the value of 50 shares of stock of the issuer at the time the ARCNs were issued was also \$1,000, the price of the stock would have to decline by more than 40 percent before a holder would take cash rather than stock. Because of the very high probability that all of the ARCNs would be converted into stock, the Service took the position that the ARCNs did not truly represent a promise to pay a sum certain. *Rev Rul 83-98* should be compared with *Rev Rul 85-119, 1985-2 CB 60* , where the amount of stock to be issued at maturity was not fixed, but was based upon the face amount of the notes. Thus, the noteholders did not share in the increase or decrease in the market value of the corporation's stock. The Service concluded that the notes constituted debt.

(n45)Footnote 6. *Gilbert v Commr, 248 F2d 399 (2d Cir 1957)* ; *PF Scheidelman & Sons, Inc v Commr, TC Memo 1965-31* ; *Rev Rul 68-54, 1968-1 CB 69* . An instrument with a fifty-year maturity was held to be a debt security in *Monon RR v Commr, 55 TC 345 (1970)* , *acq 1973-1 CB 2* .

A district court treated subordinated promissory notes issued contemporaneously with a sale of stock in an arm's-length transaction as debt rather than equity. The court focused on the form of the instrument to reach its conclusion. *Federal Express Corp v US, 645 F Supp 1281 (WD Tenn 1986)* .

(n46)Footnote 7. *Road Materials, Inc v Commr, 407 F2d 1121 (4th Cir 1969)* ; *Rev Rul 68-54, 1968-1 CB 69* .

The mere fact that interest is payable only out of income will not require an instrument to be treated as equity. *Monon RR v Commr, 55 TC 345 (1970)* , *acq 1973-1 CB 2* .

(n47)Footnote 8. *John Kelley Co v Commr, 326 US 521 (1946)* .

Shares of "Dutch auction rate preferred stock"--stock on which the dividend rate is set periodically pursuant to a Dutch auction--generally have characteristics that are more like stock than debt and will be treated as equity under the circumstances set forth in *Rev Rul 90-27, 1990-1 CB 50* . See also *Notice 2008-55, 2008-2 CB 11* , which provides that adding liquidity facilities to action rate preferred stock will not change the equity characterization if the conditions set forth in the Notice are met.

(n48)Footnote 9. *326 US 521 (1946)* . The specific dictum is:

"as material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure." (*326 US at 526*).

(n49)Footnote 10. *Wood Preserving Corp v US, 347 F2d 117 (4th Cir 1965)* .

(n50)Footnote 11. *Montclair Inc v Commr, 318 F2d 38 (5th Cir 1963)* ; *Baker Commodities, Inc v Commr, 48 TC 374 (1967)* , *aff'd 415 F2d 519 (9th Cir 1969)* , *cert denied 397 US 988* .

The corporation's equity includes retained earnings as well as paid-in capital. *Bauer v Commr, 748 F2d 1365 (9th Cir 1984)* .

(n51)Footnote 12. *Wood Preserving Corp v US, 347 F2d 117 (4th Cir 1965)* . The same result was reached in

Champaign Realty Co v US, 324 F Supp 922 (SD Ohio 1971) , where the debt-equity ratio was 51/2 to 1.

(n52)Footnote 13. *Baker Commodities, Inc v Commr*, 48 TC 374 (1967) , *aff'd* 415 F2d 519 (9th Cir 1969) , *cert denied* 397 US 988 .

(n53)Footnote 14. The equity producing factors included the absence of written evidence of the debt, the expression of intent not to demand repayment unless profits we earned, and the use of the advances to purchase essential assets.

(n54)Footnote 15. The debt was in "proper" form; the holding of debt was not in proportion to the ownership of stock; there was a reasonable expectation of repayment; the corporation was a going concern; and the transaction was entered into for valid business reasons.

The Tax Court found debentures to be debt in *Delta Plastics, Inc v Commr*, TC Memo 2003-54 , where an initial debt-equity ratio of 26 to 1 was reduced to 4 to 1 in just over three years. In addition, the obligation to repay the debentures was unconditional, there were loans from third parties, none of the debenture holders was granted a management position or increase in voting rights, and the taxpayer made all scheduled payments of principal and interest on time.

(n55)Footnote 16. *Rev Proc 2010-3*, 2010-1 IRB 110 , § 4.02(1). The Service may issue a letter ruling with respect to an instrument issued by a domestic corporation if (1) the taxpayer believes that the facts strongly support the proposed classification of the instrument as debt or stock and (2) the taxpayer can demonstrate that there are unique and compelling reasons to justify the issuance of a letter ruling. However, the taxpayer is advised to first contact the office of the Associate Chief Counsel (Corporate) in such cases to discuss whether the Service will consider issuing such a ruling.

(n56)Footnote 17. *McSorley's, Inc v US*, 323 F2d 900 (10th Cir 1963) ; *Harkins Bowling v Knox*, 164 F Supp 801 (D Minn 1958) . A pro rata holding was considered irrelevant where the corporation had only one stockholder, *JS Birtz Constr Co v Commr*, 387 F2d 451 (8th Cir 1967) .

(n57)Footnote 18. *Baker Commodities, Inc v Commr*, 48 TC 374 (1967) , *aff'd* 415 F2d 519 (9th Cir 1969) , *cert denied* 397 US 988 ; *Hofert Co v US*, 1969 US Dist LEXIS 12660 (CD Cal 1969) .

(n58)Footnote 19. *American-LaFrance-Foamite Corp v Commr*, 284 F2d 723 (2d Cir 1960) , *cert denied*, 365 US 881 .

(n59)Footnote 20. *Wood Preserving Corp v US*, 347 F2d 117 (4th Cir 1965) ; *SP Realty Co v Commr*, TC Memo 1968-156 (corporation needed funds equal to 42 times its capital investment in order to acquire its basic assets); Stone, "Debt-Equity Distinctions in the Tax Treatment of the Corporation and its Shareholders," 42 Tul L Rev 251 (1968).

(n60)Footnote 21. *Schnitzer v Commr*, 13 TC 43 (1949) , *aff'd per curiam* 183 F2d 70 (9th Cir 1950) , *cert denied* 340 US 911 .

(n61)Footnote 22. *Burr Oaks Corp v Commr*, 365 F2d 24 (7th Cir 1966) , *cert denied* 385 US 1007 .

(n62)Footnote 23. 365 F2d at 27 .

(n63)Footnote 24. 48 TC 374 (1967) , *aff'd*, 415 F2d 519 (9th Cir 1969) , *cert denied* 397 US 988 .

(n64)Footnote 25. Equity found because no expectation of repayment or because repayment contingent on success of business: *Slappey Drive Indus Park v US*, 561 F2d 572 (5th Cir 1977) ; *Burton v Commr*, 549 F2d 1111 (6th Cir 1977) ; *Raymond v US*, 511 F2d 185 6th Cir 1975) ; *Miles Prod Co v Commr*, 457 F2d 1150 (5th Cir 1972) ; *Dixie*

Dairies Corp v Commr, 74 TC 476 (1980) ; *Davis v Commr*, 69 TC 814 (1978) .

Debt found: repayment expected or substantially accomplished: *Anderson v US*, 555 F2d 236 (9th Cir 1977) ; *Bordo Prods Co v US*, 476 F2d 1312 (Ct Cl 1973) ; *Turner Tire Co v US*, 344 F Supp 634 (MD La 1972) .

(n65)Footnote 26. The absence of a note or agreement to repay is often considered an "equity" factor. See, eg, *Road Materials, Inc v Commr*, 407 F2d 1121 (4th Cir 1969) ; *Berkowitz v US*, 411 F2d 818 (5th Cir 1969) .

In *Hollenbeck v Commr*, 422 F2d 2 (9th Cir 1970) , the advances were evidenced by demand notes bearing interest and containing the ordinary attributes of debt. However, the treatment accorded the lending of the money and its repayment was not consistent with the normal relation of debtor and creditor, and, so, the advance was held to be equity. This had the added consequence of denying Section 1244 stock status to stock issued in return for a cancellation of the "debt." See § 2.07[2][c][i].

(n66)Footnote 27. *Tomlinson v 1661 Corp*, 377 F2d 291 (5th Cir 1967) (inability to obtain outside financing except at higher interest rates not fatal to a finding of debt); *Ram Corp v US*, 305 F Supp 831 (WD NC 1969) (equity found; outside financing wholly unavailable).

(n67)Footnote 28. Subordination to all indebtedness of the corporation whether already incurred or to be incurred in the future led to a "no debt" finding in *US v Snyder Bros Co*, N 9 *supra*. Where the shareholder-creditors were placed on equal footing with other unsecured creditors, debt status for the advance was upheld. *Tomlinson v 1661 Corp*, 377 F2d 291 (5th Cir 1967) .

(n68)Footnote 1. *IRC § 385(a)*. The difficulty of providing "comprehensive and specific statutory rules of universal and equal applicability" led Congress to frame the legislation in terms of a grant of authority to prescribe Regulations. S Rep No 91-252, 91st Cong, 1st Sess 138 (1969).

(n69)Footnote 2. *IRC § 385(b)*.

(n70)Footnote 3. The proposed regulations were published in the Federal Register on March 24, 1980.

(n71)Footnote 4. 48 Fed Treas Reg 31053-31054, 50711 (1983).



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CHAPTER 3 Forming the Corporation

1-3 Taxation of Securities Transactions § 3.07

§ 3.07 Expenses of the Transferee Corporation

[1] Organizational Expenditures.

Expenditures incurred in the organization of a corporation (e.g., legal fees, filing fees) are clearly capital expenditures that are not currently deductible. Nor should such expenses normally be amortizable because of the indeterminate life of the corporation. However, *IRC Section 248(a)* allows a corporation to amortize its "organizational expenditures" over a period of not less than 60 months, beginning with the month in which the corporation begins business.

An organizational expenditure is defined as any expenditure that is (1) incident to the creation of the corporation, (2) chargeable to capital account, and (3) of a character that, if expended incident to a corporation having a limited life, would be amortizable over such life.ⁿ¹ The regulations amplify the statutory definition by treating the following as organizational expenses: legal services incident to the organization of the corporation, such as drafting the corporate charter, by-laws, minutes of organizational meetings, terms of original stock certificates, and the like; necessary accounting services; expenses of temporary directors and of organizational meetings of directors or stockholders; and fees paid to the state of incorporation.ⁿ² On the other hand, expenditures connected with the issuance or sale of shares of stock or other securities, such as commissions, professional fees, and printing costs are not organizational expenses within the meaning of *IRC Section 248*, even if the particular issue of stock to which the expenditures relate is for a fixed term of years.ⁿ³

A corporation is deemed to have made an election to amortize organizational expenditures for the taxable year in which the corporation begins business. A corporation may opt out of the deemed election by electing to capitalize its organizational expenditures on a timely filed Federal income tax return (including extensions) for the taxable year in which the corporation begins business. The election either to amortize organizational expenditures or to capitalize organizational expenditures is irrevocable and applies to all organizational expenditures of the corporation.ⁿ⁴

[2] Expenditures Incurred in Issuing or Selling Stock.

As mentioned above, expenditures connected with the issuance or selling of stock or other securities are not organizational expenses and must be relegated to the realm of nondeductible capital expenditures.ⁿ¹ Included in this category are: expenses incurred in issuing stock;ⁿ² fees paid in connection with the registration of capital stock issues with the Securities and Exchange Commission;ⁿ³ stock exchange listing costs;ⁿ⁴ and expenditures relating to the payment of stock dividends or stock splits.ⁿ⁵ However, fees paid to maintain a stock exchange listing,ⁿ⁶ expenses

incurred in filing periodic reports required by the SEC,ⁿ⁷ and amounts paid to a registrar and transfer agent for the maintenance of capital stock records not related to an original issuance of stock, stock dividend, or reorganization,ⁿ⁸ are deductible as ordinary and necessary business expenses.

FOOTNOTES:

(n1)Footnote 1. *IRC § 248(b)*.

(n2)Footnote 2. *Treas Reg § 1.248-1(b)(2)*.

(n3)Footnote 3. *Treas Reg § 1.248-1(b)(3)(i)*.

(n4)Footnote 4. *Temp Treas Reg § 1.248-1T*.

(n5)Footnote 1. A deduction is available in the year in which the corporation ceases business and liquidates. *Shellabarger Grain Prods Co v Commr*, 146 F2d 177 (7th Cir 1944) .

(n6)Footnote 2. *Baltimore & Ohio RR v Commr*, 78 F2d 460 (10th Cir 1935) .

(n7)Footnote 3. *Affiliated Capital Corp v Commr*, 88 TC 1157 (1987) (cost of filing post-effective amendments); *Rev Rul 69-330*, 1969-1 CB 51 .

(n8)Footnote 4. *Dome Mines, Ltd v Commr*, 20 BTA 377 (1930) .

(n9)Footnote 5. *General Bancshares Corp v Commr*, 326 F2d 712 (8th Cir 1964) .

(n10)Footnote 6. *Chesapeake Corp v Commr*, 17 TC 668 (1951) .

(n11)Footnote 7. *Rev Rul 65-13*, 1965-1 CB 87 .

(n12)Footnote 8. *Rev Rul 69-615*, 1969-2 CB 26 .



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CHAPTER 3 Forming the Corporation

1-3 Taxation of Securities Transactions § 3.08

§ 3.08 Reporting and Record-Keeping Requirements

Statements containing information relating to a transfer coming within *IRC Section 351* are to be filed as part of the tax returns of the transferors and transferee corporation for the year in which the exchange occurs. The statement for each transferor must contain the following information:

- (1) A description of the property transferred, or of the transferor's interest therein, together with a statement of the cost or other basis thereof, adjusted to the date of transfer.
- (2) With respect to the stock of the transferee corporation received in the exchange, a statement of, (i) the kind of stock and preferences, if any; (ii) the number of shares of each class received; and (iii) the fair market value per share of each class at the date of the exchange.
- (3) The amount of money received, if any.
- (4) With respect to other property received, (i) a complete description of each separate item; (ii) the fair market value of each separate item at the date of the exchange; and (iii) in the case of a corporate shareholder, the adjusted basis of the other property in the hands of the transferee corporation immediately before the distribution to the corporate shareholder.
- (5) With respect to liabilities of the transferor assumed by the transferee corporation, (i) the nature of the liabilities; (ii) when and under what circumstances created; (iii) the corporate business purpose for the assumption by the transferee corporation; and (iv) whether the assumption eliminates the transferor's primary liability.ⁿ¹

The statement filed by the transferee corporation must include:

- (1) A complete description of the property received from the transferors.
- (2) A statement of the cost or other basis thereof in the hands of the transferors adjusted to the date of transfer.

(3) The following information with respect to the stock of the transferee corporation: (i) the total issued and outstanding capital stock immediately prior to and immediately after the exchange, with a complete description of each class of stock; (ii) the classes of stock and number of shares issued to each transferor in the exchange, and the number of shares of each class of stock owned by each transferor immediately prior to and immediately after the exchange; and (iii) the fair market value of the capital stock as of the date of the exchange that was issued to each transferor.

(4) The amount of money, if any, that passed to each of the transferors in connection with the transaction.

(5) With respect to other property that passed to each transferor, (i) a complete description of each item at the date of the exchange, (ii) the fair market value of each separate item at the date of the exchange; and (iii) in the case of a corporate transferor, the adjusted basis of each separate item in the hands of the transferee corporation before the distribution to the corporate transferor in connection with the exchange.

(6) The following information regarding the transferor's liabilities assumed by the transferee corporation in the exchange: (i) the amount and a description thereof; (ii) when and under what circumstances created, and (iii) the corporate business reason for assumption by the transferee corporation.ⁿ²

Permanent records in substantial form must be kept by every taxpayer who participated in the exchange, showing the information required to be reported, in order to facilitate the determination of gain or loss from a subsequent disposition of stock and other property received in the exchange.ⁿ³

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.351-3(a)*.

(n2)Footnote 2. *Treas Reg § 1.351-3(b)*.

(n3)Footnote 3. *Treas Reg § 1.351-3(c)*.



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CHAPTER 4 Dividend Distributions

1-4 Taxation of Securities Transactions 4.syn

§ 4.syn Synopsis to Chapter 4: Dividend Distributions

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CHAPTER 4 Dividend Distributions

1-4 Taxation of Securities Transactions § 4.01

§ 4.01 Introduction

A corporate distribution can have as its purpose the partial or complete liquidation of the corporation, the partial or complete redemption of a shareholder's interest, or merely the distribution of surplus earnings to the shareholders. Each of these produces its own set of tax consequences; all of these do so because the corporation and its owners are separate tax entities.

The major concern attending any nonliquidating distribution is the extent to which the distribution is a "dividend." Leaving aside those nonliquidating distributions which are in redemption of stock, the determination as to whether a distribution is a dividend requires consideration of:

- (1) the type of property distributed, for if it consists of stock or stock rights of the distributing corporation, the distribution can, perhaps, be received tax-free;
- (2) the nature of the recipient, for the amount ultimately subject to tax will differ if the distributee is a corporation or a noncorporate entity; and
- (3) the earnings and profits of the distributing corporation, for this determines the extent to which the distribution will be a dividend, and, thus, constitute ordinary income.

Normally, dividends are taxed at ordinary income rates. However, for taxable years 2003-2010, qualified dividends are taxed at preferential net capital gain rates.ⁿ¹

FOOTNOTES:

(n1)Footnote 1. See the discussion at § 2.06[2][a][i].



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CHAPTER 4 Dividend Distributions

1-4 Taxation of Securities Transactions § 4.02

§ 4.02 Dividend Defined

[1] The Relevance of Earnings and Profits.

As a general rule, state law authorizes payment of a dividend only when the corporation has a surplus; a distribution while the corporation is insolvent or which will render the corporation insolvent is prohibited.ⁿ¹ While these provisions have local law effect, they play no part in the determination of a dividend for tax purposes.ⁿ² Under the Code, a distribution becomes a dividend whenever made:

"(1) out of [the corporation's] earnings and profits accumulated after February 28, 1913, or

"(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of earnings and profits at the time the distribution was made."ⁿ³

It is readily observed that even though a corporation may have an accumulated deficit both at the beginning and end of the year, a distribution will be classified as a dividend to the extent of the corporation's current earnings and profits. Therefore, ascertainment of the amount of accumulated earnings and profits becomes necessary only when earnings and profits of the year of distribution are less than the total of the distributions made during the year.

The Internal Revenue Service has ruled that the date of payment controls in determining whether and when a distribution is made out of earnings and profits.ⁿ⁴ In a second ruling, the Service held that the date on which a check is mailed determines the tax status and effect on earnings and profits of the distribution.ⁿ⁵ If the distribution consists of property other than cash, the fair market value of the property is determined as of the date of distribution without regard to whether such date is the same as that on which the distribution is includable in gross income.ⁿ⁶

The Code further provides that every distribution by a corporation "is made out of earnings and profits to the [full] extent thereof, and from the most recently accumulated earnings and profits."ⁿ⁷ This creates a priority of distribution sources headed by earnings and profits of the current taxable year and followed, first, by earnings and profits accumulated after February 28, 1913, and, then, by earnings and profits accumulated before that date.ⁿ⁸ No class of earnings and profits may be invaded until a prior one has been completely exhausted. This last consideration is important only when the distributions made during the taxable year exceed the earnings and profits of that year. In such

event, the current earnings and profits are spread ratably across the distributions in the proportion that the total of such earnings and profits bears to the total distributions made during the year. The balance of each distribution will be a dividend only if there are earnings and profits accumulated since February 28, 1913 available on the date of distribution.ⁿ⁹

Application of the earnings and profits source rules may be illustrated by the following:

Example:

At the beginning of the year, a corporation had \$6,000 in earnings and profits accumulated since February 28, 1913. Its earnings and profits for the current year amounted to \$21,000. The corporation made two cash distributions during the taxable year, one on June 30, in the amount of \$20,000, and the other on December 31, in the amount of \$10,000. Since current earnings and profits are apportioned ratably, \$14,000 of such earnings and profits is allocated to the June distribution, and \$7,000 to the one made in December. The entire \$6,000 in accumulated earnings and profits will provide the source for the balance of the earlier distribution, making it a dividend in its entirety. Whether the source of the remaining \$3,000 of the December distribution is pre-March 1, 1913, earnings and profits or sources other than earnings and profits is unimportant. The dividend portion of the distribution can never be greater than \$7,000.ⁿ¹⁰

Suppose a corporation has accumulated earnings and profits at the beginning of the year, but suffers a current loss of sufficient magnitude to reduce such earnings and profits below the total amount of distributions made during the year. Of importance, here, is the way in which a current deficit affects the amount of accumulated earnings and profits available on each distribution date. Unless it can be shown that the loss developed in a particular way or at a particular point in time, so that the actual earnings and profits available at the time of distribution can be ascertained, the loss is deemed to have been incurred evenly throughout the year.ⁿ¹¹

Example:

A corporation, which has accumulated earnings and profits of \$10,000, suffers a loss of \$20,000 in the current year. The corporation makes end-of-quarter distributions of \$5,000 each. If the manner or time in which the loss developed cannot be determined, the earnings and profits available at the end of the first quarter will amount to \$5,000 (\$10,000 less one-fourth of the loss). Only the first distribution will be taxed as a dividend, for no earnings and profits will be available for any other distribution. If, however, proof can be adduced to show that the entire loss was in fact, incurred in the second half of the year, the first two distributions would be made out of accumulated earnings and profits and be taxed as dividends.

[a] Computation of Earnings and Profits.

What are earnings and profits? The Code does not say.ⁿ¹² Clearly, they are not the equivalent of the accounting concept of "earned surplus."ⁿ¹³ Nor are earnings and profits the same as taxable income.ⁿ¹⁴ However, taxable income is perhaps as good a starting place as any to look for the meaning of earnings and profits.

Beginning with taxable income, one must add "all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 61 or corresponding provisions of prior revenue acts."ⁿ¹⁵ Thus, if the corporation receives interest on municipal obligations excluded from gross income by *IRC Section 103*, or proceeds of insurance exempted by *IRC Section 101(a)*, the amount of these receipts will enter into the computation of earnings and profits. The quoted Regulation attempts to include in earnings and profits amounts received by the corporation which become available for distribution to its shareholders. To be consistent, items exempted from inclusion in gross income by some nonrecognition provision should not enter the computation of earnings and profits, since the mere change in form which results from the exchange does not produce the kind of "income" which can be passed on to shareholders. And this is exactly what *IRC Section 312(f)(1)* of the

Code provides--no inclusion in earnings and profits until recognition.ⁿ¹⁶

A number of courts took the rationale of *IRC Section 312(f)* and applied it in cases which closely resemble nonrecognition transactions. For example, in *Bangor & Aroostook R.R. v. Commissioner*,ⁿ¹⁷ a corporation elected to exclude cancellation of indebtedness income under the predecessor of *IRC Section 108* and to adjust the basis of its assets as required by present *IRC Section 1017*.ⁿ¹⁸ It then attempted to include the excluded amount in its accumulated earnings and profits for the purpose of decreasing its excess profits tax. The attempt failed. No increase in earnings and profits was the result reached as well in *Meyer v. Commissioner*,ⁿ¹⁹ where the debt cancellation came as part of an arrangement under Chapter XI of the Bankruptcy Act. Such cancellation did not give rise to income, but a reduction in basis was required. The situation in *Meyer* was complicated by the fact that the cancelled debt exceeded the reduction in basis. The Government took the position that the excess worked an increase in the debtor's earnings and profits on the theory that an economic benefit had been conferred on the corporation. Because of this the Service announced that it would not follow *Meyer*.ⁿ²⁰ The Bankruptcy Tax Act of 1980 clarified the situation. Income from discharge of indebtedness increases earnings and profits, whether or not current tax is imposed on the income, except to the extent the discharged amount is applied to reduce basis under *IRC Section 1017*.ⁿ²¹ In addition, if the interest of any shareholder in a corporation is eliminated in a bankruptcy or similar case and the corporation has a deficit in earnings and profits, the deficit is reduced by the amount equal to the paid-in capital allocable to the interest that is terminated.ⁿ²²

A logical extension of the notion that earnings and profits should reflect the amount available for distribution is the elimination from the computation of earnings and profits of any deduction which does not call for an expenditure by the corporation.ⁿ²³ For example, the dividends received deduction must be disregarded when computing earnings and profits. Similarly, if the corporation is entitled to a depletion deduction, it must be figured on a cost basis for earnings and profits, even though percentage depletion is allowable in determining taxable income.ⁿ²⁴ A like provision, *IRC Section 312(k)(1)*, effective for taxable years beginning after June 30, 1972, calls for the use of the straight-line method of depreciation in computing earnings and profits, even if the corporation uses another method to determine its depreciation deduction for other purposes. Enactment of the accelerated cost recovery system provisions as part of the Economic Recovery Tax Act of 1981 brought with it *IRC Section 312(k)(3)(A)*, which, as amended by the Tax Reform Act of 1986, provides that in the case of property placed in service after 1986, the deduction for depreciation for earnings and profits purposes must be determined under the alternative depreciation method of *IRC Section 168(g)*.ⁿ²⁵ Depreciable property which is immediately expensed under *IRC Section 179* is taken into account for earnings and profits purposes on a ratable basis over a five-year period beginning with the year in which the deduction is taken.ⁿ²⁶

IRC Section 312(n), added by the Tax Reform Act of 1984, is "designed to ensure that a corporation's earnings and profits more closely conform to its economic income."ⁿ²⁷ Under its terms, in computing earnings and profits:

- (1) Construction period interest, property taxes and carrying charges are capitalized and added to the basis of the property to which they relate;
- (2) Intangible drilling costs allowed as a deduction under *IRC Section 263(c)* are capitalized and amortized ratably over the 60-month period beginning with the month in which production from the well begins;
- (3) Mineral exploration and development costs allowable as a deduction under *IRC Section 616(a)* or *617* are capitalized and amortized ratably over the 120-month period beginning with the later of the month in which production begins or the month in which the amount was paid or incurred;
- (4) Amounts amortized under *IRC Sections 173* (relating to circulation expenditures), *177* (relating to trademark and trade name expenditures), and *248* (relating to organizational expenditures) are capitalized and treated as part of the basis of the asset to which they relate;

- (5) Earnings and profits are increased or decreased by the amount of increase or decrease in the corporation's LIFO recapture amount as of the close of any taxable year;ⁿ²⁸
- (6) All principal payments due on property sold by the corporation on the installment basis are treated as having been received in the year of sale;
- (7) Taxpayers who determine taxable income under the completed contract method of accounting must use the percentage of completion method for earnings and profits purposes; and
- (8) In the case of a redemption to which *IRC Section 302(a)* or *303* applies, earnings and profits are to be reduced in proportion to the amount of the corporation's outstanding stock that is redeemed.ⁿ²⁹

If deductions which do not call for any outlay are removed from the computation of earnings and profits, thereby increasing earnings and profits, then actual outlays which are not deductible for one reason or another should serve to decrease earnings and profits. Thus, earnings and profits are reduced by the disallowed excess of capital losses over capital gains,ⁿ³⁰ disallowed losses incurred in transactions with a controlling shareholder,ⁿ³¹ nondeductible expenses incurred in carrying tax-exempt interest bonds, compensation paid but not deductible because excessive,ⁿ³² and federal income taxes. However, *IRC Section 312(m)* permits no decrease for interest rendered nondeductible by *IRC Section 163(f)* because paid on a registration-required obligation not in registered form, unless at the time of issuance, the issuer is a foreign corporation that is not a controlled foreign corporation and the issuance of the obligation did not have as a purpose the avoidance of *IRC Section 163(f)*, or *IRC Section 312(m)*.ⁿ³³

An interesting problem concerns the proper charge to earnings and profits when a corporation contributes appreciated property to a charity. The Tax Court holds that the earnings and profits can be reduced by an amount equal to the excess of the fair market value of the property over the amount allowed as a charitable deduction.ⁿ³⁴ The Internal Revenue Service takes the position that the proper charge is an amount equal to the adjusted basis of the donated property, even though fair market value is the measure of the gift for deduction purposes.ⁿ³⁵

The foregoing discussion has centered on the relationship between taxable income and earnings and profits, and the adjustment required to conform the two concepts. But earnings and profits can also be increased or decreased by transactions which have no bearing on the taxable income of the corporation. Thus, earnings and profits will be affected when a corporation makes a distribution of property with respect to its stock;ⁿ³⁶ makes a distribution in partial liquidation or in redemption of its shares;ⁿ³⁷ is a party to a divisive reorganization under Section 355;ⁿ³⁸ or distributes property at a time when it is obligated on a loan made, guaranteed, or insured by the United States (or one of its agencies or instrumentalities), and the amount of the outstanding loan exceeds the basis of the property standing as security for the loan.ⁿ³⁹

[i] Effect of Accounting Method on Earnings and Profits. The Regulations state that "the amount of the earnings and profits in any case will be dependent upon the method of accounting properly employed in computing taxable income ..."ⁿ⁴⁰ If the corporation keeps its accounting records and files its tax returns on the cash receipts and disbursements method, it must use the same method in determining earnings and profits. Furthermore, since it appears that consistency is required even as to individual items, a corporation which deducts bad debts on an individual charge-off basis for tax purposes cannot use the bad debts reserve method in computing earnings and profits.ⁿ⁴¹

While courts are fairly in agreement that a consistent approach should be taken when the same item affects both taxable income and earnings and profits, there is a difference of opinion as to whether consistency is required when the item affects earnings and profits alone. A major area of disagreement concerns the permissibility of an accrual of federal income taxes for the purpose of determining earnings and profits when the corporation uses the cash basis method of

accounting. It is plain to see that an accrual of taxes payable in the following year will work a decrease in earnings and profits as of the close of the year to which the taxes relate, rather than in the year of payment. Such an accrual has been permitted by some courts on the theory that an accounting method is relevant only in determining the income and deductions of a taxpayer, and should not control whenever the item cannot be deducted to arrive at taxable income.ⁿ⁴² Courts reaching the contrary result do so on the basis of accounting method and the requirement of consistency.ⁿ⁴³ Disregard of accounting method principles has not been limited to cases involving cash basis corporations. Those on the accrual basis have been permitted to use contested tax liabilities relating to prior years to reduce earnings and profits as of the close of such prior years, even though no deduction would be permitted until the liability became fixed and certain.ⁿ⁴⁴

[2] Personal Holding Company Dividends.ⁿ¹

If a corporation is a personal holding company in the taxable year in which the distribution is made, the extent to which the distribution constitutes a dividend is not limited by the traditional sources--current earnings and profits and accumulated earnings and profits. In the case of a personal holding company, "the term 'dividend' also means any distribution of property ... made by the corporation to its shareholders, to the extent of its undistributed personal company income ... for such year."ⁿ² Thus, even if a personal holding company has neither accumulated nor current earnings and profits, a dividend can result if it has undistributed personal holding company income for the taxable year.ⁿ³

A further provision of *IRC Section 316(b)(2)* creates dividend income to the extent of undistributed personal holding company income even where the distribution is in complete liquidation of the company, but only if:

- (1) the distribution occurs within 24 months after adoption of the plan of liquidation;
- (2) the distributee is a noncorporate shareholder of the corporation; and
- (3) the corporation designates the distributed amounts as dividends.ⁿ⁴

The amount which a noncorporate shareholder must treat as a dividend cannot exceed his allocable share of the corporation's undistributed personal holding company income for the year.ⁿ⁵

[3] Constructive Dividends.

The double taxation of corporate profits through a tax at the corporate level on corporate earnings, and a tax at the shareholder level on distributed earnings, fosters attempts to siphon off earnings and profits via distributions disguised as something other than a dividend. The variations on the disguised dividend theme are many; the effect is singular--to confer an economic benefit on the shareholder--and economic benefit, rather than formal dividend action by the corporation, is the crucial test in finding a constructive dividend.ⁿ¹

[a] General Principles. The double taxation of corporate profits--a corporation income tax on corporate earnings and an individual income tax at the shareholder level when the after-tax earnings are distributed as dividends--has long motivated shareholders to move corporate earnings into their hands via transactions characterized as something other than dividends. Treasury regulations recognize the right of shareholders to engage in transactions with their corporations in some other capacity--as employees, creditors, sellers, purchasers, lessors, lessees, and the like--and so long as those transactions are conducted on arm's length terms they should not have dividend consequences.ⁿ² It is when shareholders try to cloak distributions with respect to their stock in the garb of ordinary business transactions that the IRS becomes concerned. These often take the form of corporate "loans" to shareholders for which there is no expectation of repayment, or corporate payment of shareholders' personal liabilities or expenses under the guise of "corporate expenses," or the sale, lease or other transfer of corporate assets or services to shareholders for less than fair

value, or conversely, the sale, lease or other transfer of shareholder assets or services to the corporation at prices exceeding their fair value.

The Treasury and the courts developed the concept of "constructive" or "disguised" corporate distributions to contend with such schemes.ⁿ³ In accord with the "broad definition" of "dividend" in *section 316(a) of the Internal Revenue Code*,ⁿ⁴ a shareholder may be charged with the receipt of a "constructive" dividend, taxable in the same manner as a legally declared dividend, whenever a constructive distribution of property confers an economic benefit on the shareholder.ⁿ⁵ The formalities of a dividend declaration are not required; indeed, a shareholder may be deemed to have received constructive dividends "even though ... [the corporation] has not made a pro rata distribution to the entire class of stockholders, and even though neither the corporation nor the shareholder intended a dividend and the corporation did not record the distribution as a dividend for bookkeeping purposes."ⁿ⁶

A constructive dividend must be a distribution of "property" by a corporation to its shareholders, but in constructive dividend cases the courts generally use "property" and "economic benefit" synonymously. *Section 317 of the Internal Revenue Code* circularly defines "property" as "any property," with the exception of the corporation's own stock and rights to acquire its stock.ⁿ⁷ That definition is "broad" enough to treat a corporation's rendition of services to shareholders a distribution of property.ⁿ⁸ "Property" also includes an option given to shareholders to acquire the corporation's property, even if the option only gives the right to purchase at a price equal to the property's fair market value at the time the option is distributed.ⁿ⁹

A shareholder may be charged with a constructive dividend even if corporate property never actually passes through his hands, but is transferred by the corporation to a nominee,ⁿ¹⁰ or a third party in satisfaction of a legal or moral obligation of the shareholder,ⁿ¹¹ or a third party whose acquisition of the property results from the shareholder's substantial influence over the corporation and in a substantial if intangible personal benefit to the shareholder.ⁿ¹² Such cases often invoke the "assignment of income" principle: a shareholder may not escape taxation on a constructive dividend by using his "controlling interest in the dividend-paying corporation and ... effective power to direct the flow of corporate wealth to another, without routing the transaction through his own hands."ⁿ¹³ In these cases, the Internal Revenue Service and the courts will treat the property as having first been "constructively received" from the corporation by the shareholder, then transferred by the shareholder to the recipient of the economic benefit. When property has not simply been transferred to the shareholder's alter ego or creditor, the deemed transfer is usually a gift (if the recipient is a family member) or a contribution to capital (if the recipient is another corporation or entity in which the shareholder owns a significant financial interest).ⁿ¹⁴

A showing that a shareholder caused property to be transferred from one of his controlled corporations to another does not, without more, establish a constructive dividend to the shareholder, however; the transfer must result in a benefit to the shareholder personally, as opposed to an enrichment of the transferee corporation that benefits the shareholder, if it all, only derivatively by increasing the value of his stock in the transferee.ⁿ¹⁵ In *Sammons*, a leading case, a shareholder caused a corporation he controlled to transfer its funds to an insolvent subsidiary as a contribution to capital, which allowed the subsidiary to repay debts owed to the shareholder. The intercompany transfer from the controlled corporation to its subsidiary, standing alone, could not be regarded as a constructive dividend to the shareholder, for it neither increased his personal wealth nor gave him direct control over the funds.ⁿ¹⁶ The re-transfer of the funds from the formerly insolvent subsidiary into the shareholder's hands could provide the necessary personal shareholder benefit,ⁿ¹⁷ but in this case most of the transferred funds went towards repayment of a debt that had previously been guaranteed by another of the transferor's subsidiaries; and the guarantor was both legally required and financially able to pay the debt if the transferee failed to do so. As to the guaranteed debt, the shareholder derived no economic benefit from the transfer and subsequent re-transfer of the funds to repay the indebtedness. The funds he received were those to which he was not only legally entitled but was assured of receiving whether or not the transfer was made. The insolvent subsidiary's remaining indebtedness was not guaranteed, however, and the shareholder's repayment would not have been possible without the transfer. To this extent, the shareholder did receive a personal economic benefit by diverting the transferor's funds to the transferee, and this could properly be treated as a constructive dividend.

The economic benefit, if any, realized by a shareholder from a corporate distribution is not always the same as the cost to the corporation of furnishing the benefit. For example, a sale of corporate property to a shareholder for less than the corporation's acquisition cost is not a bargain sale, and confers no economic benefit on the shareholder, if the property's sale price is not greater than its current fair market value.ⁿ¹⁸ Similarly, even if payment for services provided by the shareholder's corporation is below the corporation's cost of providing the service, an economic benefit is conferred only to the extent (if any) that the fair market value of the services exceeds the shareholder's payment.ⁿ¹⁹

A corporate expenditure or transfer made for a legitimate business purpose of the corporation will not result in a constructive dividend even if, as a consequence of such an expenditure, an economic benefit is incidentally conferred upon a shareholder.ⁿ²⁰ This rule is not surprising since the purpose of the constructive dividend doctrine is to tax as dividends distributions which are disguised to look like legitimate business transactions but, in substance, are not.ⁿ²¹ Thus, it is normally taken for granted that corporate expenditures for such ordinary and necessary business expenses as the costs of providing a pleasing work environment, business-related travel and entertainment expenses, the business use of corporate automobiles and other transportation facilities, business meals and similar expenses do not create constructive dividends to shareholder-managers because of the incidental personal benefits they may derive from such expenditures, particularly when nonshareholder employees are not taxable on similar benefits they incidentally enjoy from such expenditures.ⁿ²²

An asserted business purpose will not insulate a shareholder from constructive dividend treatment, however, if shareholder benefit was not merely an incidental consequence but the primary purpose of making the expenditure; indeed, the business purpose test is frequently referred to as the "primary purpose" test.

[W]here the primary or dominant motivation for a distribution ... [is] to benefit the stockholder rather than the corporation ... the articulation of a concededly subordinate business justification should [not] cause the entire transaction to be recharacterized for tax purposes[W]e hold that where the business justifications put forward are not of sufficient substance to disturb a conclusion that the distribution was *primarily* for shareholder benefit, this prong of the dividend characterization test is met.ⁿ²³

Moreover, a business purpose may not be enough to avoid constructive dividend treatment if the route chosen for accomplishing that purpose--i.e., the distribution of corporate property--was motivated by shareholder rather than corporate requirements.ⁿ²⁴

The business purpose test is sometimes difficult to apply, not only because "the line between shareholder benefit and corporate benefit is not always clear"ⁿ²⁵ but because the cases are not always consistent in their application of the test. *Sammons* said the test is a search for subjective intent to determine if the distribution was motivated by a desire to primarily benefit the shareholder.ⁿ²⁶ Subsequently, however, in *Kuper v Commr*, decided in the same circuit (the Fifth) explained that "the search for underlying purpose usually involves the objective criterion of actual primary economic benefit to the shareholders as well."ⁿ²⁷ Finally, in *Baumer v US*, the Fifth Circuit announced as a "guiding principle" that "the intent of the parties does not govern the characterization of a distribution. Instead, courts have looked to the economic effect of the transaction at issue in determining the existence of a dividend."ⁿ²⁸ That would seem to leave little if any room for a consideration of subjective intent, though constructive dividend decisions continue to take subjective intent into account.ⁿ²⁹

[b] Corporate "Loans" to Shareholders. The withdrawal of corporate funds unaccompanied by any intention to create an obligation to repay the "loan" is a common source of constructive dividends.ⁿ³⁰ Even where the original withdrawal constitutes a genuine loan, a later cancellation of the indebtedness by the corporation can produce dividend income.ⁿ³¹ The shareholder may seek to escape dividend income consequences by claiming either that the original withdrawal constituted a dividend (a contention that will work a benefit only if the statute of limitations for the original

year has run),ⁿ³² or that the cancellation was a gift from the corporation to the shareholder.ⁿ³³ The chances of success, in either case, seem slim. The taxpayer putting forth a prior dividend claim will no doubt have the difficult task of overcoming the fact that the withdrawal was carried as a loan on the books of the corporation, and that the taxpayer did not originally consider the withdrawal a dividend.ⁿ³⁴ The taxpayer urging a gift will be faced with an even more difficult problem, namely, that courts rarely find the existence of a gift in a business setting.ⁿ³⁵

"For 'disbursements to constitute true loans there must have been, at the time the funds were transferred, an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure repayment' ... In the absence of direct evidence of intent, the nature of the transaction may be inferred from its objective characteristics, ... including the presence or absence of debt instruments, collateral, interest provisions, repayment schedules or deadlines, and any other attributes indicative of an enforceable obligation to repay the sums advanced."ⁿ³⁶ However, "no simple rule exists for determining whether an instrument should be classified as debt or equity; the ultimate test is whether in substance the arrangement more nearly resembles debt or equity, and to answer that question, all the facts and circumstances must be examined and considered."ⁿ³⁷

Thus, charging a withdrawal to the account of the shareholder and carrying the advance as a receivable is often cited as a factor tending to show the withdrawal was a loan and not a disguised dividend, but this factor will not insure nondividend treatment.ⁿ³⁸ Evidencing the obligation to repay with a note and charging and collecting interest on the balance is persuasive of debt characterization, but still not determinative in all circumstances.ⁿ³⁹ The attempt by the corporation to collect the advance weighs heavily in favor of treating the transaction as a loan,ⁿ⁴⁰ as does the fact that the taxpayer repaid at least part of the amount withdrawn.ⁿ⁴¹ While full repayment is generally decisive of the intent issue,ⁿ⁴² it will not be if repayment is matched by further withdrawals, or if repayment is made in an amount relatively insignificant in relation to the total withdrawal.ⁿ⁴³ Finally, the shareholder's inability to repay the loan at the time of withdrawal may be taken as evidence of an intent never to repay.ⁿ⁴⁴

For years, courts were virtually unanimous in holding that an interest-free loan by a corporation to a shareholder did not create income for the shareholderⁿ⁴⁵ but, in 1984, Congress made below-market loans income-producing events. *IRC Section 7872(a)* views the transaction as a transfer of the forgone interest from the lender to the borrower, and a retransfer of the interest by the borrower to the lender.ⁿ⁴⁶ Thus, if a below-market loan is made by corporation to a shareholder, the following tax consequences ensue: a dividend to the shareholder, interest income to the corporation, and interest deduction for the shareholder unless disallowed by some other provision of the Code.ⁿ⁴⁷

If the loan is a term loan, the transfer is treated as occurring on the date the loan is made in an amount equal to the excess of the amount loaned over the present value of all payments that are required to be made under the terms of the loan.ⁿ⁴⁸ Such excess is considered to be original issue discount so that the lender is treated as receiving interest income in a pattern producing a constant yield to maturity over the life of the loan.ⁿ⁴⁹ If the loan is a demand loan the imputed interest that gives rise to the dividend, interest income, and interest deduction is determined for each day the loan is outstanding.ⁿ⁵⁰

[c] Bargain Transactions. A sale of corporate property to shareholders for less than the property's fair market value confers an obvious economic benefit on the shareholders. The Regulations have long taken the position that the shareholders receive a distribution from the corporation in this situation to which section 301 applies, equal in amount to the difference between the price paid for the property and its fair market value.ⁿ⁵¹ The Regulations nevertheless regard the bargain transaction as, in part, a valid sale by the corporation and, prior to the amendment of *IRC section 311(b)* by the Tax Reform Act of 1986, the corporation would have been taxable, in most cases, on the difference between the price paid by the shareholders and the corporation's adjusted basis in the property as gain on the sale or exchange of the property. Under *IRC section 311(b)* as amended, however, the corporation is now taxed on the entire difference between its adjusted basis and the fair market value of the value of the property, as though it had sold the property to its shareholders at fair market value.

Example:

A corporation sells land which cost \$1 million (and has an adjusted basis of \$1 million to the corporation) but a current value of \$4 million, to its sole shareholder for \$2 million. The transaction will be treated as a distribution to the shareholder of \$2 million (\$4 million value of property less the shareholder's \$2 million payment) and, assuming the corporation has sufficient earnings and profits, the distribution will be taxable as a dividend under *IRC section 301*. Under the regulations, the transaction is regarded as a legitimate sale by the corporation to the extent of the difference between the shareholder's payment and the corporation's adjusted basis in the land, resulting in gain on the sale of the property of \$1 million (\$2 million sales price less \$1 million adjusted basis).ⁿ⁵² However, *IRC section 311(b)* now requires the corporation to compute its gain as though it sold the land to the shareholders for fair market value, so that the corporation must report gain of \$3 million rather than \$1 million.ⁿ⁵³

The converse of the bargain sale is present when the shareholder sells property to the corporation and receives a price in excess of fair market value. In that case, the shareholder's constructive dividend is equal to the difference between the price paid by the corporation and the property's lower fair market value, while the corporation's basis in the property is limited to its fair market value.ⁿ⁵⁴

A "bargain rental" of corporate property will result in a constructive dividend to the extent of the difference between the fair rental value of the property and the amount paid by the shareholder.ⁿ⁵⁵

[d] Excessive Compensation. *IRC Section 162(a)(1)* allows "a reasonable allowance for salaries or other compensation for personal services actually rendered" to be deducted from gross income. But when payments labeled salary or compensation are found not to be reasonable in amount but excessive, "if such [excessive] payments correspond or bear a close relationship to stockholdings, and are found to be a distribution of earnings, or profits, the excessive payments will be treated as a [nondeductible] dividend."ⁿ⁵⁶

May a court infer that compensation is excessive because, over a substantial period of time, shareholders of the corporation have taken only salaries and the corporation has never paid dividends? In *Charles McCandless Tile Service v US*,ⁿ⁵⁷ the corporation never paid a dividend, compensation was paid to shareholder/employees in proportion to their stock interests, half the corporation's pre-tax profits (before reduction by their compensation) was paid out to the shareholder/employees as compensation, and the corporation's return on equity capital was "conspicuous by its absence." Even though the Court of Claims found that the total amount of compensation paid to the shareholder/employees was "within the realm of reasonableness," it disallowed a portion of the compensation deduction as a disguised dividend to increase the corporation's earnings to a level that achieved what the court considered a reasonable rate of return on its equity. "Even a payment deemed reasonable," the court said, "is not deductible to the extent that it is in reality a distribution of corporate earnings and not compensation for services rendered."ⁿ⁵⁸

Most courts, however, require independent proof that the shareholder/employee's compensation is not "reasonable" before disallowing a deduction for compensation as a disguised dividend. They typically employ a multifactor analysis which examines most if not all of the following factors:

the employee's qualifications, the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with gross income and net income; the prevailing economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to ... [nonstockholder as well as stockholder] employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years."ⁿ⁵⁹

More recently, courts have applied an "independent investor" or "happy investor" test, which uses the taxpayer

corporation's return on equity as the touchstone and assumes that if an independent investor would be happy with the corporation's returns, the shareholder/employee's salary is probably reasonable. "If the bulk of the corporation's earnings are being paid out in the form of compensation, so that the corporate profits, after payment of the compensation, do not represent a reasonable return on the shareholder's equity in the corporation, then an independent shareholder would probably not approve of the compensation arrangement. If, however, that is not the case and the company's earnings on equity remain at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company disguised as salary."ⁿ⁶⁰ See *Elliott's, Inc v Commr*, 716 F2d 1241, 1247 (9th Cir 1983) .

The adoption of an "independent investor" test in *Elliot's Inc.* followed the court's rejection of an "automatic dividend rule," as it characterized the Court of Claims' approach in *McCandless Tile*. The court explained that a company's failure to pay dividends was a poor indicator of whether management's performance justified its compensation, because many investors, in public as well as closely held corporations, prefer that earnings be reinvested rather than distributed, particularly when alternative means of raising capital are impractical or unavailable.ⁿ⁶¹

The Court of Appeals for the Seventh Circuit places the heaviest emphasis on the happy investor test, holding that satisfaction of that test creates a rebuttable presumption of the reasonableness of shareholder/employee compensation.ⁿ⁶² Other courts of appeal that have adopted the test view it as simply another factor in the multifactor analysis, albeit one that "may be a substantial factor" in certain cases.ⁿ⁶³ The Court of Appeals for the Tenth Circuit is the only circuit thus far to reject the "independent investor" test in favor of exclusive reliance on the traditional multifactor analysis.ⁿ⁶⁴ The Tax Court, unless compelled by its *Golsen* rule to apply a contrary rule adopted by the circuit to which the case before it is appealable,ⁿ⁶⁵ employs a multifactor test viewed "through the lens of an independent investor."ⁿ⁶⁶

An issue that sometimes arises in reasonable compensation cases is whether a shareholder/employee's consistent practice of taking an annual bonus based on a formula, such as a percentage of pretax profits, points towards a disguised dividend or in favor of the reasonableness of such compensation. The Tax Court has argued that a shareholder/employee has no need for an incentive bonus plan because, as a shareholder in the company, there is already sufficient incentive to work hard.ⁿ⁶⁷ The Court of Appeals for the Ninth Circuit rejected that argument because it would prevent shareholder/employees of closely held corporations from working under the same type of incentive arrangements available to non-shareholder employees, a discriminatory result for which the Court could find no justification in the statute or Congressional intent.ⁿ⁶⁸ Moreover, as the Seventh Circuit's opinion in *Menard, Inc.* points out, the argument proves too much; it could justify treating all compensation paid to a controlling shareholder/employee as unnecessary and, therefore, unreasonable.ⁿ⁶⁹

Compensation paid pursuant to any longstanding, consistently applied compensation plan is evidence of reasonableness, but the issue ultimately depends on whether the formula itself is reasonable.ⁿ⁷⁰ The regulations provide that the reasonableness of the formula should be judged at the time the plan is adopted, "even though in the actual working out of the contract ... [compensation] may prove to be greater than the amount which would ordinarily be paid."ⁿ⁷¹ However, the Court of Appeals in *Elliotts, Inc.*, suggested that the operation of the formula be viewed on a long-term basis since "a formula which is reasonable at its inception may later become unreasonable because of changed circumstances."ⁿ⁷² Furthermore, consistent with its adoption of the "independent investor" test as a factor to be considered in the analysis of reasonableness, the Court of Appeals cautioned that the formula "should not stand in the way of a satisfactory return on equity."ⁿ⁷³

It is not uncommon for a closely held corporation to adopt by-laws or enter into agreements with its shareholder-managers which require the latter to return to the corporation any part of their compensation that the Internal Revenue Service determines to be "excessive" or "unreasonable."ⁿ⁷⁴ In *Oswald v Commr*,ⁿ⁷⁵ the Tax Court held, and the Internal Revenue Service subsequently agreed, that the shareholder-manager was entitled to deduct the amount returned to the corporation pursuant to the requirements of the by-law or agreement as an ordinary and

necessary expense under *IRC section 162*.ⁿ⁷⁶ The by-law or agreement does not create an "expectation of repayment" that would support a contention that the excessive compensation was not taxable when received, however; whether taxable as compensation or as a constructive dividend, the shareholder is deemed to have received money from the corporation under a "claim of right" which must be reported as income even though it is subsequently determined that it did not belong to him.ⁿ⁷⁷

[e] Payment of Personal Expenses of Shareholders. An expenditure by a corporation which benefits a shareholder need not be treated as a disguised dividend if the primary purpose of the expenditure is one related to the corporation's trade or business.ⁿ⁷⁸ When the emphasis shifts, and the payment is made primarily to benefit the shareholder, the probability of attack on the ground that the payment constitutes a disguised dividend becomes likely.ⁿ⁷⁹ In addition, the Government will couple this attack with a disallowance of any deduction by the corporation on the theory that the expenditure was not an ordinary and necessary expense of doing business. Thus, reimbursement to a shareholder for excessive entertainment expenses incurred for the primary benefit of the shareholder may be considered a disguised dividend distribution to the shareholder.ⁿ⁸⁰ The same result obtains if the corporation assumes the cost of purchasing and maintaining items such as cars and boats used solely by shareholders for their personal enjoyment and convenience.ⁿ⁸¹ The measure of the dividend in such cases will be the fair rental value of the item.ⁿ⁸²

A crucial factor in determining deductibility is whether the payment in question is one customarily incurred in doing business. For example, in *Tulia Feedlot v. United States*,ⁿ⁸³ shareholders were asked to guarantee a loan which would not have been made without the guarantee. For this, the shareholders demanded a fee equal to 3 percent of the loan. Without the fee, there would have been no guarantee. In reversing a lower court decision that the fee was a necessary expenditure reasonable in amount, the Fifth Circuit took the view that the payments looked suspiciously like dividends. Of importance was the failure on the part of the corporation to show that the fee was ordinary or that similar consideration would have been paid to nonshareholders.

A singular problem is the difficulty in distinguishing between an expense which is primarily made for the benefit of the corporation, but which incidentally benefits the shareholder, and one made primarily to benefit the shareholder. For example, a corporation's payment to a third party in settlement of a claim against a shareholder may not produce dividend income if the corporation was also a party to the proceeding in which the claim was asserted and the settlement relieved the corporation of liability.ⁿ⁸⁴ However, if the only person who could have been liable is the stockholder, payment of the claim will put him in receipt of a constructive dividend.ⁿ⁸⁵ In like fashion, dividend consequences will ensue if the corporation satisfies a contractual obligation of a shareholder,ⁿ⁸⁶ although such will not be the result if the corporation is the primary obligor and the shareholder merely secondarily liable.ⁿ⁸⁷

FOOTNOTES:

(n1)Footnote 1. Eg, *NY Bus Corp Law § 510* (McKinney 1963).

(n2)Footnote 2. See, eg, *Virginia Natl Bank v US*, 450 F2d 1155 (4th Cir 1971) , cert denied 405 US 1065 .

(n3)Footnote 3. *IRC § 316(a)*. Ordinary distributions represent the first charge against earnings and profits. *Baker v US*, 460 F2d 827 (8th Cir 1972) ; *Rev Rul 74-339*, 1974-2 CB 103 ; *Rev Rul 74-338*, 1974-2 CB 101 . This requires current earnings and profits to be computed and applied to dividends without diminution by reason of redemption or liquidation distributions. *Anderson v Commr*, 67 TC 522 (1976) , *affd per curiam* 583 F2d 953 (7th Cir 1978) .

The Service will not issue rulings regarding the determination of earnings and profits. *Rev Proc 2007-3*, 2007-1 CB 108 .

A corporation adopted a plan that provided the shareholders with "poison pill" rights. The purpose of the plan was to establish a mechanism by which the corporation could provide shareholders with rights to purchase stock at substantially less than fair market value as a means of responding to unsolicited offers to acquire the corporation.

Although adoption of the plan constituted the distribution of a dividend under state law, it was not a distribution of stock or property giving rise to the realization of gross income by any taxpayer. *Rev Rul 90-11, 1990-1 CB 10* .

Report, "Elimination of 'Earnings and Profits' from the Internal Revenue Code," 39 *Tax Lawyer* 285 (1986).

(n4)Footnote 4. *Rev Rul 62-131, 1962-2 CB 94* . However, in *Commr v Goldwyn, 175 F2d 641 (9th Cir 1949)* , the Ninth Circuit held that a prior year's dividend reduced accumulated earnings and profits at the time the dividend was declared, not when it was paid.

(n5)Footnote 5. *Rev Rul 65-23, 1965-1 CB 520* .

(n6)Footnote 6. *Treas Reg § 1.301-1(b)*.

(n7)Footnote 7. *IRC § 316(a)*.

(n8)Footnote 8. *Treas Reg § 1.316-2(a); Rev Rul 74-164, 1974-1 CB 74* .

(n9)Footnote 9. *Treas Reg § 1.316-2(b)*.

(n10)Footnote 10. *Treas Reg § 1.316-2(d)*.

(n11)Footnote 11. *Treas Reg § 1.316-2(b); Rev Rul 74-164, 1974-1 CB 74* .

(n12)Footnote 12. A number of articles have been written on the subject. See, eg, McDaniel, "Earnings and Profits: More Than a Cold Accounting Concept: Additions To and Subtractions From," 32 *NYU Inst on Fed Tax* 445 (1974); Schweitzer, "Earnings and Profits: Decisions, Rulings Offer Guidance to Computation and Planning," 36 *J Tax'n* 102 (1972); Paul, "Ascertainment of 'Earnings or Profits' for the Purpose of Determining Taxability of Corporate Distributions," 51 *Harv L Rev* 40 (1937); Katcher, "What is Meant by Earnings and Profits," 18 *NYU Inst on Fed Tax* 235 (1960).

Guidelines for determining the taxable status of corporate distributions and the computation of earnings and profits can be found in *Rev Proc 75-17, 1975-1 CB 677* .

See *Est of DeNiro v Commr, TC Memo 1990-398* , for an instance in which a mistaken assumption that a corporation's earnings and profits were the same as its retained earnings led to an incorrect computation of earnings and profits.

(n13)Footnote 13. *Treas Reg § 1.312-6(a)*.

(n14)Footnote 14. *Treas Reg § 1.312-6(b)*.

(n15)Footnote 15. *Treas Reg § 1.312-6(b)*.

(n16)Footnote 16. The section provides that "gain or loss ... shall increase or decrease the earnings and profits to, but not beyond, the extent to which ... realized gain or loss was recognized. ..." For the purpose of *IRC § 312(f)(1)*, a disallowed wash sale loss is considered an unrecognized loss. *IRC § 312(f)(2)* dictates no increase in earnings and profits from the receipt of a stock dividend or other distribution which is not a taxable dividend and which is directly applied in reduction of basis.

An exception to *IRC § 312(f)(1)* arises in the case of intercompany profits "realized" by a parent but not returned as income because of the filing of a consolidated return. The earnings and profits of the parent are increased in the year in which the profit is realized. *Henry C Beck Co v Commr, 52 TC 1 (1969)* , *aff'd per curiam 433 F2d 309 (5th Cir 1970)* .

(n17)Footnote 17. *193 F2d 827 (1st Cir 1951)* , *cert denied 343 US 934* .

(n18)Footnote 18. A similar fact pattern can be found in *Rev Rul 58-546, 1958-2 CB 143* .

(n19)Footnote 19. *383 F2d 883 (8th Cir 1967)* .

(n20)Footnote 20. *Rev Rul 75-515, 1975-2 CB 117* , declared obsolete in *Rev Rul 2003-99, 2003-2 CB 388* .

(n21)Footnote 21. *IRC § 312(l)(1)*. In the opinion of Congress, the considerations underlying the deferral of recognition of cancellation of indebtedness income by a debtor in a bankruptcy case do not justify tax forgiveness to shareholders receiving nonliquidating distributions. S Rep No 96-1035, 96th Cong, 2d Sess 44 (1980).

(n22)Footnote 22. *IRC § 312(l)(2)*. The reduction in deficit can never create positive earnings and profits.

(n23)Footnote 23. An example is the deduction for net operating loss carryovers. *Treas Reg § 1.312-6(d)*; *Hutton v US, 501 F2d 1055 (6th Cir 1974)* ; *Rev Rul 75-153, 1975-1 CB 106* .

(n24)Footnote 24. *Treas Reg § 1.312-6(c)(1)*.

(n25)Footnote 25. For property placed in service after 1980, and before 1987, a special recovery period must be used for determining earnings and profits, to wit: five years for three-year property, 12 years for five-year property, 25 years for ten-year property, 35 years for 15-year property, and 40 years for 18-year property and low-income housing. If the corporation elects a longer recovery period in figuring its depreciation deduction, it must use that period in calculating depreciation for earnings and profits. *IRC § 312(k)(3)(C)*.

In computing earnings and profits, the allowance for depreciation is determined without the reduction in basis required by *IRC § 48(q)* because of the taking of an investment credit. *IRC § 312(k)(5)*.

(n26)Footnote 26. *IRC § 312(k)(3)(B)*.

(n27)Footnote 27. S Rep No 98-169, 98th Cong, 2d Sess 198 (1984).

(n28)Footnote 28. The term "LIFO recapture amount" means the amount, if any, by which the inventory amount of the corporation's inventory assets (stock in trade of the corporation, or other property of a kind that would properly be included in inventory if on hand at the close of the taxable year) under the first-in, first-out method exceeds the inventory amount of the assets under the LIFO method. The inventory amount of the assets under the first-in, first-out method is determined by using cost or market (whichever is lower), unless the corporation uses the retail method of valuing inventories. *IRC § 312(n)(4)(B), (C)*.

(n29)Footnote 29. The provisions of paragraphs (1) through (4) apply to amounts paid or incurred in taxable years beginning after Sept 30, 1984. The LIFO inventory rules are effective for taxable years beginning after Sept 30, 1984. Paragraph (6) applies to sales after Sept 30, 1984, in taxable years ending after that date. The provisions of paragraph (7) apply to contracts entered into after Sept 30, 1984, in taxable years ending after that date. Tax Reform Act of 1984, § 61(e)(1)(A). The provisions of paragraph (8) apply to distributions in taxable years beginning after Sept 1, 1984.

In the case of a foreign corporation that derives less than 20 percent of its gross income from sources within the US, paragraph (5), applies only in the case of taxable years beginning after Dec 31, 1985, while paragraph (6) applies in the case of taxable years beginning after Dec 31, 1987. *IRC § 312(n)(8)*.

(n30)Footnote 30. *Treas Reg § 1.312-7(b)(1)*.

(n31)Footnote 31. *Treas Reg § 1.312-7(b)(1)*.

(n32)Footnote 32. *Neel v Commr, 1951 Tax Ct Memo LEXIS 278* , is to the contrary. However, pursuant to stipulation, the case was vacated and remanded by the Fifth Circuit on Oct 10, 1952.

(n33)Footnote 33. See § 19.05[1][d] for a discussion of IRC § 163(f).

(n34)Footnote 34. *Kaplan v Commr*, 43 TC 580 (1965) , *nonacq as to this issue*, 1978-1 CB 2 .

(n35)Footnote 35. *Rev Rul 78-123*, 1978-1 CB 87 . The Service reaches this position by increasing earnings and profits by the amount of unrealized appreciation and then decreasing earnings and profits by the fair market value of the property. This produces a charge equal to adjusted basis.

(n36)Footnote 36. IRC § 312(a), (b), (c) discussed in § 4.07[2] *infra*.

(n37)Footnote 37. See §§ 5.05[2] and 6.05 *infra* .

(n38)Footnote 38. IRC § 312(h). Allocation of earnings and profits in corporate separations is treated in § 8.06[3] *infra* .

(n39)Footnote 39. IRC § 312(i). The adjustment calls for an increase in earnings and profits by the amount of the excess of the outstanding loan over the adjusted basis of the security therefor, followed immediately after the distribution by a corresponding decrease in earnings and profits.

(n40)Footnote 40. *Treas Reg § 1.312-6(a)*. Thus, amortizable bond premium on tax-exempt bonds is an expense of the year to which it is attributable, and must be reflected in earnings and profits for that year even though no deduction can be claimed for the expense. *Rev Rul 71-165*, 1971-1 CB 111 .

(n41)Footnote 41. *Neptune Meter Co v Price*, 98 F2d 76 (2d Cir 1938) .

(n42)Footnote 42. *Drybrough v Commr*, 238 F2d 735 (6th Cir 1956) ; *Demmon v US*, 321 F2d 203 (7th Cir 1963) .

(n43)Footnote 43. *Webb v Commr*, 572 F2d 135 (5th Cir 1978) , *affg per curiam* 67 TC 1008 (1977) ; *Helvering v Alworth Trust*, 136 F2d 812 (8th Cir 1943) , *cert denied* 320 US 784 (1943) ; *Ferguson v Commr*, 47 TC 11 (1966) , *acq* 1970-2 CB xix; *Arenstein v Commr*, TC Memo 1993-339 ; *Manning v Commr*, TC Memo 1993-127 ; *Mazzocchi Bus Co v Commr*, TC Memo 1993-43 , *aff'd* 14 F3d 923 (3d Cir 1994) ; *Rev Rul 70-609*, 1970-2 CB 78 .

Estimated tax payments made by corporations using the cash receipts and disbursements method of accounting reduce earnings and profits in the year paid regardless of ultimate tax liability. *Rev Rul 79-69*, 1979-1 CB 134 .

(n44)Footnote 44. *Estate of Stein v Commr*, 25 TC 940 (1956) , *acq*, 1957-2 CB 7 ; *Rev Rul 57-332*, 1957-2 CB 231 . The Fifth Circuit does not follow this view. See *Bernstein v US*, 234 F2d 475 (5th Cir 1956) , *cert denied* 352 US 915 .

(n45)Footnote 1. A discussion of personal holding companies is contained in 3 Rabkin & Johnson, *Federal Income, Gift and Estate Taxation*, Ch 17 (Matthew Bender).

(n46)Footnote 2. IRC § 316(b)(2)(A)(ii).

(n47)Footnote 3. *Treas Reg § 1.316-1(d)*, Ex (2).

(n48)Footnote 4. IRC § 316(b)(2)(B). The notification requirement is satisfied if the corporation claims a dividends paid deduction in the amount of the designated dividend in its return for the year in which, or in respect of which, the distribution is made, and includes such amount in Form 1099 and in a written statement of dividends paid furnished to the shareholder. *Treas Reg § 1.316-1(b)(5)*.

(n49)Footnote 5. IRC § 316(b)(2)(B)(iii); *Treas Reg § 1.316-1(b)(3)*, (d), Ex (5). If there is more than one

distribution in the year, or more than one class of stock, the amount of dividend in each distribution or allocable to each class of stock must be figured separately.

(n50)Footnote 1. *US v Smith*, 418 F2d 589, 593 (5th Cir 1969) ; Rabkin & Johnson, 3 *Federal Income, Estate and Gift Taxation*, § 21.07 (Matthew Bender); Comment, "Disguised Dividends: A Comprehensive Survey," 3 *UCLA L Rev* 207 (1956). The ensuing discussion assumes the presence of earnings and profits, for without them, there can be no disguised dividend. Although the absence of earnings and profits will prevent the distribution from being cast as a dividend, it still must be treated as a corporate distribution. *BB Rider Corp v Commr*, TC Memo 1982-98 (1982) , *aff'd* 725 F2d 945 (3d Cir 1984) .

A corporation's cancellation of a shareholder's debt without consideration can be treated as a distribution to the shareholder, that, in turn can be treated as a dividend to the extent of the corporation's earnings and profits. *Burke v Commr*, TC Memo 1997-237 , *aff'd by unpublished order* 176 F3d 488 (10th Cir 1999) .

A taxpayer's total control over a corporation and use of corporate funds for personal reasons can result in constructive dividends, even though the taxpayer does not hold legal title to the corporation's stock at the time of the advances. See *eg*, *Yelencsics v Commr*, 74 TC 1513 (1980) ; *Cordes v Commr*, TC Memo 1994-377 .

(n51)Footnote 2. *IRC § 301(a)* provides that only distributions made by a corporation with respect to its shareholders' stock are taxable as dividends. Thus, *IRC § 301* does not apply to amounts paid by a corporation to a shareholder acting in some other capacity. *Treas Reg § 1.301-1(c)*. The shareholder may be taxable on the payment under a Code section other than *IRC § 301*--under *IRC § 61*, for example, if the corporate payment represents compensation for his services--but since the payment will often be deductible by the corporation as a business expense, the desired goal of avoiding double taxation of corporate earnings will have been achieved.

(n52)Footnote 3. Once a common issue in IRS audits, the number of tax disputes involving "disguised dividends" appears to have diminished substantially in recent years. If true, it may be because taxpayers are increasingly avoiding the double taxation dilemma, within the letter and spirit of the law, by using "pass-through" entities such as S corporations and limited liability companies taxed as partnerships, rather than "C corporations" the formerly preferred investment vehicle for closely held businesses. See Chapters 14 and 15, *infra*. The Congressional Research Service reported that, according to IRS data, the number of businesses taxed as partnerships grew 38 percent between 1983 and 2006, with most of the growth being attributed to LLCs. "CRS Report Says Most US Businesses Likely Taxed at Individual Rates," 2009 *TNT* 154-24 (Aug 13, 2009).

The taxation of qualifying dividends from C corporations at capital gain rather than ordinary income tax rates beginning in 2004 has also diluted the incentive to employ disguised dividend schemes.

(n53)Footnote 4. Section 316(a) defines a dividend as any distribution of property by a corporation to its shareholders made out of post-1913 earnings and profits or earnings and profits of the taxable year. It further provides that all corporate distributions of property are deemed made out of the corporation's earnings and profits, (starting with the most current) to the extent thereof. See § 4.02[1].

(n54)Footnote 5. *Crosby v US*, 496 F2d 1384, 1388 (5th Cir 1974) ; *US v Smith*, 418 F2d 589, 593 (5th Cir 1969) ; *Gibbs v Tomlinson*, 362 F2d 394, 397 (5th Cir 1966) . It must be remembered that a constructive distribution of property is only a constructive dividend if the corporation has sufficient earnings and profits to cover the distribution. See § 4.02[1], above. The tax consequences to the shareholder of a constructive distribution without earnings and profits may well approximate those of a constructive dividend, however. The economic benefit received by the shareholder in the transaction would still be considered a distribution of corporate property with respect to the shareholder's stock, and the value of the benefit received by the taxpayer in excess of the taxpayer's basis in the stock would be taxed as gain on a sale or exchange of the stock. See *IRC § 301(c)*, discussed in § 4.03[3] below. Currently, such gain would be taxable at the same capital gains rates that would have applied to a constructive dividend. See *IRC §*

1(h)(11).

(n55)Footnote 6. *Crosby v US*, 496 F2d at 1388 .

(n56)Footnote 7. *IRC § 317* parenthetically provides a few non-exclusive examples of property: "money, securities, and indebtedness to the corporation." The term "securities" here does not include the distributing corporation's own stock or rights to acquire its stock. *IRC § 317, supra*. For the tax treatment of distributions of stock dividends and stock rights, see § 4.06 below.

(n57)Footnote 8. *Loftin and Woodard, Inc v US*, 577 F2d 1206, 1214 (5th Cir 1978) .

(n58)Footnote 9. *Baumer v US*, 580 F2d 863, 881 (5th Cir 1978) . See also *Redding v Commr*, 630 F2d 1169, 1181-1184 (7th Cir 1980) , *cert denied* 450 US 913 (1981) ; *Weigl v Commr*, 84 TC 1192, 1221-1223 (1985) ; *Rev Rul 80-292*, 1980-2 CB 104 ; *Rev Rul 70-521*, 1970-2 CB 72 .

In *Palmer v Commr*, 302 US 63, 71 (1937) , a case decided under the Revenue Act of 1928, the US Supreme Court said, in dictum, that "the mere issue of rights to subscribe [to the purchase of corporate property] and their receipt by stockholders, is not a dividend. No distribution of corporate assets or diminution of the net worth of the corporation results in any practical sense." The cases and rulings cited above concluded that the addition of *IRC § 317* to the Internal Revenue Code significantly changed the statutory framework and justified disregarding this dictum in *Palmer*. Under the Internal Revenue Code as currently written, the distribution of an option to acquire corporate property can be considered a dividend (assuming sufficient earnings and profits) because an option comes within the Code's broad definition of "property." Moreover, as the Court of Appeals stated in *Baumer*, "Any determination of whether the grant of an option to purchase property constitutes a distribution of valuable rights must consider not only the "spread" between the exercise price of the option and the fair market value of the underlying property, but also the length of time during which the rights can be exercised and the potential for appreciation during that period. *Baumer v US*, 580 F2d at 879 (n. 23). Thus, even an option to purchase corporate property at its fair value at the time the option is issued may be a taxable dividend if the purchase rights are exercisable over a substantial period of time (which was not the case in *Palmer*) and there is a reasonable expectation of appreciation in the value of the property during that period. *Id*.

(n59)Footnote 10. See *Honigman v Commr*, 466 F2d 69 (6th Cir 1972) (transfer of corporate property which shareholder caused to be sold for less than fair market value to a second corporation organized by the shareholder's wife resulted in a constructive dividend to the shareholder).

(n60)Footnote 11. *Hardin v US*, 461 F2d 865, 872 (5th Cir 1972) (corporate payments to shareholder's sister-in-law "to satisfy what Taxpayer obviously felt to be a personal or moral responsibility for his sister-in-law's welfare"); *Baumer v US*, 580 F2d at 883 (gratuitous transfer of valuable option to purchase corporate property to shareholder's adult son "to satisfy the moral obligation of Father to compensate Son for taking advantage of a business opportunity Father had personally discouraged Son from pursuing").

(n61)Footnote 12. See *Green v US*, 460 F2d 412 (5th Cir 1972) (corporate property acquired at bargain price by shareholder's adult and minor children was a constructive dividend to their father); *Sammons v Commr*, 472 F2d 449 (5th Cir 1972) (transfer of corporate property between corporations within affiliated group that allowed controlling shareholder to collect otherwise uncollectible debt from the transferee was a constructive dividend to shareholder); *Kuper v Commr*, 533 F2d 152 (5th Cir 1976) (transfer of corporate funds from one brother-sister corporation to another that facilitated an exchange of stock between the shareholders was a constructive dividend to the shareholders).

Whether a shareholder has sufficient stock ownership to permit the exercise of "substantial influence" is a factual matter which precludes any "bright line" rule, though clearly in some circumstances such influence can be exercised even by a shareholder with less than majority ownership. *Green v US*, 460 F2d at 421 . The shareholder in *Green* was found to have exercised substantial influence over the corporation despite owning less than 8 percent of its stock. He

was the corporation's president as well as a director who presided over board meetings, but, "most important of all," the Court could find no other plausible explanation for why the corporation would confer an economic benefit upon non-shareholders "who were strangers to the company save for their connection to it through their mother and father." *Id.* "[W]here a corporation consummates a transaction with favorable consequences for a controlling shareholder's immediate family, 'only in the most extraordinary circumstances' would it be possible to conclude that the shareholder had not exercised 'substantial influence' in causing a diversion of corporate assets, thereby justifying constructive dividend treatment."

In *Commr v Riss*, 374 F2d 161, 167-169 (8th Cir 1967), on the other hand, the Court refused to charge a minority shareholder with a constructive dividend even though his former spouse enjoyed the use of a corporate-owned residence. As the result of a property settlement the shareholder had no legal obligation to provide his ex-wife with a home or support, and though he was chairman of the board of the family corporation, a majority of its stock was owned by his adult children who had, perhaps, greater reason for allowing the corporation to make the house available to their mother, and who themselves used the house as a residence for part of the period in issue.

The Court noted in *Riss* that the family corporation's claimed deductions for depreciation and maintenance expenses with respect to the ex-wife's residence had been disallowed by the Internal Revenue Service and that the disallowance was upheld by the Tax Court, a decision from which the corporation did not appeal. However, the Court observed that "the fact that such items were disallowed as a corporate business expense does not in itself establish that an economic benefit flows to a shareholder." 374 F2d at 169. See also *Palo Alto Town & Country Village, Inc v Commr*, 565 F2d 1388, 1391 (9th Cir 1977).

(n62)Footnote 13. *Green v US*, 460 F2d at 419. See also *Honigman v Commr*, 466 F2d at 74; *Hardin v US*, 461 F2d at 872; *Commr v Riss*, 374 F2d at 169. As noted below, § 4.05[2][b], *infra*, the general rule regarding the assignment of dividend income, whether or not the shareholder owns a controlling interest in the corporation, is that dividends are always taxable to the beneficial owner of the stock.

(n63)Footnote 14. See *Hagaman v Commr*, 958 F2d 684, 691 (6th Cir 1992). In *Rountree Cotton Co v Commr*, 113 TC 422 (1999), *aff'd per curiam* by unpublished opinion, 2001 US App LEXIS 5258 (10th Cir 2001), interest-free loans were made by a closely held corporation to a borrower entity owned in part by the lender's shareholders and in part by non-shareholders, all of whom were members of the immediate families of the lender's shareholders. The issue was whether these "below market" loans were made "directly or indirectly" between the corporation and its shareholders within the meaning of IRC § 7872(c)(1)(C), despite the fact that the borrowing entity was owned in part by non-shareholder family members. See § 4.02[3][b], notes 47 and 48, *infra*, and accompanying text. The Tax Court analyzed the transaction as though the corporation first made a "below-market" loan solely to its shareholders, on which imputed interest was deemed distributed to the shareholders and then repaid to the corporation as interest in accordance with the provisions of IRC § 7872. The shareholders were then deemed to have re-loaned a portion of the borrowed funds to the family member-owners of the borrower in accordance with their interests in the entity that had actually borrowed the funds. The result is comparable to constructive dividend cases like *Hardin* and *Green*; indeed, the Tax Court justified the result with language that could have been lifted from a constructive dividend case. "To the extent that ... family members who were not shareholders received some benefit from the below-market loans, they did so only because the lender's shareholders (who were also ... family members) made the decision or choice that they so benefit." 113 TC at 436.

(n64)Footnote 15. See, eg, *Sammons v Commr*, 472 F2d at 453; *Mills v Commr*, 840 F2d 229, 235 (4th Cir 1988).

(n65)Footnote 16. See *Sammons v Commr*, 472 F2d at 453. In the context of transfers of property between vertically integrated corporations, the Fifth Circuit observed, the shareholder has "no more control over or right to the money [after a gratuitous transfer from parent to subsidiary] than he did before the transfer occurred," nor does the parent "relinquish its interest in the transferred funds ... though its control over them may be attenuated ... Only when

[the transferor's] funds are diverted from the lineal chain of ownership, either to the shareholder himself or to a collaterally owned chain of corporations, does his right to the funds have a source independent of his direct or indirect ownership of the stock of the distributing corporation, and only then has the [parent] corporation relinquished control of the funds."

Dictum in *Sammons* suggests that gratuitous transfers between brother-sister corporations are different, and require the application of a business purpose test to distinguish "between the normal business transactions of [the] related corporations and those transactions designed primarily to benefit the stockowner." 472 F2d at 451. As a practical matter, however, the analysis is not appreciably different in either case. Courts do not regard a gratuitous transfer of property between commonly controlled corporations as necessarily conferring an economic benefit on the common shareholder and will refuse to infer such a benefit absent a showing that the shareholder benefitted personally from the transfer. See *Joseph Lupowitz Sons, Inc v Commr*, 497 F2d 862, 868 (3d Cir 1974) (interest-free loans made from one brother-sister corporation to another did not personally benefit their common shareholders and the loans were therefore not constructive dividends; "absence of a specific business purpose in making the transfers... does not mandate a different result."). See also *Mills v Commr*, 840 F2d 229, 235 (4th Cir 1988) ("Any transfer that benefits a corporation can be said indirectly to benefit the corporation's shareholders, but it is not a constructive dividend unless it benefits the shareholder in some direct way quite apart from his strictly derivative interest as a shareholder.")

The courts' attitude towards the constructive dividend implications of brother-sister property transfers is illustrated by the Tax Court's decision in *White Tool and Machine Co v Commr*, 41 TCM 116, TC Memo 1980-443, 1980 Tax Ct Memo LEXIS 145. In that case, one of the shareholders' controlled corporations paid excessive rentals for leased property to other commonly controlled "brother-sister" corporations. The Internal Revenue Service disallowed the rent deduction claimed by the payor corporation to the extent it exceeded an arm's length rental determined under IRC § 482 and, in addition, charged the common shareholders with constructive dividends equal to the excessive rentals paid to the brother-sister recipients. The Tax Court upheld the Service's § 482 adjustment but rejected constructive dividend treatment for the shareholders because they had neither received nor made personal use of the transferred funds. The Tax Court acknowledged that the controlled group had (temporarily) realized tax savings as a result of the payor corporation's deduction of the excessive rentals at no tax cost to the transferees, which had losses with which to offset the excessive rental income, but refused to treat this as a personal benefit to the group's shareholders. In the first place the Service's § 482 adjustment had eliminated the benefit; moreover, any net increase in the value of the shareholders' stock as a result of the temporary increase in their corporations' after-tax income was a "derivative" and not a personal benefit. See also *R T French Co v Commr*, 60 TC 836, 854-856 (1973).

(n66)Footnote 17. See *McLemore v Commr*, TC Memo 1973-59, 1973 Tax Ct Memo LEXIS 228, 32 TCM 259, aff'd 494 F2d 1350 (6th Cir 1974).

(n67)Footnote 18. This follows from the general rule that when a corporation distributes property in kind as a dividend to its stockholders, whether legally declared or constructively paid, the amount of the distribution taken into account by the recipient is the fair market value of the property, not the corporation's adjusted basis in the property. IRC § 301(b)(1); See § 4.03[1], *infra*.

(n68)Footnote 19. *Loftin & Woodard, Inc v US*, 577 F2d at 1219-1223; *Ireland v US*, 621 F2d 731 (5th Cir 1980). What it costs the corporation to provide a service to a shareholder may be used as a surrogate for the fair market value of the service only if fair value is not otherwise ascertainable. "The equation of value with costs is, therefore, not the norm but the exception." *Loftin & Woodard, Inc v US*, 577 F2d at 1223. As *Loftin & Woodard, Inc* demonstrates, the data necessary to establish the cost of providing a service to the shareholder may be more readily to hand than evidence of fair market value but its determination may be no less controversial, particularly if the corporation is performing a custom service. For example, should "cost" be limited to out-of-pocket costs or include an allocation of the corporation's fixed expenses, and how should direct costs benefitting several-9 jobs should be apportioned to services performed for the shareholder.

(n69)Footnote 20. See, eg, *Mills v Commr*, 840 F2d 229, 235 (4th Cir 1988) ; and *Rushing v Commr*, 52 TC 888 (1969) , *aff'd on other grounds*, 441 F2d 593 (5th Cir 1071) . In both cases, the court refused to find that interest-free advances from one brother-sister corporation to another were constructive dividends to their common stockholder because the corporation making the advances was serving a substantial business interest of its own in assuring the success of the transferee's business. See also *Sammons v Commr*, 472 F2d at 451 , in which the Court of Appeals observed that, where property is transferred between brother-sister corporations, the business purpose test serves to distinguish "between the normal business transactions of [the] related corporations and those transactions designed primarily to benefit the stockowner." The business purpose test is not limited to transfers within a related group of corporations, however; many if not most constructive dividend cases turn on the issue of whether an expenditure or transfer made directly to a shareholder is justified by a corporate business purpose. See § 4.02[3][e], *infra*.

(n70)Footnote 21. See *Mills v Commr*, 840 F2d at 235 : "When there is no evasion of corporate income tax and the only benefit to the shareholder is indirect or derivative, transfers between closely related corporations are not constructive dividends to the common shareholder.

(n71)Footnote 22. Congress has imposed special substantiation and other requirements as conditions to the deductibility of these expenses because the personal consumption element makes them particularly subject to abuse, whether the benefit is enjoyed by shareholder-managers or non-shareholder employees. See *IRC §§ 274, 280F*. However, a corporation's failure to meet these additional Code requirements does not mean that the expense was not incurred for a proper corporate purpose, and accordingly disallowance of a deduction to the corporation under these provisions neither requires nor supports a constructive dividend to the shareholder. *Ashby v Commr*, 50 TC 409, 418 (1968) . Neither, of course, does such a disallowance prevent the Internal Revenue Service from imputing a constructive dividend to the shareholder if in fact the expenditure was made primarily for the shareholder's benefit. See *Nichols, North, Buse Co v Commr*, 56 TC 1225, 1238-1239 (1971) , *acq*, 1972-1 CB 1 .

(n72)Footnote 23. *Sammons v Commr*, 472 F2d at 452 (emphasis in original).

(n73)Footnote 24. In *Kuper v Commr*, 533 F2d at 162 , the court of appeals agreed with the Tax Court that the transfer of funds from one of the shareholders' commonly controlled corporations to another was motivated by the "primary corporate goal" of removing one of the shareholders from the ownership and management of the transferor corporation, thereby avoiding continuing managerial friction among the shareholders. But, the Court said, "it is not the ultimate motivating factor which is in question but rather the intent behind the specific route by which the larger purpose was accomplished." 533 F2d at 162 . The remaining shareholders could have accomplished the corporate purpose by having the transferor corporation pay them a cash dividend for use as "boot" in their stock-for-stock exchange to equalize the values of the transferor's stock they received with the value of the transferee's stock given up by the departing shareholder in the exchange. Instead, they chose to accomplish the equalization by having the transferor corporation make a gratuitous transfer of funds to the transferee, a route which personally benefitted the shareholders by enabling them to exchange stocks of equal value without having to come up with additional cash to compensate for the pre-transfer difference in stock values, but which, as compared with the dividend route, served no business purpose of the transferor corporation.

(n74)Footnote 25. *Sammons v Commr*, 472 F2d at 452 .

(n75)Footnote 26. *Sammons v Commr*, 472 F2d at 451 . At the same time, the Court noted that "the search for intent or purpose is not ordinarily prerequisite to discovery of a dividend." *Id*.

(n76)Footnote 27. *Kuper v Commr*, 533 F2d at 160 (emphasis in original).

(n77)Footnote 28. 580 F2d at 876 .

(n78)Footnote 29. See *Cox Enterprises Inc & Subsidiaries v Commr*, 97 TCM 1767, TC Memo 2009-134, 2009 Tax Ct Memo LEXIS 134 (2009) , in which subjective intent was not only taken into account but trumped a significant

economic benefit resulting from a corporation's transfer of property for a consideration concededly well below the property's fair market value to a partnership composed of the beneficiaries of trusts that owned the corporation. The taxpayer was a closely held corporation owned by three trusts of which the trustees were two sisters and the beneficiaries were the sisters (holders of life estates) and their children (the remaindermen). The corporation's subsidiary transferred a going business, a television station, to a partnership in which the subsidiary owned a 51 percent interest; the trust beneficiaries directly or indirectly owned the remaining 49 percent. The taxpayer corporation *conceded* for purposes of its motion for summary judgment that the fair market value of the television station assets transferred to the partnership exceeded the value of the 51 percent partnership interest the corporation received in exchange by \$60.5 million. Treating this *ipso facto* enhancement in the value of the trust beneficiaries' minority interests in the partnership as a distribution with respect to the subsidiary's stock, and ultimately a constructive dividend to the taxpayer's stockholders, the Internal Revenue Service contended that as a corollary of this determination the distributing corporation was taxable under *IRC § 311(b)* on the appreciation (excess of fair market value over basis) of the assets deemed distributed.

The Tax Court held that no constructive dividend, and therefore no corporate distribution of appreciated property taxable under *IRC § 311(b)*, took place because none of the parties intended the transaction to confer an economic benefit on the taxpayer's shareholders. The corporation had been advised by management consultants to reduce its investment in the broadcasting business but efforts to find a third party buyer for the television station had been unsuccessful. By transferring the TV station to the partnership, the taxpayer could at least partially achieve its disinvestment goal while serving another important if somewhat inconsistent corporate objective: demonstrating to its remaining broadcast employees that it continued to be committed to the broadcasting business. Most important, however, was the "undisputed" fact that the conceded discrepancy between the value of the station assets transferred to the partnership and the value of the partnership interest the taxpayer received in exchange had been wholly "unintentional," occurring despite rather than as a result of the parties' wishes. *TC Memo 2009-134* (Slip Op, p 40). The parties made good faith efforts to determine an arm's length price for the station assets by engaging an outside accounting firm to make an appraisal and even increasing the assets' valuation as recommended by a second appraiser after errors were discovered in the first appraisal. The parties' benign intent was inconsistent with, and therefore precluded, a constructive dividend, notwithstanding that, as a matter of actual economic fact, the family wealth of the shareholder trusts' beneficiaries had been enhanced, and the corporation's net worth diminished, by over \$60 million.

The Tax Court also concluded that the admitted inadequacy of the consideration received by the corporation did not benefit the shareholder trusts but rather was inimical to their interests. A transfer that effectively diverted corporate assets to the trust's beneficiaries prior to the time they were scheduled to receive distributions of the trust corpus was necessarily contrary to the wishes of the grantor of the trusts, the deceased father of the two sisters. *Cox Enterprises Inc & Subsidiaries v Commr, TC Memo 2009-134*, (Slip Op pp 40-46) .

Cf. *Lamble v Commr, TC Memo 1967-185*, 1967 *Tax Ct Memo LEXIS 76*, 26 *TCM* 912 , another case in which the Commissioner asserted that the allegedly non-arm's price paid for a going business resulted in a constructive dividend, even though good faith efforts (including an outside appraisal) had been made to arrive at a fair, arm's length price for the business. In *Lamble*, however, not being bound by the taxpayer's concession to the contrary, the Tax Court found that the price paid for the business was in fact its fair market value, and so avoided the difficult issue that confronted the Court in *Cox Enterprises*.

See also Field Service Advice Memoranda [sic] of November 10, 1998, *FSA LEXIS 571*. This FSA, despite the redactions made by the Internal Revenue Service, was obviously prepared in connection with the audit of Cox Enterprises that resulted in the Tax Court litigation. Interestingly, the author of the FSA concluded that "when a transaction is bona fide and conducted in an arm's length manner, the ultimate objective of the constructive dividend theory has been obtained and the courts need not determine independently the value of the property transferred." (FSA, p. 42).

(n79)Footnote 30. Eg, *Liverno is Trust v Commr*, 433 F2d 879 (6th Cir 1970) ; *Tollefsen v Commr*, 431 F2d 511 (2d Cir 1970) , *cert denied*, 401 US 908 ; *Regensburg v Commr*, 144 F2d 41 (2d Cir 1944) , *cert denied*, 323 US 783 .

(n80)Footnote 31. *Treas Reg § 1.301-1(m)*; *Shephard v Commr*, 340 F2d 27 (6th Cir 1965) , *cert denied*, 382 US 813 ; *Kaplan v Commr*, 21 TC 134 (1953) , *acq*, 1954-1 CB 5

(n81)Footnote 32. *Shephard v Commr*, 340 F2d 27 .

(n82)Footnote 33. See, eg, *Fitch v Helvering*, 70 F2d 583 (8th Cir 1934) .

(n83)Footnote 34. *Wiese v Commr*, 93 F2d 921 (8th Cir 1938) , *cert denied*, 304 US 562 ; *Shephard v Commr*, 340 F2d 27 .

(n84)Footnote 35. *Commr v Duberstein*, 363 US 278 (1960) .

(n85)Footnote 36. See *Geftman v Commr*, 154 F3d 61, 68 (3rd Cir 1998) , quoting *Haag v Commr*, 88 TC 604, 615-616 (1987) , *aff'd* 855 F2d 855 (8th Cir 1988) (table). See also *Fin Hay Realty Co v US*, 398 F2d 694, 696 (3rd Cir 1968) .

(n86)Footnote 37. *Monon Railroad v Commr*, 55 TC 345, 356 (1970) , *acq*, 1973-2 CB 3 , citing, *inter alia*, *John Kelley Co v Commr*, 326 US 521, 530 (1946) .

(n87)Footnote 38. *Regensburg v Commr*, 144 F2d 41 (2d Cir 1944) , *cert denied*, 323 US 783 ; *Spheeris v Commr*, 284 F2d 928 (7th Cir 1960) , *cert denied* 366 US 944 . In addition to the fact that the advances in *Regensberg* were treated as receivables on the corporation's books, they were made to the four principal stockholders of the corporation, all brothers, in amounts that differed significantly from their respective percentage interests in the corporation's stock, while other shareholders apparently received no advances at all. The Court of Appeals conceded that such inequality of economic benefits among shareholders was an "extraordinary feature" of a disguised dividend scheme, but even taken together with the corporation's treatment of the advances as debts on its books it did not prevent the trial judge from concluding (as he did) that the advances were in substance constructive dividends, largely on the basis that the advances had been allowed to accumulate over a 40 year period to a "staggering total" that exceeded the value of the borrowing shareholders' stock. *Regensberg v Commr*, 144 F2d at 44 .

(n88)Footnote 39. *Page v Haverty*, 129 F2d 512 (5th Cir 1942) (note existed, loan found); *Spheeris v Commr*, 284 F2d 928 (7th Cir 1960) , *cert denied* 366 US 944 (no note, held a dividend). The presence or absence of a note can be outweighed by other factors. See *Meyer v Commr*, 45 BTA 228 (1941) , *acq*, 1942-1 CB 12 , and *White v Commr*, 17 TC 1562 (1952) , *acq*, 1952-2 CB 3 . In *Est of Taschler v US*, 440 F2d 72 (3d Cir 1971) , the deduction of interest from the taxpayer's salary did not convert a withdrawal into a loan. The taxpayer was in complete control of the corporation and, thus, had complete control over the amount of his salary.

(n89)Footnote 40. *White v Commr*, 17 TC 1562 (1952) , *acq*, 1952-2 CB 1 . Filing a claim against the estate of deceased stockholder did not prevent the court from finding the existence of a constructive dividend in *Regensburg v Commr*, 144 F2d at 44 .

(n90)Footnote 41. *Straub Distrib Co v Commr*, TC Memo 1971-46 ; *Shaken v Commr*, 21 TC 785 (1954) , *acq*, 1954-2 CB 5 .

(n91)Footnote 42. *Page v Haverty*, 129 F2d 512 ; *Rhodes v Commr*, 34 BTA 212 (1936) , *acq*, XV-1 CB 19, *rev'd* 100 F2d 966 (6th Cir 1939) .

(n92)Footnote 43. Comment, "Disguised Dividends: A Comprehensive Survey," 3 *UCLA L Rev* 207, 226 (1956); *Regensburg v Commr*, 144 F2d 41.

(n93)Footnote 44. *Crabbe v Commr*, TC Memo 1956-52 ; *Meyer v Commr*, 45 BTA 228 (1941) , acq 1942-1 CB 12 .

(n94)Footnote 45. *Dean v Commr*, 35 TC 1083 (1961) nonacq 1973-2 CB 4 ; *Beaton v Commr* 664 F2d 315 (1st Cir 1981) ; *Martin v Commr*, 649 F2d 1133 (5th Cir 1981) ; *Suttle v Commr*, 625 F2d 1127 (4th Cir 1983) ; *Baker v Commr*, 75 TC 166 , aff'd, 677 F2d 11 (2d Cir 1982) . The only court to hold otherwise was the then Court of Claims but it was reversed on appeal. *Hardee v US*, 708 F2d 661 (Fed Cir 1983) , rev'g 50 AFTR 2d 82-5252 .

(n95)Footnote 46. The provision is effective for term loans made after June 6, 1984 and demand loans outstanding thereafter. In addition to loan transactions "directly or indirectly" between a corporation and its shareholders, the provision applies to below-market gift loans, below-market compensation related loans between employer and employee or between an independent contractor and a person for whom the contractor provided services, any below-market loan one of the principal purposes of which is the avoidance of any federal tax, and any other below-market loan where the interest arrangements have a significant effect on any federal tax liability of the lender or borrower. IRC § 7872(c)(1). It does not apply to transactions governed by IRC § 483 or 1274.

(n96)Footnote 47. See *Rountree Cotton Co v Commr*, 113 TC 422, n 12 . The imputed interest provisions are inapplicable to any day on which the aggregate outstanding amount of loans between corporation and shareholder does not exceed \$10,000, unless one of the principal purposes of the loan's interest provisions is the avoidance of any federal tax. IRC § 7872(c)(3).

(n97)Footnote 48. IRC § 7872(b)(1). The present value of any payment is determined as of the date of the loan using a discount rate equal to the applicable federal rate in effect under IRC § 1274(d) on the date of the loan for loans of similar duration, compounded semiannually. IRC § 7872(f)(1), (2)(A).

(n98)Footnote 49. IRC § 7872(b)(2).

(n99)Footnote 50. The imputed interest rate for demand loans is the federal short-term rate in effect under IRC § 1274(d) for the period for which the forgone interest is being determined. IRC § 7872(f)(2)(B).

(n100)Footnote 51. *Treas Reg § 1.301-1(j)* (1955). The Treasury has been maintained this position since 1923. See TD 3435 , II-1 CB 50 (1923) (declared obsolete in *Rev Rul 69-31*, 1969-1 CB 307 because the position taken therein is contained in later statements on the subject.)

(n101)Footnote 52. *Treas Reg §§ 1.301(j)(1), 1.301(k)* Example (1).

(n102)Footnote 53. See *S Tulsa Pathology Lab v Commr*, 118 TC 84 (2002) ; § 4.08[1][b], *infra* .

(n103)Footnote 54. *Goldstein v Commr*, 298 F2d 562 (9th Cir 1962) ; *Emmerson v Commr*, 44 TC 86 (1965) . However, where the property sold consisted of an entire business and the allegedly excessive portion of the price actually represented the fair market value of the business' goodwill, the taxpayer could not be charged with receipt of a disguised dividend. *Staab v Commr*, 20 TC 834 (1953) , acq, 1953-2 CB 6 .

(n104)Footnote 55. *Rev Rul 58-1*, 1958-1 CB 173 (apartments rented to stockholders at lower rentals than those charged general public).

(n105)Footnote 56. *Treas Reg § 1.162-8*. See also *Treas Reg § 1.162-7(b)(1)*. With dividends now taxable at capital gains rates in the shareholder-employee's hands, while compensation is taxed as ordinary income and subject to payroll taxes (up to certain limits), the "unreasonable compensation" issue does not have quite the *in terrorem* effect it once did. See *Menard Inc v Commr*, 560 F3d 620, 621-622 (7th Cir 2009) .

(n106)Footnote 57. 422 F2d 1336 (1970) .

(n107)Footnote 58. 422 F2d at 1339 .

(n108)Footnote 59. *Mayson Mfg Co v Commr*, 178 F2d 115, 119 (6th Cir 1949) Among the many cases that have employed these or similar factors are: *Haffner's Service Stations, Inc v Commr*, 326 F3d 1 (1st Cir 2003) ; *Eberl's Claim Service, Inc v Commr*, 249 F3d 994 (10th Cir 2001) ; *LabelGraphics Inc v Commr*, 221 F3d 1091 (9th Cir 2000) ; *Alpha Medical, Inc v Commr*, 172 F3d 942 (6th Cir 1999) ; and *Rutter v Commr*, 853 F2d 1267 (5th Cir 1988) . But see *Menard, Inc v Commr*, 560 F3d at 622-623 , where the Court of Appeals for the Seventh Circuit (Posner, J.) after collecting the cases, criticized the multifactor analysis as unduly subjective and unpredictable. "Multifactor tests with no weight assigned to any factor are bad enough...; multifactor tests when none of the factors is concrete are worse, and that is the character of most of the multifactor tests of excessive compensation." As Judge Posner had previously complained in *Exacto Spring Corp v Commr*, 196 F3d 833 (7th Cir 1999) : "[T]he ... [multifactor] test invites the Tax Court to set itself up as a superpersonnel department for closely held corporations ... The test ... invites the court to decide what the taxpayer's employees *should* be paid on the basis of the judges' own ideas of what jobs are comparable, what relation an employee's salary should bear to the corporation's net earnings, what types of business should pay abnormally high (or low) salaries, and so forth. The judges of the Tax Court are not equipped by training or experience to determine the salaries of corporate officers; no judges are." 196 F3d at 835 (emphasis in original).

(n109)Footnote 60. See *Elliott's, Inc v Commr*, 716 F2d 1241, 1247 (9th Cir 1983) .

(n110)Footnote 61. While that may be true, it will be recalled that the Court of Claims in *McCandless* also used return on equity to determine the amount of shareholder/employee compensation that it deemed unreasonable. The difference between *Elliott's Inc* and *McCandless* is perhaps not so great as it might appear.

(n111)Footnote 62. *Menard, Inc v Commr*, 560 F3d at 623 ; *Exacto Spring Corp v Commr*, 196 F3d at 839 .

(n112)Footnote 63. *Owensby & Kritikos, Inc v Commr*, 819 F2d 1315, 1327 (5th Cir 1987) . See also *Dexsil Corp v Commr*, 147 F3d 96, 101 (2nd Cir 1998) (failure of Tax Court to apply multifactor analysis from perspective of an independent investor constituted reversible error.)

(n113)Footnote 64. *Eberl's Claim Serv, Inc v Commr*, 249 F3d 994, 1003-1004 .

(n114)Footnote 65. *Golsen v Commr*, 54 TC 742 (1970) .

(n115)Footnote 66. See *Haffner's Service Stations, Inc v Commr*, TC Memo 2002-38 , *aff'd* 326 F3d 1 (1st Cir 2003) .

(n116)Footnote 67. See *Elliott's, Inc v Commr*, TC Memo 1980-282 , *reversed and remanded*, *Elliott's, Inc v Commr*, 716 F2d 1241, 1248 .

(n117)Footnote 68. *Elliott's, Inc v Commr*, 716 F2d at 1248 . See also *Owensby & Kritikos, Inc v Commr*, 819 F2d at 1328; *Menard, Inc v Commr*, 560 F3d 620 (7th Cir 2009) .

(n118)Footnote 69. See, however, *Pepsi-Cola Bottling Co v Commr*, 528 F2d 176, 182 (10th Cir 1975) , where the Court of Appeals for the Tenth Circuit accepted that an incentive arrangement that might be appropriate for a nonshareholder executive might not be reasonable for a controlling shareholder/employee, "since an incentive to the stockholder to call forth his best effort would not be needed."

(n119)Footnote 70. *Elliott's Inc v Commr*, 716 F2d at 1248 ; *Owensby & Kritikos, Inc v Commr*, 819 F2d at 1328 .

(n120)Footnote 71. *Treas Reg § 1.162-1(b)(2)*. See also *Treas Reg § 1.162-1(b)(3)* (reasonableness should be judged as of the date when the contract for services was made, not those existing when the contract is questioned).

(n121)Footnote 72. *Elliott's Inc v Commr*, 716 F2d at 1248 (n 8). However, if the formula "has proved reasonable

over a long period of time, ... it should normally not be deemed unreasonable solely because it has overcompensated in one or two years." *Id.*

(n122)Footnote 73. 716 F2d at 1248 .

(n123)Footnote 74. Some courts have held that such by-laws or agreements may themselves be evidence of an intent to pay excessive salaries to shareholder-managers. See *Charles Schneider & Co v Commr*, 500 F2d 148, 150 (8th Cir 1974) ; *Menard Inc v Commr*, TC Memo 2004-207 at 74 ; 2004 Tax Ct Memo LEXIS 215 , reversed 560 F3d 620 . In reversing the Tax Court, the Court of Appeals for the Seventh Circuit expressed the opinion that such a by-law was "flimsy grounds" for a finding that the corporation intended to pay "excessive" or "unreasonable" compensation to its shareholder. 560 F3d at 624 .

(n124)Footnote 75. 49 TC 645 (1968) , acq 1968-2 CB 2 .

(n125)Footnote 76. See also *Pahl v Commr*, 67 TC 286 (1976) ; *Rev Rul 69-115*, 1969-1 CB 50 . In the absence of such a by-law or agreement, however, the shareholder-manager's repayment to the corporation of salary deemed excessive by the Internal Revenue Service is no more deductible than the voluntary repayment of a legally declared dividend. *Pahl v Commr*, 67 TC at 292 , citing *Crellin's Estate v Commr*, 203 F2d 812 (9th Cir 1953) , cert denied 346 US 873 (1953) .

(n126)Footnote 77. See *Pahl v Commr*, 67 TC 286 ; *Emmerson v Commr*, 44 TC at 90 (n 1).

(n127)Footnote 78. *Lang Chevrolet Co v Commr*, TC Memo 1967-212 ; § 4.02[3][a], *supra* .

(n128)Footnote 79. *Dolese v US*, 605 F2d 1146 (10th Cir 1979) , cert denied, 445 US 961 ; *Benjamin v Commr*, 592 F2d 1259 (5th Cir 1979) , aff'g 66 TC 1084 (1976) ; *Perma-Rock Prods, Inc v US*, 373 F Supp 159 (D Md 1973) ; *Crosby v US*, 31 AFTR2d 73-1191 (SD Miss 1973) , aff'd in part, vacated and remanded in part 496 F2d 1384 (5th Cir 1974) .

(n129)Footnote 80. Cf. *Berkeley Mach Works & Foundry Co v Commr*, TC Memo 1968-278 , aff'd per curiam 422 F2d 362 (4th Cir 1970) . *Cooper v Commr*, 1949 Tax Ct Memo LEXIS 118 , aff'd 184 F2d 514 (3d Cir 1950) . However, disallowance under IRC § 274 due to the failure to satisfy the substantiation requirements of the provision is not a sufficient ground upon which to base a finding of a constructive dividend. There must also be a showing that the expenditures were not ordinary and necessary expenses of the corporation. *Tennessee Sec, Inc v Commr*, TC Memo 1978-434 , aff'd, 674 F2d 570 (5th Cir 1982) ; § 4.02[3][a], *supra* , at n 23.

(n130)Footnote 81. *Nicholls, North, Buse Co v Commr*, 56 TC 1225 (1971) , acq, 1972-1 CB 2 ; *American Properties, Inc v Commr*, 28 TC 1100 (1957) , aff'd per curiam 262 F2d 150 (9th Cir 1958) ; *Greenspon v Commr*, 23 TC 138 (1954) , acq, 1955-1 CB 4 , aff'd on this issue 229 F2d 947 (8th Cir 1956) ; *Holland v Commr*, TC Memo 1974-135 .

(n131)Footnote 82. However, if the car or boat is owned by the shareholder, the measure of the dividend is simply the amount of the expenses paid by the corporation. See, eg, *Progressive Engineering, Inc v Commr*, TC Memo 1975-82 .

(n132)Footnote 83. 513 F2d 800 (5th Cir 1975) , cert denied 423 US 947 .

(n133)Footnote 84. *Ruben v Commr*, 97 F2d 926 (8th Cir 1938) .

(n134)Footnote 85. *Sachs v Commr*, 32 TC 815 (1959) , aff'd 277 F2d 879 (8th Cir 1960) , cert denied 364 US 833 .

(n135)Footnote 86. Eg, *Bayou Verrett Land Co v Commr*, 450 F2d 850 (5th Cir 1971) ; *Enoch v Commr*, 57 TC

781 (1972) , *acq*, 1974-1 CB 1 ; *Anderson v Commr*, TC Memo 1976-28 ; *Parsons v Commr*, TC Memo 1972-72 . In *Casner v Commr*, 450 F2d 379 (5th Cir 1971) , a distribution by a corporation to selling shareholders was held to constitute a dividend to the purchasers on the ground that the distribution represented a portion of the contract price. The sellers treated the payment, which predated the sale but was part of the sale transaction, as being on account of the agreed price. The Fifth Circuit concurred. The Service views such distributions as ones falling within the ambit of *IRC* § 301 and, thus, will not follow *Casner*. Rev Rul 75-493, 1975-2 CB 108 ; see also *Ltr Rul* 8118004 .

(n136)Footnote 87. But see *Goldstein v Commr*, TC Memo 1984-62 , and *Yelencsics v Commr*, 74 TC 1513 (1980) , where the corporation's undertaking of primary liability did not serve a corporate purpose.



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Taxation of Securities Transactions

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CHAPTER 4 Dividend Distributions

1-4 Taxation of Securities Transactions § 4.03

§ 4.03 The Individual Shareholder

[1] Amount of the Distribution.

A necessary element in the determination of the amount of dividend income received by a shareholder is the prior determination of the amount of the distribution itself. This amount is set at the amount of money received, plus the fair market value (determined as of the date of distribution) of any other property received.ⁿ¹ Reduction in the amount of the distribution is called for whenever a liability of the corporation is assumed by the shareholder in connection with the distribution, or if the shareholder receives property which is subject to a liability immediately before and immediately after the distribution.ⁿ² The extent of reduction is the amount of liability assumed or acquired. However, in no event can the amount of the distribution be reduced below zero.ⁿ³

The regulations provide that the shareholders include the distribution in gross income when the cash or other property is unqualifiedly made subject to their demands.ⁿ⁴ However, if a dividend is declared payable on December 31, and the corporation follows its usual practice of paying the dividend by checks mailed so that the shareholders would not be received until January of the following year, the dividend is not considered to have been constructively received in December.ⁿ⁵

[2] Amount Treated as a Dividend.

The portion of the distribution constituting a dividend will depend on the extent to which the corporation has earnings and profits available as a source of distribution.ⁿ¹ If the earnings and profits exceed the amounts distributed to all shareholders, then obviously the entire distribution qualifies as a dividend. If the distribution exceeds the available earnings and profits, then each shareholder need treat the distribution as a dividend only to the extent of his allocable share of earnings and profits.

[3] Treatment of Distributions in Excess of the Amount Considered a Dividend.

The portion of a distribution which exceeds the amount treated as a dividend is applied against, and in reduction of, the adjusted basis of the shareholder's stock.ⁿ¹ If the distribution is of such magnitude that it exceeds even the basis for the stock, the amount by which the distribution exceeds both the amount of the dividend and the adjusted basis of the stock is considered gain from the sale or exchange of property.ⁿ² Whether the gain is capital or ordinary will turn on the character of the stock in the hands of the shareholder; *IRC Section 301(c)(3)(A)* merely provides the sale or exchange

requirement.

For example, assume a shareholder receives a distribution of \$1,000, \$300 of which is treated as dividend by reason of *IRC Sections 301(c)(1) and 316*. If we assume further that the adjusted basis of the stock is \$500, then the first \$500 of the portion of the distribution which is not a dividend (\$700) will reduce the shareholder's basis to zero. The remaining \$200 will be considered gain from the sale or exchange of the stock. Had the shareholder's basis prior to the distribution been greater than \$700, the entire excess distribution would have been applied against, and in reduction of, the basis of the stock.

An additional consideration is presented when the shares with respect to which the distribution is made were purchased at different times or for different prices. For example, assume that the shareholder in the last example held 200 shares, 150 of which were purchased in 1960 at a cost of \$150, and the balance in 1970 at a cost of \$350. The dividend income would still be \$300, the extent of the corporation's earnings and profits. But the amount of gain increases to \$375. This result flows from a rule which requires that there be allocated to each block of stock the proportion of the distribution that the number of shares in that block bears to the number of shares outstanding.³ Thus, we find:

	Allocated to 150 share block	Allocated to 50 share block
Amount received	\$750	\$250
Amount treated as a dividend	225	75
Balance of distribution	525	175
Basis	150	350
Gain	\$375	\$-0-

[4] Basis of Property Distributed in Kind.

A noncorporate distributee receiving a distribution of property in kind generally assumes a basis for such property equal to its fair market value.¹ Such basis is not affected by a reduction in the amount distributed resulting from the distributee's assumption of a liability or receipt of property subject to a liability. Nor is it in any way dependent on the tax consequences attaching to the distribution. The general rule applies whether the distribution is treated as a dividend or not.

FOOTNOTES:

(n1)Footnote 1. See *IRC §§ 301(b)(1), 301(b)(3)*. *IRC § 317(a)* defines "property" as money, securities or any other property, but not stock or rights to acquire stock of the distributing corporation. The date of distribution is the date of payment, not the date of declaration. *Rev Rul 62-131, 1962-2 CB 94*.

A distribution by a subsidiary to its parent of indebtedness of the parent is a distribution of property in an amount equal to the fair market value of the indebtedness. *Rev Rul 2004-79, 2004-2 CB 106*.

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The value of stock of a subsidiary corporation that is distributed to shareholders of the parent corporation and can only be sold with stock of the distributing corporation ("paired" or "stapled" stock) presents special valuation problems. *Rev Rul 80-213, 1980-2 CB 101*, contains relevant factors to be considered in valuing the stock.

(n2)Footnote 2. *IRC § 301(b)(2)*. For distributions occurring after Jan 4, 2001, no reduction can be made for the amount of any liability unless the liability is assumed by the shareholder within the meaning of *IRC § 357(d)(1)* and (2) (discussed in § 3.02[2][a][ii]). *Treas Reg § 1.301-1(g)(1)*. The reduction cannot reduce the amount of the distribution below zero. *Treas Reg § 1.301-1(g)(2)*.

A shareholder in a C corporation cannot reduce the amount of gain by the basis of the shareholder in a debt owed by the corporation. *Spera v Commr, TC Memo 1998-299*.

(n3)Footnote 3. *IRC § 301(b)(2)*.

(n4)Footnote 4. *Treas Reg §§ 1.301-1(b), 1.451-2(b)*.

(n5)Footnote 5. *Treas Reg § 1.451-2(b)*.

(n6)Footnote 1. See § 4.02[1], *supra*, for the manner in which earnings and profits are allocated to distributions made during the taxable year.

Resolving a conflict among the Courts of Appeal, the US Supreme Court held in *Boulware v US, 552 US 421 (2008)* that a criminal defendant who diverts funds from a corporation in which he owns a significant stock interest cannot be guilty of tax evasion under *IRC § 7201* if the funds were distributed with respect to his stock, the corporation did not have earnings and profits in the year the funds were diverted, and the amount diverted did not exceed the defendant's basis in the corporation's stock. The Court of Appeals for the Ninth Circuit, relying on its earlier decision in *US v Miller, 545 F2d 1204, 1215 (9th Cir 1976)*, had held that in order to rely on the defense that the diversion represented a return of capital, the defendant had to show that the diverted funds were intended as a return of defendant's investment in the corporation's stock. The Supreme Court found no such requirement in *IRC §§ 301* and *316*, which provide a purely objective test for determining whether a distribution with respect to stock is a nontaxable return of capital. Holding that the Government must prove the existence of a tax deficiency as an essential element of the crime of tax evasion under *IRC § 7201*, the Court said that the rules for determining whether a tax deficiency exists are no different in criminal or civil tax cases. On remand, however, the Court of Appeals upheld defendant's conviction on the ground that defendant's offer of proof at trial that the funds diverted represented a nontaxable return of capital was inadequate on grounds other than failure to prove intent (for example, defendant failed to offer evidence showing that the diverted funds represented a distribution with respect to his stock in the first instance, a showing that "at the very least" requires either "evidence of nexus between the corporate distribution and stock ownership," or a showing "that there were no other alternative explanations.") *US v Boulware, 558 F3d 971, 977 (9th Cir 2009)*.

(n7)Footnote 1. *IRC § 301(c)(2)*. If a transaction governed by *IRC § 304(a)(1)* (acquisition of stock by a related corporation other than a subsidiary) is treated as a dividend, the transferor of the stock is deemed to have contributed the acquired stock to the capital of the acquiring corporation. The increase in the transferor's basis in the stock of the acquired corporation occurs before the deemed distribution takes place. *TAM 9748003*.

(n8)Footnote 2. *IRC § 301(c)(3)(A)*. To the extent that the excess is out of an increase in value accrued before March 1, 1913, it is exempt from tax. *IRC § 301(c)(3)(B)*.

A shareholder in a C corporation cannot reduce the amount of gain by the basis of the shareholder in a debt owed by the corporation. *Spera v Commr, TC Memo 1998-299*.

(n9)Footnote 3. *Johnson v US, 435 F2d 1257 (4th Cir 1971)*.

(n10)Footnote 1. *IRC § 301(d)*. An increase in the conversion ratio of convertible debentures, treated as a taxable stock dividend under *IRC § 305(b)(2)*, increases the basis of the debentures in an amount equal to the fair market value of the deemed distribution. *Rev Rul 76-186, 1976-1 CB 86* .



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CHAPTER 4 Dividend Distributions

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§ 4.04 The Corporate Shareholder

[1] Amount of the Distribution.

The amount of a distribution to a corporate shareholder is the same as in the case of a noncorporate shareholder, namely, the amount of money and the fair market value of property other than money received by the shareholder.ⁿ¹ At one time, property distributions to corporate taxpayers were taken into account by them at the lesser of adjusted basis in the hands of the distributing corporation or fair market value. This was required to prevent the combination of the then extant rule that a distributing corporation did not recognize gain on the distribution of appreciated property, and the dividends received deduction allowed to corporations, from greatly reducing or eliminating any tax on the appreciation.

[2] Amount Treated as a Dividend.

The rules determining the extent to which a distribution is a dividend apply with equal force to corporate and noncorporate distributees. A corporate shareholder is required to include in gross income only that portion of the distribution which represents such stockholder's ratable share of the earnings and profits of the distributing corporation.

IRC Section 301(e) prescribes a special rule for distributions received by a 20 percent corporate shareholder--a corporation that owns (directly or indirectly through the application of *IRC Section 318*) at least 20 percent of the voting stock in the distributing corporation or at least 20 percent of the total value of all stock in the distributing corporation except nonvoting stock which is limited and preferred as to dividends. In determining the extent of the dividend to the 20 percent corporate shareholder, and for no other purpose, the earnings and profits of the distributing corporation are computed without the application of *IRC Sections 312(k)* and *312(n)*, other than *IRC Section 312(n)(7)*.ⁿ¹ The special rule applies only if the corporate shareholder would, but for the rule, be entitled to a dividends received deduction with respect to the distribution involved.

[a] Dividends Received Deduction.

[i] Dividends Received From Domestic Corporations. Under *IRC Section 243(a)* a corporation is allowed a deduction of at least 70 percent of the amount received as dividends from domestic corporations that are subject to income taxation under the Code.ⁿ² An 80-percent deduction is allowed if the taxpayer owns 20 percent or more of the stock (by vote and value) of the distributing corporation.ⁿ³ If the recipient happens to be a small business investment company operating under the Small Business Investment Company Act of 1958, or a member of the same affiliated

group of corporations as the distributing corporation and certain other conditions are met, the allowable deduction rises to 100 percent of the amount received.ⁿ⁴ The effect of the general rule is to limit the maximum rate of tax on dividends received to 10.5 percent (30 percent of the dividends received taxed at the maximum corporate tax rate of 35 percent).

Excluded from the dividends which qualify for the deduction are (1) those paid by mutual savings banks, cooperative banks, and building and loan associations, if payment of the dividend gives rise to a deduction under *IRC Section 591*;ⁿ⁵ (2) long-term capital gains dividends paid by a regulated investment company;ⁿ⁶ (3) dividends paid by a real estate investment trust;ⁿ⁷ and (4) any dividend received on preferred stock of a public utility, if payment of the dividend affords the public utility a deduction under *IRC Section 247*.ⁿ⁸ Also excluded is any distribution to meet qualification requirements for the effective tax exemption that inures to possessions corporations and certain corporations doing business in the Virgin Islands.ⁿ⁹

[ii] Dividends Received From Affiliated Corporations. *IRC Section 243(a)(3)* allows a deduction equal to 100 percent of qualifying dividends, defined in *IRC Section 243(b)(1)* as dividends received by a corporation which, at the close of the day the dividends are received, is a member of the same affiliated group of corporations as the distributing corporation.ⁿ¹⁰ Two other conditions must be satisfied before a dividend can be denominated a qualifying dividend. First, the group must be consistent in its foreign tax treatment, that is, a dividend will not be a qualifying dividend if, for any taxable year that includes the day on which the dividend is received, one or more members of the affiliated group choose to take the benefits of *IRC Section 901* (foreign tax credit), and one or more members of the group claim a deduction for taxes otherwise creditable under *IRC Section 901*.ⁿ¹¹ Second, either (1) the dividend must be distributed out of earnings and profits of a taxable year of the distributing corporation ending after December 31, 1963, and on each day of the year the distributing and receiving corporations were members of the affiliated group, or (2) the dividends are paid by a corporation with respect to which an election under *IRC Section 936* is in effect for the taxable year in which the dividends are paid.ⁿ¹² The election under *IRC Section 936* gives rise to a credit for taxes attributable to taxable income from sources outside the United States, from the active conduct of a trade or business within a possession of the United States, and from qualified possessions sources investment income. With certain exceptions contained in transition rules, *IRC Section 936* does not apply to any taxable year beginning after December 31, 1995.ⁿ¹³

In the case of an affiliated group that contains one or more life insurance companies, no dividend by any member of the group will be a qualifying dividend unless an election made by the common parent is in effect for the taxable year in which the dividend is received or the dividend is received from a corporation with respect to which an election under *IRC Section 936* is in effect for the taxable year in which the dividend is received.ⁿ¹⁴ The consequence of the election restricts the extent to which members of the group can claim certain benefits normally available to corporations.ⁿ¹⁵

[iii] Dividends Received on Preferred Stock of a Public Utility. *IRC Section 244* provides a special deduction for dividends received from public utilities on preferred stock issued before October 1, 1942,ⁿ¹⁶ if the dividends on such stock are "cumulative, limited to the same amount, and payable in preference to the payment of dividend on other stock."ⁿ¹⁷ Computation of the allowable deduction is a three-step process. First, the amount of preferred stock dividends received is multiplied by a fraction, the numerator of which is 14 and the denominator of which is the highest corporate tax rate in effect for the taxable year. The product of that multiplication is then subtracted from the dividends received. The remainder is then multiplied by 70 percent (80 percent if the distributee shareholder is a 20-percent shareholder) and the product of this second multiplication becomes the allowable deduction. If the public utility and the receiving corporation are members of an affiliated group and the dividends would be qualifying dividends under *IRC Section 243(d)(1)*, were it not for *IRC Section 243(c)(4)*, the multiplying percentage in the third step is 100 percent. To illustrate:

Example:

Suppose, in 2002, a corporation received \$200,000 in preferred stock dividends from a public utility. If the entire \$200,000 qualified for the dividend paid deduction of *IRC Section 247*, and if the dividends were not "qualifying dividends" as defined in *IRC Section 243(b)*, and the corporation was not a

20-percent shareholder, the allowable deduction would be computed as follows:

Preferred stock dividends received	\$200,000
Less: $14/35 \times \$200,000$ (IRC Section 244(a)(2)) ⁿ¹⁸	80,000
Remainder subject to 70 percent deduction	\$120,000
70 percent of \$120,000 (IRC Section 244(a)(3))	\$84,000

If the corporation was a 20-percent shareholder, the deduction would be 80 percent of \$120,000, or \$96,000. If the public utility and the corporation receiving the dividends were members of an affiliated group, and if the dividends met the definition of *IRC Section 243(b)(1)*, the allowable deduction would be \$117,647, the entire remainder resulting from the fraction-multiplication, subtraction process required by *IRC Section 244(a)(2)*.

[iv] Dividends Received From Foreign Corporations. *IRC Section 245* allows a 70-percent deduction (80 percent in the case of a 20-percent shareholder) for the United States-source portion of dividends received from a foreign corporation, other than a passive foreign investment company, if at least 10 percent of the stock of the foreign corporation (by vote and value) is owned by the taxpayer.ⁿ¹⁹ The United States-source portion of any dividend is an amount that bears the same ratio to such dividend as the post-1986 undistributed United States earnings bears to the total post-1986 undistributed earnings of the foreign corporation.ⁿ²⁰ The foreign corporation's post-1986 undistributed earnings are the earnings and profits of the corporation accumulated in taxable years beginning after 1986 as of the close of the taxable year in which the dividend is distributed, without diminution for dividends distributed during the year.ⁿ²¹ Its post-1986 undistributed United States-source earnings are the portion of the total post-1986 undistributed earnings that is attributable to (1) income of the corporation that is effectively connected with the conduct of a trade or business within the United States and is subject to federal income tax, or (2) any dividend received (directly or through a wholly owned foreign corporation) from a domestic corporation at least 80 percent of the stock of which (by vote and value) is owned (directly or through the wholly owned foreign corporation) by the 10-percent owned foreign corporation.ⁿ²²

The deduction percentage will increase to 100 percent if the domestic corporation owns 100 percent of the foreign corporation and all of the latter's gross income from all sources is effectively connected with the conduct of a trade or business within the United States.ⁿ²³

A domestic corporation is allowed a 100-percent deduction for dividends distributed out of earnings and profits attributable to foreign trade income for a period during which the distributing corporation was a foreign sales corporation.ⁿ²⁴ A 70-percent deduction (80 percent in the case of a 20-percent shareholder) is allowed with respect to dividends distributed out of earnings and profits attributable to qualified interest and carrying charges received or accrued by the distributing corporation while it was a foreign sales corporation.ⁿ²⁵

[v] Restrictions on the Dividends Received Deduction. The dividends received deductions allowed by *IRC Sections 243, 244, and 245* do not apply if (1) the distributing corporation is for the taxable year of distribution or for the preceding taxable year, exempt from tax under either *IRC Section 501* or *IRC Section 521*,ⁿ²⁶ or (2) the distributing corporation is a Domestic International Sales Corporation (DISC) or former DISC and the dividend is paid out of its accumulated DISC income or previously taxed income or is a deemed distribution pursuant to *IRC Section 995(b)(1)*

.n27 In addition, deduction is denied if the dividend is on any share of stock which is held by the taxpayer for 45 days or less during the 91-day period beginning 45 days before the ex-dividend date (90 days or less during the 181-day period beginning 90 days before the ex-dividend date if the dividend is on certain preferred stock),^{n27.1} or to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.ⁿ²⁸ The 45- and 90-day holding periods will be reduced for any period (during such holding periods) in which:

- (1) the seller has an option to sell, is under a contractual obligation to sell, or has made and not closed a short sale of substantially identical stock or securities;
- (2) the taxpayer is a grantor of an option to buy substantially identical stock or securities; or
- (3) the taxpayer has diminished the taxpayer's risk of loss by holding one or more positions with respect to substantially similar or related property.^{n28.1}

A mandatory redemption provision found in preferred stock is generally not considered a contractual obligation to sell.^{n28.2}

The term "substantially similar or related property" is applied according to the facts and circumstances of each case. In general, property is substantially similar or related to stock when:

- (1) the fair market values of the stock and the property primarily reflect the performance of:
 - (a) a single firm or enterprise,
 - (b) the same industry or industries, or
 - (c) the same economic factors such as interest rates, commodity prices, or foreign-currency exchange rates; and
- (2) changes in the fair market value of the stock are reasonably expected to approximate, directly or inversely, changes in the fair market value of the property, a fraction of the fair market value of the property, or a multiple of the fair market value of the property.^{n28.3}

A taxpayer diminishes its risk of loss on its stock by holding positions with respect to similar or related property if changes in the fair market values of the stock and the positions are reasonably expected to vary inversely.^{n28.4} A taxpayer is also treated as diminishing its risk or loss by holding substantially similar or related property if it engages in the following transactions or their substantial equivalents:

- (1) a short sale of common stock while holding convertible preferred stock of the same issuer and the price changes of the convertible preferred stock and the common stock are related;
- (2) a short sale of a convertible debenture while holding convertible preferred stock into which the debenture is convertible or common stock; or
- (3) a short sale of convertible preferred stock while holding common stock.^{n28.5}

Finally, a taxpayer diminishes its risk of loss on stock by holding a position in substantially similar or related property if the taxpayer is the beneficiary of a guarantee, surety agreement, or similar arrangement that provides for payments that will substantially offset decreases in the fair market value of the stock.^{n28.6}

A position established as a hedge of one outstanding position, transaction, or obligation of the taxpayer (other than stock) is not treated as diminishing the risk of loss with respect to any other position held by the taxpayer. In determining whether a position is established to hedge an outstanding position, transaction, or obligation of the taxpayer, substantial deference will be given to the relationships that are established in its books and records at the time the taxpayer entered into the position.^{n28.7}

A position reflecting the value of a portfolio (a group of stocks of 20 or more unrelated issuers) is substantially similar or related to the stocks held by the taxpayer only if the position and the taxpayer's holdings substantially overlap as of the most recent testing date.^{n28.8} A position may be substantially similar or related to a taxpayer's entire stock holdings or to a portion of the taxpayer's stock holdings.^{n28.9}

A three-step procedure is used to determine whether a position and the taxpayer's stock holdings overlap.^{n28.10} First, the taxpayer must construct a subportfolio that consists of stock in an amount equal to the lesser of the fair market value of each stock represented in the position and the fair market value of the stock in the taxpayer's stock holdings; the subportfolio may contain less than 20 stocks.^{n28.11} Second, if the fair market value of the subportfolio is equal to or greater than 70 percent of the fair market value of the stocks represented in the position, the position and the subportfolio overlap.^{n28.12} Third, if the position does not substantially overlap with the subportfolio, the taxpayer must repeat the two prior steps reducing the size of the position. The largest percentage of the position that results in a substantial overlap is substantially similar or related to the subportfolio determined with respect to that percentage of the position.^{n28.13}

A position that reflects the fair market value of more than one stock, but not of a portfolio of stocks, is treated as a separate position with respect to each of the stocks the value of which the position reflects.^{n28.14}

Under an anti-abuse rule, a position that reflects the value of more than one stock is a position in substantially similar or related property to the appropriate portion of the taxpayer's stock holdings if (a) changes in the value of the position or the stocks are reasonably expected to virtually track (directly or indirectly) changes in the value of the taxpayer's stock holdings, or any portion of the taxpayer's stock holdings and other portions of the taxpayer, and (b) the position is acquired or held as part of a plan a principal purpose of which is to obtain tax savings (including a tax deferral) in excess of the expected pre-tax economic profits from the plan.^{n28.15}

For purposes of *IRC Section 246(c)*, rights and obligations under notional principal contracts are considered separately even though payments with regard to those rights and obligations are generally netted for other purposes. Thus, if a taxpayer is treated as receiving payments under a notional principal contract when the fair market value of the taxpayer's stock declines, the taxpayer has diminished its risk of loss by holding a position in substantially similar or related property regardless of the netting of the payments under the contract for any other purpose.^{n28.16}

Positions held by a party related to the taxpayer within the meaning of *IRC Section 267(b)* or *707(b)(1)* are treated as positions held by the taxpayer if held with a view to avoiding application of *Regulations Section 1.246-5* or *1.1092(d)-2*. The same holds true if the taxpayer holds an interest in, or is a beneficiary of, a pass-through entity, intermediary, or other arrangement with a view to avoiding application of those provisions.^{n28.17}

The deduction will also be denied if the taxpayer is obligated to make corresponding payments with respect to positions in substantially identical stock or securities.ⁿ²⁹ The latter situation will generally occur when a taxpayer has both a long and a short position in the same stock. No deduction will be allowed on account of the dividends received on the stock held long to the extent the taxpayer is obligated to make payments to cover the dividends with respect to its offsetting short position in the same stock.ⁿ³⁰

IRC Section 246A reduces the amount of the deduction otherwise allowable under *IRC Sections 243, 244* and *245(a)*, if

the dividends are received with respect to debt-financed portfolio stock. The reduction is achieved by substituting for the usual deduction amount a percentage determined by multiplying 70 percent (80 percent in the case of a 20-percent shareholder) by 100 percent less the average indebtedness percentage. The latter percentage is derived by dividing the average amount of the portfolio indebtedness with respect to the stock during the base period by the average amount of the adjusted basis of the stock during the base period.ⁿ³¹ However, the reduction with respect to any dividend cannot exceed the amount of any interest deduction (including short sale expense) allocable to the dividend.ⁿ³²

Stock is debt-financed portfolio stock if: (1) as of the ex-dividend date the corporate shareholder owns less than 50 percent of the total value of the stock of the distributing corporation; and (2) there is portfolio indebtedness--indebtedness directly attributable to the stockⁿ³³--during the base period, i.e., the shorter of: (a) the period beginning on the ex-dividend date for the most recent dividend on the stock and ending on the day before the ex-dividend date for the dividend involved; or (b) the one-year period ending on the day before the ex-dividend date for the dividend involved.ⁿ³⁴

Finally, the aggregate amount of the deductions allowed by *IRC Sections 243(a)(1), 244(a), and 245* cannot exceed specified percentages of the corporation's taxable income computed without regard to such deductions, the net operating loss deduction allowed by *IRC Section 172(a)*, the deduction for income attributable to domestic production activities under *IRC Section 199*, or the dividends paid deduction of *IRC Section 247* without regard to any adjustment to basis prescribed by *IRC Section 1059* because of the receipt of extraordinary dividends, and without regard to any capital loss carryback to the taxable year under *IRC Section 1212(a)(1)*.ⁿ³⁵ An 80-percent limitation is applied separately with respect to dividends received from 20-percent owned corporations. A 70-percent ceiling is then applied separately with respect to dividends not from 20-percent owned corporations, with taxable income reduced by the aggregate amount of dividends from 20-percent owned corporations.ⁿ³⁶ If, however, the receiving corporation has a net operating loss for the taxable year of receipt, the dividends received deductions are not affected by the limitations.ⁿ³⁷ To illustrate:

Example:

Suppose the corporation's books of account show gross income from operations of \$50,000, dividends received from 20-percent owned corporations of \$50,000, dividends from other domestic corporations of \$100,000, and allowable business expenses of \$100,000. The corporation's taxable income without regard to the dividends received deduction is \$100,000 (\$200,000 in income less \$100,000 in deductions). The dividends received deduction allowed with respect to the dividends received from the 20-percent owned corporations would be \$40,000 (80 percent of \$50,000). The deduction would not be affected by the limitation since the dividends were less than 80 percent of taxable income. The deduction allowed in the case of the dividends from other domestic corporations (normally \$70,000) would be limited to \$35,000 (70 percent of taxable income of \$100,000 reduced by dividends of \$50,000 received from 20 percent owned corporations). If, however, the deductible business expenses amounted to \$300,000, the corporation would have a net operating loss, and the full \$110,000 allowed by *IRC Section 243(a)* would be deductible, increasing the net operating loss for the year to \$210,000.ⁿ³⁸

A further consequence of the receipt of dividends qualifying for the dividends received deduction is a reduction in basis if the dividend is an extraordinary dividend and the recipient has not held the stock on which the dividend was paid for more than two years before the date on which the corporation declares, announces, or agrees to, the payment of the dividend, whichever is the earliest (the "dividend announcement date").ⁿ³⁹ This reduction is equal to the nontaxed portion of the dividend, that is, the amount of the dividend includable in gross income less the dividends received deduction allowable with respect to the dividend under *IRC Section 243, 244, or 245*, and occurs at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates.ⁿ⁴⁰ However, the basis cannot be reduced below zero. Because of this, an amount equal to the aggregate nontaxed portions of extraordinary dividends that did not reduce the basis of the stock is treated as gain from the sale or exchange of the stock for the taxable year in which the extraordinary dividend is received.ⁿ⁴¹ The rules do not apply to any extraordinary dividend if the stock has been held by the taxpayer during the entire period that the distributing corporation (or a predecessor corporation) has been in

existence and no earnings and profits of the corporation are attributable to transfers of property from (or earnings and profits of) a corporation that is not a qualified corporation,ⁿ⁴² or to distributions between members of an affiliated group filing consolidated returns.ⁿ⁴³ However, in the case of a redemption that (i) is not pro rata as to all shareholders, (ii) is part of a partial liquidation of the redeeming corporation, or (iii) would not have been treated in (whole or in part) as a dividend if any options had not been taken into account under the option attribution rule of *IRC Section 318(a)(4)*, or if *IRC Section 304(a)* had not applied, any amount treated as a dividend with respect to the redemption is an extraordinary dividend without regard to the period of time the taxpayer held the stock.^{n43.1} A reorganization exchange that is treated as a dividend is treated as a redemption of stock for purposes of applying the foregoing rule.^{n43.2}

A dividend is an extraordinary dividend if the amount of cash and the fair market value of property received equals or exceeds 5 percent of the taxpayer's basis of preferred stock and 10 percent of the basis of any other stock.ⁿ⁴⁴ Dividends which have ex-dividend dates within a period of 85 consecutive days are treated as a single dividend.ⁿ⁴⁵ Dividends with ex-dividend dates during a period of 365 consecutive days are treated as extraordinary dividends if the aggregate of such dividends exceeds 20 percent of the taxpayer's adjusted basis in the stock.ⁿ⁴⁶

Pursuant to *IRC Section 1059(f)*, any dividend, including a dividend deemed received under *IRC Section 305* or any other provision,ⁿ⁴⁷ with respect to "disqualified preferred stock" is an extraordinary dividend without regard to the period the taxpayer held the stock. Disqualified preferred stock is stock issued after July 10, 1989, that is preferred as to dividends if:

- (a) when issued, the stock has a dividend rate that declines, or can reasonably be expected to decline, in the future;
- (b) the issue price of the stock exceeds its liquidation rights or stated redemption price; or
- (c) the stock is otherwise structured to enable corporate shareholders to reduce tax through a combination of dividend received deductions and loss on the disposition of the stock.ⁿ⁴⁸

The distributee corporation can elect to determine whether a distribution is an extraordinary dividend by reference to the fair market value of the share on the day before the ex-dividend date in lieu of its adjusted basis, if the taxpayer can establish the fair market value of the property to the satisfaction of the Service.ⁿ⁴⁹ *Revenue Procedure 87-33*ⁿ⁵⁰ sets forth the following guidelines for establishing fair market value for purposes of the election:

For stock traded on a national or regional exchange or on the NASDAQ system, the closing price of the stock on the day before the ex-dividend date is treated as the fair market value of the stock. If there were no sales of stock on the specified day, the mean of the bid and asked prices on the day before the ex-dividend date establish the fair market value. For stock listed on more than one exchange, the price of the stock on a composite listing of the combined exchanges must be used if the records are set forth in a generally available listing or publication of general circulation. If such a composite listing is not available, the records of the price on the exchange where the stock is principally traded must be used.

If the stock is not publicly traded, a taxpayer wishing to make the election must request a written determination of the stock's fair market value from the Service. The request must be made no later than 60 days after the close of the taxable year containing the ex-dividend date (or the last of the ex-dividend dates at issue if the election is made for purposes of *IRC Section 1059(c)(3)*), and must include a proposed determination of the stock's fair market value which is supported by a credible appraisal that follows the guidelines contained in *Revenue Ruling 59-60*,ⁿ⁵¹ as amplified by *Revenue Ruling 77-287*,ⁿ⁵² *Revenue Ruling 80-213*,ⁿ⁵³ and *Revenue Ruling 83-120*.ⁿ⁵⁴ The Corporation Tax Division of the Service will respond with a letter indicating what fair market value has been established to its satisfaction.

In order to make the election, the taxpayer's tax return for the year must contain a statement that is headed "ELECTION

FILED UNDER SECTION 1059(c)(4)" and includes the following information: (1) the taxpayer's name, address, and taxpayer's identification number; (2) identification of the stock; (3) the amount of the dividends; (4) the number of shares of stock; and (5) the ex-dividend date(s). If the stock is publicly traded, the taxpayer must add the closing price of the stock (or, if applicable, the mean of the bid and asked prices of the stock) on the day before the ex-dividend date, and identify the publication that sets forth the composite listing, principal exchange listing, or NASDAQ listing used. If the stock is not publicly traded, the taxpayer must attach a copy of the Service's response as to value, unless the taxpayer has not received the response at the time the return is filed, in which case the taxpayer must furnish the proposed fair market value of the stock shown in the written request, and represent that the request was filed.

A special provision governs dividends on qualified preferred stock. Were it not for the special rule, a dividend of greater than 5 percent paid within any period of 85 days or less would be an extraordinary dividend. Preferred stock is qualified preferred stock if (1) it provides for fixed dividends payable at least annually; and (2) dividends were not in arrears when the taxpayer acquired the stock.ⁿ⁵⁵

IRC Section 1059 does not apply to any qualified preferred dividend if the taxpayer holds the stock for more than five years.ⁿ⁵⁶ If the stock is not held for more than five years, the reduction called for by *IRC Section 1059(a)(1)* cannot be greater than the excess of (a) the qualified preferred dividends paid during the period the taxpayer held the stock, over (b) the qualified dividends that would have been paid during the period on the basis of the stated rate of return on the stock.ⁿ⁵⁷

In addition to the usual dividend distributions, the extraordinary dividend concept is expanded to include any distribution (without regard to the holding period of the stock or the relative magnitude of the distribution) to a corporate shareholder in partial liquidation, or as part of a non-pro rata redemption of stock.ⁿ⁵⁸ For this purpose, a distribution will be treated as in partial liquidation if it satisfies the requirements of *IRC Section 302(e)*.ⁿ⁵⁹

[3] Treatment of Distributions in Excess of the Amount Considered a Dividend.

Distributions which exceed the amount includable in ordinary income as a dividend are handled by a corporate shareholder in the same manner as an individual. The portion that is not a dividend is first applied against and in reduction of the stock's adjusted basis.ⁿ¹ Any portion remaining after the adjusted basis has been reduced to zero is treated as a gain from the sale or exchange of property.ⁿ²

[4] Basis of Property Distributed in Kind.

The basis of property received in kind by a corporate taxpayer is its fair market value.ⁿ¹ If the distribution was made at a time when the Code fixed the amount thereof at the lesser of adjusted basis in the hands of the distributing corporation or fair market value, the basis would be the lesser of the two.

FOOTNOTES:

(n1)Footnote 1. *IRC § 301(b)(1)*.

(n2)Footnote 1. See § 4.02[1][a]. Congress intends that this provision apply only where the distribution is between corporations not filing a consolidated return. HR Rep No 100-391, 100th Cong, 1st Sess 1090 (1987).

(n3)Footnote 2. The availability of the deduction often results in a reversal of roles, the taxpayer claiming that an advance to a corporation should be treated as equity in order to treat payments made with respect thereto as dividends. Eg, *Ragland Inv Co v Commr*, 435 F2d 118 (6th Cir 1970) .

"Boot" dividends under *IRC § 356(a)(2)* qualify for the deduction. *Rev Rul 72-327, 1972-2 CB 197* .

Payments in lieu of dividends on borrowed stock do not qualify for the dividends received deduction even if the

borrowed stock is used to cover a short sale. *Prop Treas Reg § 1.1058-1(d)*.

See generally Mundstock, "Taxation of Intercompany Dividends Under an Unintegrated Regime," 44 *Tax L Rev* 1 (1988); Pearce, "The Intercompany Dividends-Received Deduction: An Area of Increasing Complexity," 68 *Ore L Rev* 161 (1989).

(n4)Footnote 3. *IRC § 243(c)(1), (2)*. Stock that is not entitled to vote is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, has redemption and liquidation rights which do not exceed the issue price of the stock except for a reasonable redemption or liquidation premium, and is not convertible into any other class of stock, is not counted as stock for determining the extent of stock ownership.

The Service holds that a corporation is not entitled to the dividends received deduction when it receives dividends on stock purchased after the record date for the dividend payment. *Rev Rul 82-11, 1982-1 CB 51*. The ruling involved a situation in which the stock exchange fixed the payment date as the ex-dividend date, and is based on a corporate title theory. For a case reaching a contrary result by applying an economic reality theory, see *Silco, Inc v US*, 779 F2d 282 (5th Cir 1986).

(n5)Footnote 4. *IRC § 243(a)(2), (3)*. The dividend must be a true dividend and not an attempt to disguise a nondividend payment as a dividend. *Cf Waterman SS Corp v Commr*, 430 F2d 1185 (5th Cir 1970), cert denied 401 US 939, where a parent filing a consolidated return attempted to eliminate a payment received from a subsidiary by treating the payment as an intercompany dividend; the payment actually constituted part of the purchase price paid by a third party for the subsidiary's stock.

Where a corporation made a payment to one of its 50-percent shareholders prior to a split-up, the payment constituted a dividend. See *Uniroyal Inc & Cons Subs v Commr*, TC Memo 1993-214.

(n6)Footnote 5. *IRC § 243(d)(1)*.

(n7)Footnote 6. *IRC § 243(d)(2)*. Dividends other than capital gains dividends may qualify for the deduction. *IRC § 854(b)(1)*. See § 12.04[1][c].

(n8)Footnote 7. *IRC § 243(d)(3)*.

(n9)Footnote 8. *IRC § 243(d)(4); Treas Reg § 1.243-2(d)*.

(n10)Footnote 9. *IRC § 246(e)*. The specific distribution provisions are *IRC §§ 936(h)(4) and 934(e)(3)*. With certain exceptions contained in transition rules, *IRC Section 936* does not apply to taxable years beginning after December 31, 1995. *IRC § 936(j)(1)*.

(n11)Footnote 10. The term "affiliated group" takes the meaning assigned to it by *IRC § 1504(a)*, with slight modification. *IRC § 243(b)(2)(A)*.

The regulations provide that, for purposes of meeting the requirement that both the distributing corporation and receiving corporation be part of the same affiliated group, a mere change in form, whereby a new corporation has acquired substantially all of the stock of the common parent solely in exchange for stock of the acquiring group, will not produce a new affiliated group. *Treas Reg § 1.243-4(a)(5)(i)*. A reorganization that creates a new common parent and merges the old common parent into a newly formed subsidiary of the new parent is such a mere change in form. *Rev Rul 72-274, 1972-1 CB 97*. See also *Rev Rul 85-144, 1985-2 CB 86*, and *Rev Rul 84-154, 1984-2 CB 62*.

(n12)Footnote 11. *IRC § 243(b)(2)(B)*.

(n13)Footnote 12. *IRC § 243(b)(1)(B), (C)*.

(n14)Footnote 13. *IRC § 936(j)(1)*.

(n15)Footnote 14. *IRC § 243(b)(3)(A), (C)*. The election is binding on all members of the group and can be revoked only with the consent of the Commissioner.

(n16)Footnote 15. *IRC §§ 243(b)(3)(B), 1561*. In addition, a distribution by any member of the group that is a life insurance company subject to tax under *IRC § 801* will not be treated as a qualifying dividend if the distribution is out of earnings and profits for a taxable year for which an election is not effective and for which the distributing corporation was not a component member of a controlled group of corporations because treated as an excluded member under *IRC § 1563(b)(2)(D)*.

(n17)Footnote 16. Stock issued after Oct 1, 1942 can qualify if received in a reorganization or similar exchange. *IRC § 247(b)(2)*.

(n18)Footnote 17. *Id.* The definitions of preferred stock and public utility are contained in *IRC § 247(b)*, governing the deduction for dividends paid on certain preferred stock of public utilities. This dividends paid deduction must be available to the public utility before the dividends received deduction of *IRC § 244* can be claimed. If this prerequisite cannot be met, the dividend qualifies for deduction under *IRC § 243*. *IRC § 243(d)(4)*.

(n19)Footnote 18. The highest rate of tax specified for corporations is 35 percent.

(n20)Footnote 19. *IRC § 245(a)(1), (2)*. No foreign tax credit is allowed for any taxes paid or accrued with respect to the US-source portion of any dividend received by a corporation from a qualified 10-percent owned foreign corporation, unless a treaty obligation of the US treats the dividend as arising from sources outside the US. *IRC § 245(a)(8), (10)*. In addition, the United States-source portion of the dividend is treated as income from United States sources for purposes of the foreign tax credit limitation. *IRC § 245(a)(9)*. Under *IRC § 243(e)*, any dividend paid by a foreign corporation out of earnings and profits accumulated by a domestic corporation during a period with respect to which the domestic corporation was subject to federal income taxation is treated as a domestic dividend. If *IRC § 243(e)* applies, *IRC § 245* does not. *Treas Reg § 1.245-1(a)(2)*.

For this purpose, the term "dividend" does not include any amount treated as a dividend under *IRC § 1248*. *IRC § 245(a)(11)*.

(n21)Footnote 20. *IRC § 245(a)(3)*. If the first day on which the ownership requirement is met is in a taxable year of the foreign corporation beginning after December 31, 1986, the post-1986 undistributed earnings and the post-1986 undistributed US earnings of the corporation are determined by only taking into account periods beginning after the first day of the first taxable year in which the requirement is met. *IRC § 245(a)(6)*.

(n22)Footnote 21. *IRC §§ 245(a)(4), 902(c)(1)*.

(n23)Footnote 22. *IRC § 245(a)(5)*.

(n24)Footnote 23. *IRC § 245(b)*. Earnings and profits of a 10-percent owned foreign corporation are not taken into account for purposes of determining the United States-source portion of a dividend if the 100 percent deduction is available. *IRC § 245(a)(7)*.

(n25)Footnote 24. *IRC § 245(c)(1)(A)*. The provision does not apply if the payment is attributable to *IRC § 923(a)(2)* nonexempt income or to income which would not be treated as exempt income but for *IRC § 923(a)(4)*. *IRC § 245(c)(2)*.

The deduction permitted by *IRC § 245(c)(1)(A)* cannot be claimed by S corporations. *Naporano v US, 834 F Supp 694 (DNJ 1993)*.

The Service has ruled that a corporate partner of a limited liability company classified as a partnership for federal income tax purposes is entitled to a 100 percent deduction for its distributive share of dividend income from earnings and profits of a foreign sales company that are attributable to the company's foreign trade income. *Ltr Rul 200137038*.

(n26)Footnote 25. *IRC § 245(c)(1)(B)*.

(n27)Footnote 26. *IRC § 246(a)(1)*. The restriction does not apply to dividends paid by any Federal Home Loan Bank attributable to dividends received by it from the Federal Home Loan Mortgage Corporation during the taxable year. *IRC § 246(a)(2)*.

(n28)Footnote 27. *IRC § 246(d)*.

(n29)Footnote 27.1. *IRC § 246(c)(1)(A), (c)(2)*. The holding period for preference dividends applies if the taxpayer receives dividends on such stock which are attributable to a period or periods aggregating more than 366 days. In determining the holding period, the day of disposition, but not the day of acquisition is taken into account, and no date that is more than 45 days (90 days, if applicable) after the ex-dividend date can be taken into account. *IRC § 246(c)(3)*.

A corporate shareholder of a regulated investment company (RIC) is required to meet the holding period requirements of *IRC § 246(c)(1)(A)* in order to claim a dividends received deduction for ordinary income distributions from the RIC. *Rev Rul 91-68, 1991-2 CB 43*.

The combination of simultaneously purchased stock and "put" options as part of "forward conversions" yielded a holding period of zero under *IRC § 246(c)(4)*. *Progressive Corp & Subs v US, 970 F2d 188 (6th Cir 1992)*. The case is discussed in Note, "Dividends Received Deduction: The Effect of Hedging With In-The-Money Call Options of the Holding Period Requirement of Section 246: *Progressive Corp v United States*," 46 *Tax Lawyer* 629 (1993).

If, at the beginning of the ex-dividend date, the taxpayer owns at least 80 percent of the total value of the stock of a bank or bank holding company, the taxpayer is treated as also owning any of the stock that the taxpayer has an option to acquire. *IRC § 246A(c)(3)*.

The writing of a "call" option on the stock does not reduce the holding period for the dividends received deduction, since the taxpayer still holds the stock subject to the risks of the marketplace. *Rev Rul 80-238, 1980-2 CB 96*.

(n30)Footnote 28. *IRC § 246(c)(1)(B)*, which evidences a congressional concern that corporations not abuse the dividends received deduction to obtain a tax arbitrage. *Ltr Rul 9128050*.

(n31)Footnote 28.1. *IRC § 246(c)(4)*. The provision does not apply in the case of any qualified covered call as defined in *IRC § 1092(c)(4)* other than a qualified covered call option to which *IRC § 1092(f)* applies. See *Rev Rul 90-27, 1990-1 CB 50*, for an instance in which *IRC § 246(c)(4)* will not apply to prevent a dividends received deduction for dividends paid on "Dutch-auction rate preferred stock"--stock on which the dividend rate is changed periodically through a Dutch-auction mechanism.

(n32)Footnote 28.2. *Rev Rul 94-28, 1994-1 CB 86*. However, the ruling goes on to state that *IRC § 246(c)(4)* applies to an instrument that affords the holder the rights of a creditor and is not stock for corporate law purposes, but is stock for federal income tax purposes.

(n33)Footnote 28.3. *Treas Reg § 1.246-5(b)(1)*. Reasonable expectations are the expectations of a reasonable person, based on all of the facts and circumstances at the later of the time the taxpayer acquired the stock or entered into the positions. Reasonable expectations include all explicit or implicit representations made with respect to the marketing or sale of the position. *Treas Reg § 1.246-5(b)(4)*.

(n34)Footnote 28.4. *Treas Reg § 1.246-5(b)(2)*. A position with respect to property is an interest (including a futures or forward contract or an option) in property or any contractual right to a payment, whether or not severable from stock or other property. A position does not include traditional equity rights to demand payment from the issuer, such as rights inherent in mandatorily redeemable preferred stock. *Treas Reg § 1.246-5(b)(3)*.

An option to sell that is significantly out of the money does not diminish the taxpayer's risk of loss on its stock unless the option is held as part of a strategy to substantially offset changes in the fair market value of the stock. *Treas Reg § 1.246-5(c)(2)(i)*.

(n35)Footnote 28.5. *Treas Reg § 1.246-5(c)(2)(ii)*.

(n36)Footnote 28.6. *Treas Reg § 1.246-5(c)(4)*.

(n37)Footnote 28.7. *Treas Reg § 1.246-5(c)(5)*.

(n38)Footnote 28.8. *Treas Reg § 1.246-5(c)(1)(i), (ii)*. A testing date is any day on which the taxpayer purchases or sells stock if the fair market value of the stock or the fair market value of substantially similar or related property is reflected in the position, any day on which the taxpayer changes the position, or any day on which the composition of the position changes. *Treas Reg § 1.246-5(c)(1)(iv)*.

(n39)Footnote 28.9. *Treas Reg § 1.246-5(c)(1)(ii)*. If a taxpayer diminishes its risk of loss by holding a position in substantially similar or related property with respect to only a portion of the shares that the taxpayer holds in a particular stock, the holding period of those shares having the shortest holding period is reduced. *Treas Reg § 1.246-5(c)(3)*.

(n40)Footnote 28.10. *Treas Reg § 1.246-5(c)(1)(iii)*.

(n41)Footnote 28.11. *Treas Reg § 1.246-5(c)(1)(iii)(A)*.

(n42)Footnote 28.12. *Treas Reg § 1.246-5(c)(1)(iii)(B)*.

(n43)Footnote 28.13. *Treas Reg § 1.246-5(c)(1)(iii)(C)*.

(n44)Footnote 28.14. *Treas Reg § 1.246-5(c)(1)(v)*.

(n45)Footnote 28.15. *Treas Reg § 1.246-5(c)(1)(vi)*. Notional principal contracts are discussed in Chapter 9A.

(n46)Footnote 28.16. *Treas Reg § 1.246-5(c)(7)*.

(n47)Footnote 28.17. *Treas Reg § 1.245-5(c)(6)*. See Ch 9 for a discussion of *IRC § 1092*.

(n48)Footnote 29. *IRC § 246(c)(1)*; *Treas Reg § 1.246-3(c)(2), (3)*.

(n49)Footnote 30. *Treas Reg § 1.246-3(c)(3)*.

(n50)Footnote 31. The provision does not apply to the 100 percent dividends received deduction available to members of the same affiliated group or to dividends received by a small business investment company. *IRC § 246A(b)*.

(n51)Footnote 32. *IRC § 246A(d)(1)*. The determination of average amounts will be specified in regulations.

If stock is not held throughout the base period, the determination is made as if the base period consisted only of that portion of the period during which the stock was held by the taxpayers. *IRC § 246A(d)(2)*.

(n52)Footnote 33. Indebtedness is portfolio indebtedness if it is clearly incurred for the purpose of acquiring

portfolio stock or is otherwise directly traceable to the stock. Indebtedness is directly traceable to dividend-paying stock when (1) the stock is held in a margin account with a securities broker; (2) a nonrecourse loan is secured, in whole or in part by dividend-paying stock; and (3) when money is received by a taxpayer as proceeds from a short sale. HR Rep No 432, 98[th] Cong, 2d Sess 853 (1984). Indebtedness is also portfolio indebtedness if the stock is acquired by the corporation using its equity, the corporation later borrows money using the stock as security, and the purchaser could reasonably have been expected to sell the stock rather than incur the indebtedness. Conf Rep No 861, 98th Cong, 2d Sess 813 (1984).

See Rev Rul 88-66, 1988-2 CB 34, in which the Service focuses on three situations to determine whether an indebtedness is directly attributable to an investment in portfolio stock. The ruling rejects the concept that indebtedness is directly attributable to the stock merely because the dividend-paying stock and the indebtedness are in existence at the same time. See also *Ltr Rul 9141006*.

The Tax Court has held that, in an appropriate case, the provisions of IRC § 246A may be used when one member of an affiliated group is the borrower and another member is the purchaser of portfolio stock. *H Enterprises Intl, Inc & Subs v Commr*, 105 TC 71 (1995). The court found such an appropriate case in a second decision involving the same taxpayer reported as *TC Memo 1998-97*. The Tax Court was affirmed by the Eighth Circuit. *183 F3d 907 (8th Cir 1999)*.

(n53)Footnote 34. IRC § 246A(c), (d)(3), (4). The ownership percentage is 20 percent if stock meeting the 50 percent test is owned by five or fewer corporate shareholders.

Stock that is not entitled to vote, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, has redemption and liquidation rights which do not exceed the paid-in capital or par value represented by such stock (except for a reasonable redemption premium), and is not convertible into another class of stock, is not counted as stock for this purpose. IRC §§ 246A(c)(4), 1504(a)(4).

(n54)Footnote 35. IRC § 246(b)(1).

(n55)Footnote 36. IRC § 246(b)(3).

(n56)Footnote 37. IRC § 246(b)(2); *Treas Reg* § 1.246-2(b).

(n57)Footnote 38. IRC §§ 172(c), 172(d)(6).

(n58)Footnote 39. IRC § 1059(a)(1)(d)(5). The provision applies to dividends declared after July 18, 1986, in taxable years ending after such date.

In determining the holding period for the stock, the day of disposition, but not the day of acquisition, is taken into account, any day which is more than one year after the stock becomes ex-dividend is not taken into account, and the tacked holding period provisions of IRC § 1223(4) (relating to wash sale stock) are inapplicable. IRC §§ 246(c)(3), 1059(d)(3).

(n59)Footnote 40. IRC § 1059(b), (d)(1). For distributions made before May 4, 1995, the reduction occurred immediately before any sale or disposition of the stock. The same rule applies to any distribution pursuant to the terms of (i) a written binding contract in effect on May 3, 1995, and at all times thereafter, or (ii) a written tender offer outstanding on May 3, 1995. Taxpayer Relief Act of 1997, § 1011(d).

(n60)Footnote 41. IRC § 1059(a)(2). For distributions before May 4, 1995, or subject to the traditional rule described in N 40, the gain was taken into account in the year in which the sale or other disposition occurred.

(n61)Footnote 42. IRC § 1059(d)(6). A qualified corporation is defined as any corporation (including a predecessor

corporation) (1) with respect to which the taxpayer holds, directly or indirectly during the entire period of the corporation's existence, at least the same ownership in the corporation distributing the dividend, and (2) that has no earnings and profits either earned by a corporation not described in clause (1) or attributable to gain on property that accrued during a period that the corporation holding the corporation was a corporation not described in clause (2).

(n62)Footnote 43. *IRC §§ 243(b)(1), 1059(e)(2).*

(n63)Footnote 43.1. *IRC § 1059(e)(1)(A).* Regulations make it clear that neither *IRC § 1059(d)(6)* nor *IRC § 1059(e)(2)* applies in such a case. *Treas Reg § 1.1059(e)-1(a).*

(n64)Footnote 43.2. *IRC § 1059(e)(1)(B).*

(n65)Footnote 44. *IRC § 1059(c)(1), (2).*

(n66)Footnote 45. *IRC § 1059(c)(3)(A).*

(n67)Footnote 46. *IRC § 1059(c)(3)(B).*

(n68)Footnote 47. HR Rep No 101-247, 101st Cong, 1st Sess 1233 (1989).

(n69)Footnote 48. In determining whether a dividend rate declines, or whether the stock would otherwise be subject to the provision, the effect of *IRC § 305* or other provisions of law on the timing and amount of the dividend must be taken into account. The provision is not intended to apply to dividends on preferred stock that decline due to an unforeseen economic downturn in the issuer's business. HR Rep No 101-247, 101st Cong, 1st Sess 1233 (1989).

(n70)Footnote 49. *IRC § 1059(c)(4)* If the taxpayer makes the election, the proper value to use in the case of the 85-day aggregation period is the fair market value of the stock on the day before the first aggregation day. For purposes of the 365-day aggregation period, the shareholder must use the weighted average of the fair market values of the stock on the days before each of the ex-dividend dates. *Rev Rul 88-49, 1988-1 CB 297*.

(n71)Footnote 50. *1987-2 CB 402*.

(n72)Footnote 51. *1959-1 CB 237*.

(n73)Footnote 52. *1977-2 CB 319*.

(n74)Footnote 53. *1980-2 CB 101*.

(n75)Footnote 54. *1983-2 CB 170*.

(n76)Footnote 55. *IRC § 1059(e)(3)(c).* A qualified preferred dividend does not include any dividend payable with respect to preferred stock if the actual rate of return on the stock exceeds 15 percent.

(n77)Footnote 56. *IRC § 1059(e)(3)(A)(i).*

(n78)Footnote 57. *IRC § 1059(e)(3)(A)(ii).*

(n79)Footnote 58. *IRC § 1059(c)(1)*, effective for dividends declared after Oct 22, 1986, for taxable years ending after such date.

(n80)Footnote 59. Since the determination whether a distribution in partial liquidation is made at the corporate rather than the shareholder level, Congress intends that the Treasury Department will have the authority to require the distributing corporation to advise the shareholders (with notice to the Service) as to the character of the distribution. The characterization will generally be binding on the shareholders. However, the Service will be free to challenge the

characterization of the distribution, provided it takes a consistent position with respect to corporate and noncorporate shareholders. HR Rep 99-841, 99th Cong, 2d Sess II-166 (1986).

(n81)Footnote 1. *IRC § 301(c)(2)*.

(n82)Footnote 2. *IRC § 301(c)(3)*.

(n83)Footnote 1. *IRC § 301(d)*.



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Taxation of Securities Transactions

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CHAPTER 4 Dividend Distributions

1-4 Taxation of Securities Transactions § 4.05

§ 4.05 Tax Accounting for Dividends Received

[1] Year of Inclusion.

The Regulations to *IRC Section 301* state that "[a] distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands."ⁿ¹ Another part of the Regulations provides that dividends declared payable and mailed on December 31, and, therefore, not received until the following year, are not constructively received in the prior year.ⁿ² Taking these two provisions together, it is an easy step to say that, at least for a cash basis taxpayer, the crucial date is the date of receipt. But suppose a taxpayer could have obtained possession of the dividend in the prior year, but determined not to do so. Here the doctrine of constructive receipt requires inclusion in the earlier year, thereby preventing taxpayers from selecting the year of inclusion.ⁿ³

Should the same rules apply if the taxpayer uses the accrual method of accounting? It is arguable that, for such a taxpayer, the dividend should enter gross income in the year in which the record date falls since that is the time at which the right to payment becomes fixed, and such right is the *sine qua non* of recognition of income for an accrual basis taxpayer.

However, this has not been the conclusion reached by the courts. Pointing to the fact that the mentioned Regulations make no distinction between cash basis and accrual method taxpayers, their decision has been to treat all taxpayers alike.ⁿ⁴

A distinction must be made between the time at which the consequences of a distribution are to be reflected in the income of the shareholder, and the time at which the status of the distribution is determined. The former is ordinarily controlled by the year of receipt; the latter looks to the distributing corporation's earnings and profits as they appear on the date of payment.ⁿ⁵

[2] The Taxable Person.

[a] Pledged or Escrowed Stock. Suppose dividends are paid to a person holding stock as security for repayment of an outstanding indebtedness or unpaid purchase price. If the dividends, though received by the escrow holder or pledgee, are applied in reduction of the balance due, the obligor receives the same measure of beneficial enjoyment as he would from actual receipt of the dividend. Viewed in this light, the taxable person must be the obligor.ⁿ¹ Of course,

if the creditor has the right to retain the dividend for his own purposes and not use it as an offset against the price or debt, the dividend is income to him.

[b] Assignment of Income Problems. It is well settled that an anticipatory assignment of the right to a future dividend does not shift the incidence of taxation to the assignee.ⁿ² A change in taxable person can occur only when there is a bona fide transfer of the stock with respect to which the dividend is paid.ⁿ³ But even that will not automatically remove the dividend from the assignor's income, for if the gift is made after the record date, the assignor will still be taxed.ⁿ⁴ Only a complete transfer prior to the record date will make the dividend taxable to the donee.ⁿ⁵

An assignment of anticipated dividends does not always constitute an anticipatory assignment of income. One fact pattern which can produce this result is that presented by *Estate of Stranahan v. Commissioner*,ⁿ⁶ where the taxpayer desiring to obtain the benefit of a large interest deduction, accelerated future income by assigning anticipated dividends for an immediate cash payment. The payment was reported as income by the taxpayer; he did not do likewise with respect to the actual dividend payments. This course of action was approved by the Sixth Circuit over the objection of the Commissioner who sought to attribute the dividend income to the assignor. The appellate court distinguished the case from one involving a gratuitous assignment on the ground that the amount paid by the assignee fairly reflected the value of the right to receive the future dividend income.

A related question is the extent to which a waiver of dividends by a majority shareholder results in the realization of income by him. It seems fairly clear that such a waiver will not cause the shareholder to be in constructive receipt of income if the waiver is made for a bona fide business reason, e.g., the preservation of working capital.ⁿ⁷ If, however, the result of the action taken by the shareholder serves to increase the share of dividends flowing to members of his family, as minority shareholders, and the purpose of the waiver is to effect such an increase, the waiver will not be recognized, and the shareholder will realize income to the extent of the waived dividend.ⁿ⁸ Using these principles as the basis for decision, the Service will rule on proposed waiver transactions if (1) there is a bona fide business reason for the waiver; and (2) relatives of the waiving shareholder (defined as his spouse, ancestors, lineal descendants and their spouses, and brothers and sisters of the whole and half blood and their spouses) are not in a position to receive more than 20 percent of the total dividends distributed to nonwaiving shareholders.ⁿ⁹ The ruling becomes inapplicable if a change in stock ownership enables nonwaiving relatives to get more than 20 percent of future dividends, unless the change occurs because of death. It becomes ineffective three after issuance.

[3] Characterization of Income Problems.

Can a taxpayer change the character of income from ordinary to capital by selling his stock prior to the payment date? The answer turns on whether the taxpayer had acquired a vested right to the dividend at the time of sale. Thus, if the sale precedes both the date of declaration and the date of payment, the seller, having acquired no right to any future dividend, does not realize dividend income even if the selling price includes the amount of any projected dividend.ⁿ¹ Clearly, if the stock were sold after the date upon which the seller became entitled to the dividend,ⁿ² he could not escape ordinary income consequences to the extent of the dividend.ⁿ³ The consequences to the purchaser follow those of the seller. If the sale antedates the time at which the right to dividends vests, the purchaser will be in receipt of ordinary income when the dividend is paid to him, even though the purchase price reflects the amount of the anticipated dividend.ⁿ⁴ The added price merely increases the purchaser's basis for his stock.

An interesting corollary to the last-stated proposition is presented when the owner of preferred stock on which dividends are accrued receives a distribution in liquidation or in redemption of his interest, and the amount of the distribution includes the amount of accrued dividends. Once again, the nature of the income received rests upon prior entitlement to the dividend. Thus, although dividends may have accrued on the stock, no part of the distribution will be deemed a dividend, unless preceded by an actual declaration of a dividend.ⁿ⁵

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.301-1(b)*.

(n2)Footnote 2. *Treas Reg § 1.451-2(b)*.

(n3)Footnote 3. *Kunze v Commr*, 19 TC 29 (1952) , *aff'd per curiam* 203 F2d 957 (2d Cir 1953) ; *Brundage v US*, 275 F2d 424 (7th Cir 1960) , *cert denied* 364 US 831 (1960) .

(n4)Footnote 4. *Dynamics Corp of Am v US*, 392 F2d 241 (Ct Cl 1968) ; *Commr v American Light & Traction Co*, 156 F2d 398 (7th Cir 1946) .

(n5)Footnote 5. *Rev Rul 62-131*, 1962-2 CB 94 .

(n6)Footnote 1. *Treas Reg § 1.61-9(c)*; *Rev Rul 56-153*, 1956-1 CB 166 ; *De Guire v Higgins*, 159 F2d 921 (2d Cir 1947) , *cert. denied*, 331 US 858 .

(n7)Footnote 2. *Hyman v Nunan*, 143 F2d 425 (2d Cir 1944) . *Cf Wallace v US*, 439 F2d 757 (8th Cir 1971) (taxpayer taxed on dividends on shares subsequently transferred to wife under divorce decree; taxpayer not trustee for his wife). An exhaustive study of the assignment of income problem is contained in Lyon & Eustice, "Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case," 17 *Tax L Rev* 293 (1962).

(n8)Footnote 3. The transferor must prove that the gift was bona fide in order to deflect the dividend income to the transferee. *Beirne v Commr*, 61 TC 268 (1973) , is an example of a case in which the assignor could not sustain this burden.

(n9)Footnote 4. *Rev Rul 74-562*, 1974-2 CB 28 ; *contra Matchette v Helvering*, 81 F2d 73 (2d Cir 1936) , *cert. denied*, 298 US 677 .

(n10)Footnote 5. *Cf Est of Putnam v Commr*, 324 US 393 (1945) ; *Bishop v Shaughnessy*, 195 F2d 683 (2d Cir 1952) (no enforceable rights accrued to donor by reason of resolution authorizing payment); but *cf Smith's Estate v Commr*, 292 F2d 478 (3d Cir 1961) , *cert. denied*, 368 US 967 (New Jersey law gave shareholders vested right at time of declaration; gift prior to record date ineffective to shift incidence of tax).

In *Caruth v US*, 865 F2d 644 (5th Cir 1989) , a gratuitous transfer of stock after the dividend declaration date, but before the record date, shifted the income to the donee.

(n11)Footnote 6. 472 F2d 867 (6th Cir 1973) .

(n12)Footnote 7. *Rev Rul 45*, 1953-1 CB 178 ; see also *Rev Rul 71-164*, 1971-1 CB 108 (taxpayer's waiver of dividends in excess of certain amount not constructive receipt by him of excess). The Service will consider a request for ruling on a proposed waiver-of-dividend transaction under the conditions set out in *Rev Proc 67-14*, 1967-1 CB 591 .

(n13)Footnote 8. *Rev Rul 56-431*, 1956-2 CB 171 . *Rev Proc 67-14*, 1967-1 CB 591 , is not determinative of whether a ruling request on a proposed waiver of dividends will be considered when the waiving or nonwaiving shareholder is a corporation. One condition that is applicable regardless of the status of the shareholder is the existence of a bona fide business reason for the proposed waiver. An important question is whether or not there is a direct business relationship between the waiving and nonwaiving shareholders. *Ltr Rul 199944021* .

(n14)Footnote 9. *Rev Proc 67-14*, 1967-1 CB 591 . *Rev Proc 67-14* contains a restriction on waiver of dividends. A ruling issued on a proposed waiver of dividends transaction will not be effective for a period longer than three years from the date of the ruling. See, eg, *Ltr Rul 9727012* .

(n15)Footnote 1. *Treas Reg § 1.61-9(c)*.

(n16)Footnote 2. Generally, the record date is the one on which a shareholder becomes entitled to a dividend. However, for stock traded on an exchange, the applicable date is the ex-dividend date. And in some cases, the declaration date may control. *Smith's Estate v Commr*, 292 F2d 478 (3d Cir 1961) , *cert. denied*, 368 US 967 .

(n17)Footnote 3. *Treas Reg* § 1.61-9(c).

(n18)Footnote 4. *Treas Reg* § 1.61-9(c).

(n19)Footnote 5. *GCM 5180*, VII-2 CB 110 (1928); *Est of Mathis v Commr*, 47 TC 248 (1966) , *acq*, 1967-1 CB 2 .



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Taxation of Securities Transactions

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CHAPTER 4 Dividend Distributions

1-4 Taxation of Securities Transactions § 4.06

§ 4.06 Stock Dividends and Distributions of Stock Rights

[1] Effect of the Distribution on Income.

The general rule contained in the present Code is that "gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock."ⁿ¹ Prior to the Tax Reform Act of 1969, this rule applied to every stock dividend or distribution of stock rights by a corporation to its shareholders, except (1) a distribution made in discharge of preference dividends for the current taxable year of the corporation or the preceding taxable year,ⁿ² or (2) any distribution in which any of the shareholders had the option at any time to have the distribution payable either in stock (or stock rights) or in property.ⁿ³ Under Regulations first proposed in 1956, and finally issued early in 1969, an election would be imputed whenever the corporation had more than one class of stock and paid dividends in cash or property to holders of one class, and dividends in stock to holders of the other.ⁿ⁴ The election derives from the fact that, under *IRC Section 1036*, shares of one class may be exchanged for shares of the other without recognition of gain or loss. Furthermore, if the corporation had, say, Class A stock convertible into Class B stock of the corporation on a stated basis, and the conversion ratio increased with the payment of cash dividends on the Class B shares, the holders of Class A stock would be deemed in receipt of a taxable dividend to the extent of the increase.ⁿ⁵

The Tax Reform Act of 1969 expanded the instances in which a stock dividend or distribution of stock rights will be taxable.ⁿ⁶ The actual effect of the new provisions is to transform the distribution from one that is tax-free under *IRC Section 305(a)* to one that is governed by *IRC Section 301*. The amount of the distribution is measured by the fair market value of the distributed stock.

In general, a distribution, which at the election of any shareholder, is payable either in stock or in property, continues to be taxable to participating shareholders in an amount equal to the fair market value of the stock on the dividend date.ⁿ⁷ Nonparticipating shareholders include the amount of cash or fair market value of property received.ⁿ⁸ Regulations provide in general that, under *IRC Section 305(b)(1)*, if any shareholder has the right to an election or option with respect to whether a distribution shall be made either in money or any other property, or is stock or stock rights of the distributing corporation, then, with respect to all shareholders, the distribution of stock or stock rights is treated as a taxable distribution regardless of whether (1) the distribution is actually made in whole or in part in stock or in stock rights; (2) the election or option is exercised or exercisable before or after the declaration of the distribution; (3) the declaration of the distribution provides that the distribution will be made in one medium unless the shareholder

specifically requests payment in the other; (4) the election governing the nature of the distribution is provided in the declaration of the distribution or in the corporate charter, or arises from the circumstances of the distribution; or (5) all or part of the shareholders have the election.ⁿ⁹

The 1969 Act enlarged the list of taxable distributions to include:

(1) A disproportionate distribution, i.e., one in which some of the shareholders receive a cash or property distribution, while others receive an increase in their proportionate interest in the assets or earnings of the corporation.ⁿ¹⁰

(2) A distribution which has the effect of the receipt of preferred stock by some common shareholders and the receipt of common stock by others.ⁿ¹¹

(3) Any distribution in respect of preferred stock, other than one which increases the conversion ratio of convertible preferred stock to take account of a stock split.ⁿ¹² Therefore, a stock distribution in discharge of preference dividends for the current or preceding taxable year remains a taxable distribution.

(4) Any distribution of convertible preferred stock, unless the distribution is shown not to have the effect of a disproportionate distribution.ⁿ¹³

[a] Disproportionate Distributions.

[i] In General. By virtue of *IRC Section 305(b)(2)*, a stock dividend becomes taxable if it is made as part of a disproportionate distribution, that is, a distribution or series of distributions that has the result of the receipt of cash or other property by some shareholders and an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation. (Any increase in proportionate interest, even one that is de minimis, will render the stock dividend taxable.) The provision comes into play if, for example, a corporation has two classes of common stock, one paying regular cash dividends and the other paying corresponding stock dividends. In contrast, if the corporation has a single class of common and a class of nonconvertible preferred that pays a cash dividend, a pro rata distribution of common shares to the holders of common will be nontaxable; there will be no increase in the proportionate interests of any of the shareholders.ⁿ¹⁴

In determining whether a distribution is disproportionate, holders of rights to acquire stock and holders of securities convertible into stock are treated as stockholders.ⁿ¹⁵ Thus, if a corporation has common stock and convertible debentures outstanding, and pays interest on the convertible securities and a stock dividend on the common stock, the payment of interest is considered as a distribution of property to a shareholder, giving rise to a disproportionate distribution and a taxable stock dividend.ⁿ¹⁶

Application of *IRC Section 305(b)(2)* does not depend upon some relationship or connection between the cash and stock distributions. Rather, taxation of the stock dividend ensues whether or not the stock distribution and the cash distributions are steps in an overall plan or are independent or unrelated.ⁿ¹⁷ All that need occur is that there be a receipt of cash or property by some shareholders and an increase in the proportionate interest of other shareholders. Moreover, there is no requirement that both elements of *IRC Section 305(b)(2)* occur in the form of a distribution as long as the result of some distribution is that certain shareholders acquire cash or property while others increase their proportionate interests.ⁿ¹⁸ For example, the requirements of *IRC Section 305(b)(2)* will be satisfied if a corporation makes a stock distribution to its shareholders and then, pursuant to prearrangement, a related corporation purchases the stock in a transaction treated as a redemption under Section 304.ⁿ¹⁹ However, where the interval between the receipt of cash or property and the stock dividend is more than thirty-six months, the stock distribution will be nontaxable unless the distribution of cash or property and the distribution of stock are made pursuant to a plan.ⁿ²⁰

[ii] Constructive Disproportionate Distributions. The proportionate interest of a shareholder can be increased not only by the payment of a stock dividend to him and not to others, but also by increasing the ratio at which stock, convertible securities, or rights that he owns can be converted into other stock, by decreasing the ratio at which stock, convertible securities, or rights owned by others can be converted into stock of the class he owns, or by the periodic redemption of stock owned by other shareholders. *IRC Section 305(c)* authorizes the Treasury to prescribe Regulations governing the extent to which "a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption which is treated as a distribution to which *IRC Section 301* applies, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder" will be treated as a constructive disproportionate distribution.ⁿ²¹ And the Treasury has done so, and seems most concerned with two problems--adjustments in conversion ratios following stock dividends and periodic redemption schemes.

[iii] Adjustments in Conversion Ratios. Under the Regulations, an increase in proportionate interest in assets or earnings and profits will be deemed to have occurred if a corporation (1) has convertible stock or securities outstanding upon which it pays dividends or interest in money or property, (2) distributes a stock dividend on the stock with respect to which the convertible stock or securities are convertible, and (3) fails to fully adjust the conversion ratio or conversion price to reflect the stock dividend.ⁿ²² In general, the presence of an antidilution formula should guard against the lack of adequate adjustment in ratio or price, but if the formula provides for a credit where stock is issued for a consideration in excess of the conversion price, the requirement for a full adjustment may not be met.ⁿ²³

To prevent the stock dividend from being treated as a taxable distribution, the distributing corporation must make the required adjustment in conversion ratio or conversion price as of the date of distribution of the stock dividend or must elect to do so no later than the earlier of (a) three years after the date of the stock dividend, or (b) the date as of which the aggregate stock dividends for which adjustment of the conversion ratio has not previously been made total at least 3 percent of the stock issued and outstanding on the date of the first such stock dividend.ⁿ²⁴ The election to make the adjustment is made by the distributing corporation in a statement attached to its income tax return for the taxable year during which the stock dividend is distributed.ⁿ²⁵ Such statement must indicate that an adjustment will be made as provided in the Regulations and must also contain a description of the antidilution provisions under which the adjustment will be made.ⁿ²⁶

The foregoing rules may be illustrated by the following examples:

Example 1:

X Corp. has a single class of common stock outstanding. It also has outstanding interest-paying debentures convertible into common stock at a fixed conversion ratio that is not subject to adjustment in the event stock dividends are paid on the common stock. In such case, any distribution of stock with respect to the common stock will be treated as a taxable stock dividend under *IRC Section 305(b)(2)*. There is an increase in the proportionate interest of the common shareholders, while the holders of convertible securities--treated as stockholders for the purpose of determining whether a distribution is disproportionate--receive only cash in the form of interest.

Example 2:

Assume the same facts in Example 1, except that the conversion ratio must be adjusted to reflect stock dividends paid with respect to the common stock. Any distribution of stock to the shareholders will now be nontaxable since the required adjustment in conversion ratio will prevent the distribution from working an increase in the proportionate interests of the common stockholders. This will hold true even though no adjustment is required until the stock dividends equal 3 percent of the common stock issued and outstanding on the date of the first such stock dividend, provided, of course, the corporation files the statement and information prescribed by the Regulations and discussed above.

Example 3:

Assume the same facts as in Example 1, except that the conversion feature is contained in preferred stock

that pays no dividends, but is redeemable in ten years at a price in excess of the issue price. Under *IRC Sections 305(b)(4)* and *305(c)*, the redemption price may be treated as a taxable stock dividend paid with respect to the preferred stock.ⁿ²⁷ If it is, is it also treated as a distribution of property for purposes of *IRC Section 305(b)(2)*? The Regulations indicate that it must be so treated, the result being that a distribution of common stock with respect to the outstanding common stock of the corporation will be a distribution that is subject to tax.ⁿ²⁸ It is questionable whether Congress intended that a distribution do double duty, that is, be taxed itself under one provision of *IRC Section 305(b)* and, at the same time, play a role in the taxation of the other distribution under a different portion of the section.

The Regulations continue in force the provisions of the 1969 Regulations that a taxable stock dividend is produced by an increase or decrease in conversion ratio coupled with the payment of cash dividends. For example, if class A shares are convertible into class B shares at an increasing rate, and the corporation distributes cash dividends to the holders of class B stock, the increase in conversion ratio will be treated as a stock dividend that results in an increase in the proportionate interests of the class A shareholders, and, thus, as a distribution subject to the provisions of *IRC Section 305(b)(2)*.ⁿ²⁹ On the other hand, a reduction in the conversion ratio of the class A shares due to the payment of cash dividends on those shares will work an increase in the proportionate interest of the class B shareholders. In that event, the holders of class B stock will be the ones in receipt of a taxable stock dividend.ⁿ³⁰

[iv] Periodic Redemption Plans. Suppose a corporation has two classes of common stock outstanding. If it redeems the shares of one class, the proportionate interests of the shareholders in the other class is increased. The same result would obtain if the corporation had only a single class of stock outstanding and redeemed the shares of some, but not all, of the shareholders; the nonredeeming shareholders would realize an increase in their proportionate interests in the corporation.

If the redemption in the latter case is taxable under *IRC Section 301*, that is, is a redemption that is essentially equivalent to a dividend, then the shareholders whose shares are not redeemed and whose proportionate interests are thereby increased, will be taxed under *IRC Section 305(b)(2)*. The redemption is treated as an actual distribution of cash to the shareholders whose stock is redeemed and as a constructive distribution of stock to the nonredeemed shareholders.ⁿ³¹ The amount of the constructive distribution is measured by the fair market value of the number of shares that each nonredeemed shareholder would have received prior to the redemption in order to increase his ownership interest to the percentage held following the redemption.ⁿ³² To illustrate:

Example 1:

A Corporation has 1,000 shares of stock outstanding. The shares are owned equally by ten shareholders, one of whom is *T*. A Corporation adopts a plan for periodic redemptions which calls for the redemption annually of 5 percent of each shareholder's stock. During the year, each of the shareholders other than *T* redeems 5 shares of his stock for cash. Assuming that the redemptions are treated as dividends under *IRC Section 301*, *T* is deemed to have received a taxable distribution of 5.25 shares. The increase is determined by computing the number of shares that *T* would have received if the corporation had sought to increase his interest immediately prior to the redemption by the same percentage that it did increase by reason of the redemptions. The computation is in two steps:

(a) First compute the percentage owned by *T* following the redemption:

Total shares owned by <i>T</i>	=	10.47 percent
Total shares outstanding		

(b) Next compute the number of shares that the corporation would have been required to distribute prior to the redemption in order to raise *T*'s ownership percentage from 10 percent to 10.47 percent.

$$\frac{100 + X}{1,000 + X} = .1047$$

$$X = 5.25$$

The value of each share deemed to be distributive to *T* is then determined by dividing the aggregate fair market value of the shares actually outstanding after the redemption (955) by the number of shares that would have been outstanding if the distribution had taken place prior to the redemption (1005.25).ⁿ³³

Example 2:

Assume the same facts as in Example 1, except that *T* owns 150 shares and that *S*, a shareholder owning fifty shares, also elects not to redeem his shares. The computation of the number of shares deemed distributed to *S* and *T* is made in the aggregate,ⁿ³⁴ and takes the following form:

(a) Compute the percentage owned by *S* and *T* following the redemption:

$$\frac{150}{960} + \frac{50}{960} = 20.83 \text{ percent}$$

(b) Compute the additional shares deemed to have been distributed to *S* and *T*:

$$\frac{200 + X}{1,000 + X} = .2083$$

$$X = 10.48$$

(c) Compute the shares deemed to have been distributed to each of the two shareholders:

To *S*:

$$\begin{array}{r} 50 \\ 200 \end{array} \times 10.48 = 2.62$$

To *T*:

$$\begin{array}{r} 150 \\ 200 \end{array} \times 10.48 = 7.86$$

The value of each of the shares deemed distributed to *S* and *T* is determined by dividing 1010.48 into the aggregate value of the 960 shares actually outstanding immediately after the redemption.

The regulatory authority granted the Treasury under *IRC Section 305(c)* is not meant to be used to bring isolated redemptions of stock under the disproportionate rule of *IRC Section 305(b)(2)*. This is clear both from the committee reports accompanying the Tax Reform Act of 1969,ⁿ³⁵ the Regulations,ⁿ³⁶ and Service rulings.ⁿ³⁷

[v] Distributions of Cash in Lieu of Fractional Shares. Suppose that a corporation, in voting a stock dividend, declares that only full shares will be issued and that cash will be distributed in lieu of fractional shares to which

shareholders would otherwise be entitled. Does this fact taint the entire distribution and cause it to be subject to tax under *IRC Section 305(b)(2)*? The answer is no,

"provided the purpose of the distribution of cash is 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 and earnings and profits of the corporation."ⁿ³⁸

A distribution of cash is deemed to be for the designated valid purpose, if the amount of cash paid annually in lieu of fractional shares is 5 percent or less of the fair market value (determined as to the date of distribution) of the stock distributed during the year.ⁿ³⁹

[vi] Reorganizations Utilizing Contingent Shares. A reorganization transaction may call for the withholding of a quantity of shares of the acquiring corporation's stock pending the resolution of certain contingencies, eg, the determination of unliquidated but potentially substantial liabilities.ⁿ⁴⁰ Will the distribution of the additional shares to the former shareholders of the acquired corporation be subject to tax under *IRC Section 305(b)(2)* if made in conjunction with, or close in time to, a distribution of property to existing shareholders? The language of the statute seems sufficiently broad to cover the transaction. However, the Regulations provide that

"A transfer of stock (or rights to acquire stock) or an increase in the conversion ratio or redemption price of stock which represents an adjustment of the price to be paid by the distributing corporation in acquiring property is not within the purview of section 305 because it is not a distribution with respect to stock."ⁿ⁴¹

[b] Distributions of Common and Preferred. Under *IRC Section 305(b)(3)*, a distribution of stock is treated as a distribution to which *IRC Section 301* applies, and not as a nontaxable stock dividend, if it results in the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders. The provision is, in effect, an extension of the disproportionate distribution rule of *IRC Section 305(b)(2)*. Without it, a nontaxable increase in proportionate interest could be achieved by coupling the distribution of common stock with a distribution of preferred instead of cash or other property.

Application of *IRC Section 305(b)(3)* may be illustrated by the following:

Example 1:

X Corp. has both class A and class B common stock outstanding. Dividends on either class may be paid in stock or in cash and without regard to the medium of payment of dividends on the other class. A dividend is declared on class A stock payable in additional shares of that stock. At the same time, a dividend is declared on the class B common, but this dividend is payable in shares of a new issue of nonconvertible preferred stock. By reason of *IRC Section 305(b)(3)*, both distributions are removed from the protection of *IRC Section 305(a)* and made distributions to which *IRC Section 301* applies. It should be noted that the rule under discussion comes into play even though there is no affirmative showing of an increase in the proportionate interests of the holders of class A shares. Apparently such an increase is presumed from the nature of the transaction.ⁿ⁴²

Example 2:

Y Corp. has a single class of stock outstanding. During the year, it declares a dividend payable in shares of a newly authorized class of preferred that is convertible into common no later than six months from the date of distribution at a price only slightly higher than the market price of the common on the date of distribution. Taking into account the dividend rate, redemption provisions, the marketability of the convertible stock, and the conversion price, it is reasonable to assume that within a relatively short period of time some, but not all, of the shareholders will exercise the conversion privilege. This transaction is

viewed as the equivalent of the receipt of preferred stock by some common shareholders (those who do not exercise their conversion rights) and the receipt of common stock by other common shareholders (those who do), causing the distribution of the preferred to be treated as a taxable stock dividend.ⁿ⁴³

[c] Distributions on Preferred Stock.

[i] In General. A distribution of stock made with respect to preferred stock is rendered taxable by *IRC Section 305(b)(4)*. This subsection applies whether the distribution consists of common or preferred,ⁿ⁴⁴ whether it is actual or constructive,ⁿ⁴⁵ and whether it is disproportionate or not.ⁿ⁴⁶ However, the rule is inapplicable where the distribution is designed to increase the conversion ratio of convertible preferred stock, and is made solely to take account of a stock dividend, stock split, or similar eventⁿ⁴⁷ with respect to the stock into which the preferred may be converted.

The Regulations define the term "preferred stock" as stock, which in relation to other classes of stock outstanding, enjoys certain limited rights and privileges (e.g., dividend or liquidation priorities), but does not have a substantial participating interest in corporate growth.ⁿ⁴⁸ The Regulations continue that the distinguishing feature of preferred stock for purposes of *IRC Section 305(b)(4)* "is not its privileged position as such, but that such privileged position is limited and that such stock does not participate in corporate growth to any significant extent."ⁿ⁴⁹ However, the mere existence of a right to participate in future growth will not prevent stock that enjoys a priority as to dividends and liquidation from being treated as preferred stock if, taking into account all of the facts and circumstances,ⁿ⁵⁰ it is reasonable to anticipate that there is little likelihood of the stock actually participating in earnings and upon liquidation beyond its preferred interest.

[ii] Recapitalizations of Preferred. It will be remembered that prior to the 1969 amendments to *IRC Section 305*, a stock dividend was taxable if it was used to discharge preference dividends for the taxable year of the corporation in which the distribution was made or for the preceding taxable year. The cases reached by the old provision are now governed by *IRC Section 305(b)(4)*. But distributions in discharge of preference dividends that would have been nontaxable under prior law are now subject to tax, for they constitute distributions made with respect to preferred stock. Moreover, when *IRC Section 305(b)(4)* is coupled with *IRC Section 305(c)*, a recapitalization of preferred stock that includes the distribution of additional shares in discharge of accumulated dividends in arrears becomes partially taxable rather than wholly tax-exempt. On the other hand, if, as part of the recapitalization, the taxpayer gives up his right to dividend arrearages but receives nothing of identifiable value in return, the transaction will be treated as a nontaxable reorganization and not as a distribution subject to *IRC Section 305(b)(4)*. To illustrate:

Example 1:

Corporation X has outstanding 1,000 shares of 8 percent cumulative preferred stock with a par value of \$100 per share. 500 shares are owned by A and 500 shares by B. The corporation is 3 years in arrears on its dividends to the preferred shareholders. Pursuant to a recapitalization under *IRC Section 368(a)(1)(E)*, each share of preferred stock, including the right to dividend arrearages, is exchanged for 1.2 shares of new preferred stock which is worth, and has a liquidation value of, \$100 per share. The exchange has the effect of increasing the preferred shareholders' proportionate interest in the assets or earnings and profits of the corporation since the fair market value of the 1.2 shares of new preferred exceeds the issue price of the old. Accordingly, *IRC Section 305(b)(4)* and *IRC Section 305(c)* combine to produce a distribution of \$20 on each share of old preferred, which distribution will be governed by the provisions of *IRC Section 301*.ⁿ⁵¹

Example 2:

Corporation Y has 1,000 shares of nonvoting cumulative preferred stock and 10,000 shares of common stock outstanding. The issue price of the preferred is \$100 a share; the fair market value of the common is \$10 a share. The corporation is three years in arrears on its dividends to the preferred shareholders. Pursuant to a recapitalization under *IRC Section 368(a)(1)(E)*, the shareholders exchange their preferred stock, and their right to dividend arrearages, on the basis of one preferred share for ten shares of

common. The common continues to trade at \$10 a share following the transaction. Since the preferred shareholders receive \$100 in value of common stock for the preferred, they did not increase their proportionate interest in the assets or earnings and profits of the corporation. Therefore, the distribution is not one to which *IRC Section 305(b)(4)* applies.ⁿ⁵²

[iii] The Effect of an Excess Redemption Premium. Suppose a corporation issues preferred stock that does not pay dividends, but is redeemable after a stated period of time at a price in excess of the issue price. If the repurchase by the corporation is viewed solely as a redemption, the shareholder's gain will take on the character of capital gain.ⁿ⁵³ And, prior to 1969, this was the way the transaction was taxed even though the higher redemption price could be looked upon as a dividend substitute.

For stock issued after January 10, 1969 and before October 10, 1990,ⁿ⁵⁴ any increase in redemption price in excess of a reasonable call premium must be taxed as a constructive dividend received ratably over the period during which the preferred stock cannot be called for redemption.ⁿ⁵⁵ A redemption premium is considered to be reasonable if it is in the nature of a penalty for a premature redemption of the preferred stock and if such premium does not exceed the amount the corporation would be forced to pay to accomplish such premature redemption under market conditions existing at the time of issuance or if it is not in excess of 10 percent of the issue price on stock that is not redeemable for five years.ⁿ⁵⁶ For example:

Example 1:

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. The increase in the redemption price is not considered a distribution on preferred stock under *IRC Section 305(b)(4)*.ⁿ⁵⁷

Example 2:

Corporation W. issues preferred stock for \$100 per share. The stock pays no dividends but is redeemable in five years for \$185, with yearly increases thereafter of \$15. There are no facts to indicate that a call premium in excess of \$10 is reasonable. Since the increase in redemption price over the issue price exceeds the reasonable call premium to the extent of \$75, that amount will be deemed to be a substitute for the distribution of dividends on such stock. The shareholder is considered to receive on the last day of each year during the five-year period, a distribution on his preferred stock in an amount equal to 15 percent of the issue price. Each \$15 increase in the redemption price thereafter is considered to be a distribution on the preferred stock at the time each such increase becomes effective.ⁿ⁵⁸

Generally, for preferred stock issued after October 9, 1990, *IRC Section 305(c)* provides that regulations to be issued must provide that the economic accrual rule and the *de minimis* rule applicable to debt instruments issued with original issue discount will apply to preferred stock that is subject to mandatory redemption or a put at a premium regardless of whether the stock is callable.ⁿ⁵⁹ The original issue discount *de minimis* rule will normally not apply to preferred stock that is callable solely at the option of the issuer. Nonetheless, the economic accrual rule will apply to the entire call premium on the stock if the premium is considered to be unreasonable.

Regulations issued to implement *IRC Section 305(c)* focus primarily on stock callable at a premium at the option of the issuer. If stock is subject to an issuer call and, based on all the facts and circumstances as of the issue date, redemption pursuant to that right is more likely than not to occur, the redemption premium is treated as a constructive distribution of additional stock on preferred stock to be accounted for under the original issue discount rules of the Code.ⁿ⁶⁰ However, even if redemption is more likely than not to occur, the constructive distribution rule does not apply if the redemption premium is solely in the nature of a penalty for premature redemption.ⁿ⁶¹ In addition, constructive distribution treatment does not result if the redemption does not exceed a *de minimis* amount, as determined under the principles of *IRC Section 1273(a)(3)*.ⁿ⁶²

Redemption pursuant to an issuer's right is not treated as more likely than not to occur if:

- (1) the issuer and the holder are not related within the meaning of *IRC Section 267(b)* or *707(b)*, substituting the phrase '20 percent' for the phrase '50 percent' in those sections;
- (2) there are no arrangements that effectively require or are intended to compel the issuer to redeem the stock; and
- (3) exercise of the right to redeem would not reduce the yield of the stock as determined under principles similar to the original issue discount principles of *IRC Section 1272(a)* or the regulations under *IRC Sections 1271 through 1275*.ⁿ⁶³

Failure to meet the safe harbor described in the preceding sentence does not affect the determination of whether the right to redeem is more likely than not to occur.ⁿ⁶⁴

The constructive distribution rules apply to preferred stock if the issuer is required to redeem the stock at a specified time or the holder has the option (whether or not currently exercisable) to require the issuer to redeem the stock.ⁿ⁶⁵ However, the rules do not apply if the issuer's obligation to redeem or the holder's option to put the stock is subject to a contingency that is beyond the legal or practical approach of either the holder or holders as a group (or through a related party within the meaning of *IRC Section 267(b)* or *707(b)*), and that, based on all of the facts and circumstances as of the issue date, renders remote the likelihood of redemption. 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 which 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.

If the provisions of the stock permit redemption at more than one time, the time and price at which redemption is most likely to occur must be determined based on all of the facts and circumstances as of the issue date. Any constructive distribution will be construed to result only with respect to the time and price so identified. However, if redemption does not occur at that identified time, the amount of any additional premium payable on any later redemption date, to the extent not previously treated as distributed, is treated as a constructive distribution over the period from the missed call or put date to the later redemption date.ⁿ⁶⁶

The issuer's determination as to whether there is a constructive distribution is binding on all holders of the stock, other than a holder that explicitly discloses that its determination differs from that of the issuer. Unless otherwise prescribed by the Service, the disclosure must be made on a statement attached to the holder's timely filed federal income tax return for the taxable year in which the holder acquired the stock.ⁿ⁶⁷

The constructive distribution rules are not limited to the actual issuer of the preferred stock. If the stock may be acquired by a person other than the issuer, the term 'issuer' includes that third person if (1) the rules would apply to the stock were the third person the issuer, and (2) acquisition of the stock by the third person would be treated as a redemption for tax purposes (under *IRC Section 304* or otherwise).ⁿ⁶⁸ In addition, if the issuer and the third person are members of the same affiliated group, the term 'issuer' includes the third person if a principal purpose of the arrangement is the avoidance of the constructive distribution rules.ⁿ⁶⁹ Finally, the agreement or arrangement for a person other than the issuer to acquire the stock may create a conversion transaction for purposes of *IRC Section 1258*.ⁿ⁷⁰

[d] Distributions of Convertible Preferred Stock. Pursuant to *IRC Section 305(b)(5)*, a distribution of convertible preferred stock is made a distribution of property to which *IRC Section 301* applies, "unless it is established to the satisfaction of the Secretary or his delegate that such distribution will not have the result described in [*IRC Section*

305(b)(2)]." Since a distribution of convertible preferred paid on an outstanding issue of preferred will be taxed in all events under *IRC Section 305(b)(4)*, the instant provision is effective only when the distribution is with respect to common stock.

The Regulations indicate that a distribution of convertible preferred stock is likely to result in a disproportionate distribution when both of the following conditions exist: (1) The conversion right must be exercised within a relatively short period of time after the distribution (e.g., four months);ⁿ⁷¹ and (2) taking into account such factors as the dividend rate, the redemption provisions, the marketability of the convertible stock, and the conversion price, it may be anticipated that some of the shareholders will convert their preferred while others will not.ⁿ⁷² The Regulations go on to state that where the conversion right may be exercised over a period of many years (say, twenty years)ⁿ⁷³ and the dividend rate is consistent with market conditions at the time of distribution, there is no basis for predicting at what time and to what extent the stock will be converted, and, therefore, it is unlikely that a disproportionate distribution will result.ⁿ⁷⁴ Where the breaking point is between four months and twenty years, the result remains uncertain and must await regulations, rulings, or court decisions.

[2] Basis of Stock or Stock Rights Received in Nontaxable Distributions.

No basis problems are encountered when *IRC Section 305(b)* turns a stock dividend into a taxable distribution. Since such a distribution is treated as one to which *IRC Section 301* applies,ⁿ¹ the basis of the stock received will be its fair market value.

Once the stock dividend is sheltered from taxation by Section 305(a), the basis of the original shares must be allocated between the old and new shares in proportion to the fair market values of each.ⁿ² For example, if a distribution of stock worth \$5,000 is made with respect to stock having a value of \$20,000 and a basis of \$10,000, the old stock will assume a basis of \$8,000 (20/25ths of \$10,000) and the new, a basis of \$2,000 (5/25ths of \$10,000).

When the distribution is of rights to acquire stock rather than stock itself, allocation in the manner prescribed in the preceding paragraph is made only if the rights are sold or exercised.ⁿ³ Thus, the lapse of rights received in a nontaxable distribution does not produce a tax loss. In addition, no allocation of basis is required, unless the taxpayer so elects, when the value of the rights on the date of distribution is less than 15 percent of the value of the stock on that date.ⁿ⁴

[3] Holding Period of Stock or Stock Rights Received in a Nontaxable Distribution.

By virtue of *IRC Section 1223(5)*, the holding period of stock received in a distribution rendered immune from taxation by *IRC Section 305(a)* includes the period during which the taxpayer held the stock with respect to which the stock dividend was paid.ⁿ¹ In similar fashion, the seller of stock rights received in a nontaxable distribution is permitted to tack the holding period of the stock to that of the rights, even when the basis of the rights is fixed at zero by Section 307(b)(1).ⁿ² However, exercise of the rights removes the ability to tack; the holding period of the acquired stock begins with the date of exercise.ⁿ³

FOOTNOTES:

(n1)Footnote 1. *IRC § 305(a)*. For purposes of *IRC § 305*, stock rights are treated as stock. *IRC § 305(d)*.

Payment of cash in lieu of fractional shares produce gain or loss, rather than ordinary income. This result is reached by treating the transaction as a distribution of the shares to the shareholders followed by a repurchase by the corporation. *Treas Reg § 1.305-3(c)*; *Rev Rul 66-365, 1966-2 CB 116* ; *Rev Rul 69-34 1969-1 CB 117* ; *Rev Rul 74-36, 1974-1 CB 85* .

The issuance of stock as part of a reorganization cannot be viewed as a distribution with respect to the stock of the distributing corporation, and is not governed by *IRC § 305*. *Rev Rul 82-158, 1982-2 CB 77* .

In 1934, the Service took the position that the receipt of rights to subscribe to bonds of the issuing corporation that are convertible into its stock did not result in income. *GCM 13414*, XIII-2 CB 124 (1934); *GCM 13275* XIII-2 CB 121 (1934). A 1956 letter ruling indicates that this will be the result if substantially all of the value of the rights is attributable to the conversion privilege. *Letter Ruling, June 27, 1956, P-H 1956 Fed Taxes P 76, 680*.

(n2)Footnote 2. *IRC § 305(b)(1)*, prior to amendment by the Tax Reform Act of 1969.

(n3)Footnote 3. *IRC § 305(b)(2)*. The election by any one shareholder made the dividend taxable for all.

(n4)Footnote 4. *Treas Reg § 1.305-2(b)(1)* amending *Treas Reg § 1.305-2(b)*, *TD 6990, 1969-1 CB 95*.

(n5)Footnote 5. *Treas Reg § 1.305-2(b)(2)*, Ex (3). If the cash dividend were paid to the holders of the Class A convertible shares, and, by reason of such payment, the conversion ratio reduced, the Class B shareholders would be the recipients of a taxable dividend. *Treas Reg § 1.305-2(b)(2)*, Ex (4).

(n6)Footnote 6. See generally, Andrews & Wilson, "Stock Dividend Taxation Under the Tax Reform Act of 1969: Expansion of an Ominous Past," *13 Ariz L Rev 751 (1971)*; Bashian, "Stock Dividends and Section 305: Regulation and the Constitution," *1971 Duke L J 1105 (1971)*; Del Cotto & Wolf, "The Proportionate Interest Test of Section 305 and the Supreme Court," *27 Tax L Rev 49 (1971)*; Lee, "Tax Reform Act Shareholder Changes: Stock Dividends," *1971 So Calif Tax Inst 191*; Metzger, "The 'New' Section 305," *27 Tax L Rev 93 (1971)*; Tierney, "Proposed Regs Under Section 305 Amplify Treasury's Tough Posture on Stock Dividends," *35 J Tax'n 86 (1971)*; Youngwood, "New Rules Governing Stock Dividends and Stock Redemptions," *29 NYU Inst on Fed Tax 277 (1971)*.

(n7)Footnote 7. *IRC § 305(b)(1)*; *Rev Rul 79-42, 1979-1 CB 130*. Dividend reinvestment plans which provide only for the transfer of cash to a bank which purchases additional shares for electing shareholders are governed directly by *IRC § 301*, since the dividends are payable only in cash. *Rev Rul 77-149, 1977-1 CB 83*. Stock dividends immediately redeemable for cash at the option of the shareholder are taxable elective dividends under *IRC § 305(b)(1)*. *Rev Rul 76-258, 1976-2 CB 95*.

It will be difficult to argue that distributions of stock in connection with a dividend reinvestment plan are not taxable distributions. See *Birmingham v Commr, TC Memo 1994-69*, for a case in which a taxpayer tried to avoid taxation by claiming, unsuccessfully, that as long as distributions are in the form of shares, they remain a paper gain only, and no income should result until the stock is sold.

In *Rev Rul 83-68, 1983-1 CB 75*, the distribution of a stock dividend by the Federal Home Loan Bank to its member banks was treated as a distribution under *IRC § 301* because at least one of the member banks had the option to have all of the shares received as a stock dividend redeemed. However in *Frontier Savings Assn v Commr, 87 TC 665 (1986)*, *aff'd sub nom Colonial Savings Assn v Commr, 854 F2d 1001 (7th Cir 1988)*, *cert denied, 109 S Ct 1556*, *acq, 1990-1 CB 1*, the dividend was not taxable even though the practice was to redeem shares owned by member banks upon request; there was always discretion to refuse to redeem the shares. The Eighth Circuit reached the same result in *Western Savings & Loan Assn v Commr, 880 F2d 1005 (8th Cir 1989)*.

According to *Rev Rul 90-98, 1990-2 CB 56*, *Rev Rul 83-68* no longer represents the Service's position regarding whether a member bank receiving a stock dividend from an Federal Home Loan Bank has an election to receive stock or property within the meaning of *IRC § 305(b)(1)*. However, except in the case of a Federal Home Loan Bank acting pursuant to a federal statutory directive and in protection of the public interest, the Service will continue to apply the principles underlying *Rev Rul 83-68* and *IRC § 305(b)(1)* to a pattern of granting redemption requests in determining whether in substance the pattern confers an election to receive stock or property.

(n8)Footnote 8. *Rev Rul 79-42, 1979-1 CB 130*.

(n9)Footnote 9. *Treas Reg* § 1.305-2(a).

(n10)Footnote 10. *IRC* § 305(b)(2).

(n11)Footnote 11. *IRC* § 305(b)(3).

(n12)Footnote 12. *IRC* § 305(b)(4).

(n13)Footnote 13. *IRC* § 305(b)(5).

(n14)Footnote 14. S Rep No 91-552, 91st Cong, 1st Sess 152 (1969); *Treas Reg* § 1.305-3(e), Ex (2).

(n15)Footnote 15. *IRC* § 305(d)(2); *Treas Reg* § 1.305-3(b)(5); *Rev Rul* 75-513, 1972-2 CB 114 .

(n16)Footnote 16. S Rep No 91-552, 91st Cong, 1st Sess (1969); *Treas Reg* § 1.305-3(b)(3).

(n17)Footnote 17. *Treas Reg* § 1.305-3(b)(2).

(n18)Footnote 18. *Treas Reg* § 1.305-3(b)(3).

(n19)Footnote 19. *Treas Reg* § 1.305-3(b)(3).

(n20)Footnote 20. *Treas Reg* § 1.305-3(b)(4).

(n21)Footnote 21. The Regulations provide that a transfer of stock or an increase or decrease in the conversion ratio or redemption price of stock which represents an adjustment of the price to be paid by a corporation in acquiring property is not within the purview of *IRC* § 305 because not a distribution of stock by a corporation with respect to its stock. *Treas Reg* § 1.305-1(c).

See *Rev Rul* 86-25, 1986-1 CB 202 , and *Rev Rul* 75-93, 1975-1 CB 101 , for examples of recapitalizations treated as isolated transactions and not as part of a plan to increase periodically a shareholder's proportionate interest in the corporation.

(n22)Footnote 22. *Treas Reg* § 1.305-3(d)(1)(i). A spin-off under *IRC* § 355 diluted the fixed rate conversion value of preferred shares of the distributing corporation. A change in the conversion ratio to protect the rights of the preferred shareholders was held not to be a deemed distribution under *IRC* § 305(c) in *Rev Rul* 77-37, 1977-1 CB 85 .

(n23)Footnote 23. *Id*; *Treas Reg* § 1.305-3(d)(1)(ii).

(n24)Footnote 24. *Treas Reg* § 1.305-3(d)(2)(ii).

(n25)Footnote 25. *Treas Reg* § 1.305(d)(4)(iii).

(n26)Footnote 26. *Treas Reg* § 1.305(d)(4)(iii).

(n27)Footnote 27. See § 4.06[1][c][iii].

(n28)Footnote 28. *Treas Reg* § 1.305-3(e), Ex (15).

(n29)Footnote 29. *Treas Reg* § 1.305-3(e), Ex (6).

(n30)Footnote 30. *Treas Reg* § 1.305-3(e), Ex (7).

(n31)Footnote 31. *IRC* § 305(c). A corporation, with 24 shareholders and 6,000 shares outstanding, adopted a plan

whereby it would redeem a total of 40 shares annually. As a result of the redemptions, certain shareholders experienced an increase in their proportionate interests in the corporation and were in receipt of taxable stock dividends. *Rev Rul 78-60, 1978-1 CB 82*.

Hime, "The Application of Sections 305(b) and 305(c) to Redemptions, Recapitalizations and Acquisitions," 48 *Tax Lawyer* 375 (1995).

(n32)Footnote 32. *Treas Reg* § 1.305-3(e), Ex (8).

(n33)Footnote 33. *Treas Reg* § 1.305-3(e), Ex (8).

(n34)Footnote 34. *Treas Reg* § 1.305-3(e), Ex (9).

(n35)Footnote 35. S Rep No 91-552, 91st Cong, 1st Sess 153 (1969).

(n36)Footnote 36. *Treas Reg* § 1.305-3(e), Examples (10) and (11). See also *Ltr Rul 200025046*.

(n37)Footnote 37. See, eg, *Rev Rul 78-115, 1978-1 CB 85*, and *Rev Rul 77-19, 1977-1 CB 84*.

(n38)Footnote 38. *Treas Reg* § 1.305-3(c)(1).

(n39)Footnote 39. *Treas Reg* § 1.305-3(c)(1).

(n40)Footnote 40. See § 8.03[1][b][ii] *infra*.

(n41)Footnote 41. *Treas Reg* § 1.305-1(c).

(n42)Footnote 42. *Treas Reg* § 1.305-4(b), Ex (1).

(n43)Footnote 43. *Treas Reg* § 1.305-4(b), Ex (2).

(n44)Footnote 44. *Treas Reg* § 1.305-5(d), Ex (1). Holders of cumulative preferred stock, on which dividends were in arrears, were given the option to receive an amount of common stock equal to, and in cancellation of, the credit balances in their accrued dividend accounts. The distribution of the common stock came within the purview of *IRC* § 305(b)(4). *Rev Rul 84-141, 1984-2 CB 80*.

(n45)Footnote 45. *Treas Reg* § 1.305-5(a).

(n46)Footnote 46. It has been argued that *IRC* § 305(b)(4) is meant to apply only when the distribution is disproportionate. Del Cotto & Wolf, "The Proportionate Interest Test of Section 305 and the Supreme Court," 27 *Tax L Rev* 49, 67-68 (1971).

(n47)Footnote 47. A distribution made to take into account the sale of stock at less than fair market value pursuant to a rights offering would be a "similar event." An adjustment made solely to take into account the distribution by a closed-end regulated investment company of a capital gain dividend with respect to the stock into which the preferred stock is convertible would not be. *Treas Reg* § 1.305-5(a).

(n48)Footnote 48. *Treas Reg* § 1.305-5(a). There is an express inclusion of "non-participating stock the terms of which require, in all events, periodic distributions with respect to it of stock or rights to acquire stock, provided the corporation has another class of stock outstanding." There is an express exclusion of convertible debentures.

(n49)Footnote 49. *Treas Reg* § 1.305-5(a); *Treas Reg* § 1.305-5(d), Examples (8) and (9).

(n50)Footnote 50. "Among the facts and circumstances to be considered are the prior and anticipated earnings per

share, the cash dividends per share, the book value per share, the extent of preference and of participation of each class, both absolutely and relative to each other, and any other facts which indicate whether or not the stock has a real and meaningful probability of actually participating in the earnings and growth of the corporation." *Treas Reg § 1.305-5(a)*; *Treas Reg § 1.305-5(d)*, Ex (8).

(n51)Footnote 51. *Treas Reg § 1.305-5(d)*, Ex (1). The amount of the distribution resulting from the recapitalization is the lesser of (a) the amount by which the fair market value or the liquidation preference, whichever is greater, of the stock received, exceeds the issue price of the stock surrendered, or (b) the amount of dividends in arrears. *Treas Reg § 1.305-7(c)(2)*. If there had not been any dividends in arrears, the distribution would have been nontaxable unless made pursuant to a plan to periodically increase the shareholders' proportionate interest in the corporation. *Treas Reg § 1.305-7(c)(1)*.

The preferred stock received in the recapitalization will continue to be treated as Section 306 stock even though the portion attributable to dividends in arrears is includable in gross income under *IRC § 305(b)(4)*: See Fetzer, "The 'New' Section 305," 27 *Tax L Rev* 93, 136 (1971). A discussion of *IRC § 306* can be found in Ch 7 *infra* .

(n52)Footnote 52. *Treas Reg § 1.305-7(c)(1)(ii)*.

(n53)Footnote 53. This assumes that the redemption meets the provisions of *IRC § 302(b)*. See § 5.02[2] *infra*.

(n54)Footnote 54. Transitional rules contained in the Tax Reform Act of 1969 and in the Omnibus Budget Reconciliation Act of 1990 can affect both dates.

(n55)Footnote 55. *Treas Reg § 1.305-5(b)(1)*.

(n56)Footnote 56. *Treas Reg § 1.305-5(b)(2)*.

In Rev Rul 75-179, 1975-1 *CB* 103 , shareholders of an acquired corporation in a statutory merger received for each share of their common stock an equal share of the acquiring corporation's new convertible preferred stock. Both the old and new stock were worth \$6 a share on the date of exchange. The new stock was (1) convertible into .55 shares of the acquiring corporation's common stock, (2) not callable by the corporation for a period of five years from the date of issuance, and (3) callable anytime thereafter, provided the common stock into which the preferred stock was convertible had a fair market value at least 25 percent greater than the call price on the date of the call. The redemption price at the end of the five year period was initially \$11 a share and thereafter declined at the rate of 10 cents a year to \$10.50 a share. Even though the redemption premium exceeded the 10 percent "safe harbor," the facts and circumstances led the Service to conclude that it would be to a shareholder's economic benefit to convert the preferred stock into common stock rather than to have the preferred stock called for redemption. (For example, the preferred stock could not be called for redemption at \$11 a share unless the value of the .55 shares of common stock into which each preferred share could be converted was 25 percent greater than \$11, or approximately \$13.75 a share.) Thus, the redemption premium was reasonable.

(n57)Footnote 57. *Treas Reg § 1.305-5(d)*, Ex (4).

(n58)Footnote 58. *Treas Reg § 1.305-5(d)*, Ex (5), (7).

(n59)Footnote 59. The original issue discount rules are discussed in § 17.02A.

(n60)Footnote 60. *Treas Reg § 1.305-5(b)(1)*, (3).

(n61)Footnote 61. *Treas Reg § 1.305-5(b)(3)(i)*.

(n62)Footnote 62. *Treas Reg § 1.305-5(b)(1)*. See Ch 17 for a discussion of the determination of a *de minimis*

amount under *IRC § 1273(a)(3)*.

(n63)Footnote 63. *Treas Reg § 1.305-5(b)(3)(ii)*.

(n64)Footnote 64. *Treas Reg § 1.305-5(b)(3)(iii)*.

(n65)Footnote 65. *Treas Reg § 1.305-5(b)(2)*.

(n66)Footnote 66. *Treas Reg § 1.305-5(b)(4)*.

(n67)Footnote 67. *Treas Reg § 1.305-5(b)(5)*.

(n68)Footnote 68. *Treas Reg § 1.305-5(b)(1)*.

(n69)Footnote 69. *Treas Reg § 1.305-5(b)(1)*.

(n70)Footnote 70. Conversion transactions are discussed in Ch 2.

(n71)Footnote 71. *Treas Reg § 1.305-6(b)*, Ex (2); S Rep No 91-552, 91st Cong, 1st Sess 152 (1969).

(n72)Footnote 72. *Treas Reg § 1.305-6(a)(2)*.

(n73)Footnote 73. *Treas Reg § 1.305-6(b)*, Ex (1); S Rep No 91-552, 91st Cong, 1st Sess 152 (1969).

(n74)Footnote 74. *Treas Reg § 1.305-6(a)(2)*.

The Service believes that a distribution of stock rights must be included in income whenever a distribution of the stock would be taxable. See *Rev Rul 80-292, 1980-2 CB 104*, and *Rev Rul 70-521, 1970-2 CB 72*.

(n75)Footnote 1. *IRC § 305(b)*.

(n76)Footnote 2. *IRC § 307(a)*; *Treas Reg § 1.307-1(a)*. Where the taxpayer owns several blocks of stock acquired at different times and prices, the basis of stock received in a nontaxable dividend is computed by allocating to each particular lot of purchased stock the amount of dividend stock attributable thereto. *Rev Rul 71-350, 1971-2 CB 176*.

(n77)Footnote 3. *Treas Reg § 1.307-1(a)*.

(n78)Footnote 4. *IRC § 307(b)*.

(n79)Footnote 1. The holding period is not tacked if the stock dividend is rendered taxable by *IRC § 305(b)(1)*, the optional dividend rule. *Rev Rul 76-53, 1976-1 CB 57*.

(n80)Footnote 2. *IRC § 1223(5)* allows tacking "if the basis of [the] stock or rights is determined under section 307"

(n81)Footnote 3. *IRC § 1223(6)*.



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CHAPTER 4 Dividend Distributions

1-4 Taxation of Securities Transactions § 4.07

§ 4.07 Stripped Preferred Stock

Stripped preferred stock purchased after April 30, 1993 is now treated in the same manner as a stripped bond.ⁿ¹ Under *IRC Section 305(e)(1)*, the purchaser of stripped preferred stock must include in gross income, during the period of time the stock is held, the same amount that would be includable if the stripped preferred stock were a bond issued on the purchase date having original issue discount equal to the excess of the redemption price of the stock over the purchase price.ⁿ² The amount included in income is treated as ordinary income.ⁿ³ A person who strips dividend rights from preferred stock, and, after April 30, 1993 disposes of the dividend rights, is treated as a purchaser of the stripped preferred stock on the date of disposition for a price equal to the person's adjusted basis in the stock.ⁿ⁴

Stripped preferred stock is stock (1) that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (2) that has a fixed redemption price, and (3) with respect to which there has been a separation in ownership between such stock and any dividend on the stock that has not become payable.ⁿ⁵

FOOTNOTES:

(n1)Footnote 1. See Ch 17. Congress intends no inference regarding the treatment of stripped preferred stock for tax purposes with respect to issues not directly addressed by *IRC § 305(e)*, including the availability of the dividends received deduction to a holder of dividends stripped from the stock, the allocation of basis by the creator of the stock, or the proper characterization of a purported sale of stripped dividend rights. HR Rep No 213, 103d Cong, 2d Sess 82 (1993).

(n2)Footnote 2. Appropriate adjustments to basis are made for amounts includable in income under *IRC § 305(e)(1)*. *IRC § 305(e)(2)*.

(n3)Footnote 3. *IRC § 305(e)(4)*.

(n4)Footnote 4. *IRC § 305(e)(3)*.

(n5)Footnote 5. *IRC § 305(e)(5)*.



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CHAPTER 4 Dividend Distributions

1-4 Taxation of Securities Transactions § 4.08

§ 4.08 Effect on the Distributing Corporation

[1] Gain or Loss Resulting From the Distribution.

[a] General Rule. As a general rule, a corporation does not recognize gain or loss upon a distribution in respect of its stock of either (1) its stock, or rights to acquire such stock, or (2) property.ⁿ¹

[b] The Statutory Exceptions. The general nonrecognition rule is severely limited by *IRC Section 311(b)(1)*, which provides for the recognition of *gain* whenever the distributing corporation distributes appreciated property, other than an obligation of the distributing corporation.ⁿ² The amount of gain is determined by assuming that the property was sold to the distributee at fair market value.ⁿ³ For this purpose, if any of the distributed property is subject to a liability or the shareholder assumes a liability of the distributing corporation, the fair market value of the property is treated as not less than the amount of such liability.ⁿ⁴

If the property distributed consists of an interest in a partnership or trust, regulations to be promulgated may provide that the amount of recognized gain is to be computed without regard to any loss attributable to property contributed to the partnership or trust for the principal purpose of recognizing the loss on the distribution.ⁿ⁵

IRC Section 897(d)(1) requires gain to be recognized whenever a foreign corporation distributes a United States real property interest, unless the basis of the distributed property in the hands of the distributee is the same as the adjusted basis of the property before the distribution increased by the amount of any gain recognized by the distributing corporation. The amount of gain to be recognized is the excess of the fair market value of the distributed interest as of the time of distribution over its adjusted basis.

[2] Effect on Earnings and Profits.

[a] General Rule. The distribution of property by a corporation with respect to its stock requires a decrease in the earnings and profits of the corporation to the extent of (1) the amount of money, (2) the principal amount of the obligations of the distributing corporation, and (3) the adjusted basis of other property, so distributed.ⁿ¹ For example, if the corporation distributes property of a value of \$10,000, but with a basis in the hands of the corporation of \$5,000, the corporation will reduce earnings and profits by \$5,000. If the property is worth only \$4,000, the corporation still reduces its earnings and profits by \$5,000. The fact that an individual shareholder would have a dividend of \$10,000 in one case, and \$4,000 in the other, is of no moment.

The time when earnings and profits are decreased is an important consideration when planning the amount and nature of any distributions. To illustrate:

Example:

If a corporation which has accumulated earnings and profits of \$15,000, and no current earnings and profits, makes a cash distribution of \$10,000 and a distribution of property having a value of \$10,000 and a basis of \$5,000, the extent of dividend income will rest on the order of distribution. If the cash is distributed first, an individual shareholder need report only \$15,000 as dividend income. This result is produced by allocating \$10,000 of earnings and profits to the first distribution and the remaining \$5,000 to the second.ⁿ² The earnings and profits available at the time of the first distribution are decreased by \$10,000, the amount of money distributed. However, if the property is distributed first, the shareholder must report dividend income of \$20,000. Here the decrease in earnings and profits resulting from the first distribution is only \$5,000, the basis of the property, leaving \$10,000 in earnings and profits to cover the distribution of cash. If, instead of accumulated earnings and profits, the corporation has current earnings and profits of \$15,000, and if both distributions are made within the current year, the amount of dividend income will be \$15,000, no matter what the order of distribution; current earnings and profits are never reduced by distributions made during the taxable year.ⁿ³ If only one distribution was made in the current year, the nature of the distribution would be important in determining the amount to be carried to the following year as accumulated earnings and profits.

[b] Exceptions to the General Rule.

[i] Distributions of Appreciated Property. A distribution of appreciated property with a fair market value in excess of adjusted basis requires that earnings and profits first be increased by the amount of the excess of fair market value over basis, and then decreased by an amount equal to the fair market value of the distributed property.ⁿ⁴ For this purpose, the adjusted basis of property is its adjusted basis for purposes of computing earnings and profits.

[ii] Distributions of Property Subject to Liabilities. *IRC Section 312(c)* mandates "proper adjustment" to earnings and profits when property is distributed subject to a liability in connection with the distribution. The Regulations make clear what is meant by the term "proper adjustment." In essence, it consists of a reduction in the amount by which earnings and profits are ordinarily decreased, namely, the adjusted basis of the distributed property, by the amount of the liability.ⁿ⁵ Thus, if the corporation has earnings and profits of \$5,000 at a time when it distributes property with a value of \$5,000 and a basis of \$2,000, and subject to a mortgage of \$1,000, the proper adjustment to earnings and profits is a reduction of \$1,000 (\$2,000, the basis of the distributed property, less \$1,000, the amount of the mortgage).

[iii] Distributions of Stock Dividends and Stock Rights. A distribution of stock or stock rights that is sheltered from taxation by *IRC Section 305(a)* is not considered a distribution of earnings and profits, and so, no adjustment is made by reason of any such distribution.ⁿ⁶ On the other hand, if the distribution is rendered taxable by *IRC Section 305(b)*, earnings and profits are reduced by the fair market value of the portion of the distribution includable in income.ⁿ⁷

FOOTNOTES:

(n1)Footnote 1. *IRC § 311(a)*.

(n2)Footnote 2. In *Pope & Talbot, Inc v Commr*, 104 TC 574 (1995), *aff'd*, 162 F3d 1236 (9th Cir 1999), a corporation transferred all of its properties in one state to a partnership and then distributed partnership units to its shareholders. At issue was the proper way to measure the gain realized on the distribution. The taxpayer contended that gain was to be determined by reference to the value of the partnership units received by its shareholders; the Service took the position that the gain should be computed as if the corporation had sold its entire interest in the properties at

their fair market value on the date of distribution. The Tax Court upheld the Service's determination. Of interest is the fact that the distribution occurred in 1985 when the applicable provision read that the distributing corporation had to recognize gain "as if the property distributed had been sold at the time of distribution." *IRC § 311(b)(1)* now provides that gain must be recognized "as if [the] property were sold to the distributee at its fair market value." Query, whether the result would be different had the transfer and distribution taken place after the effective date of the 1986 legislation?

(n3)Footnote 3. In *South Tulsa Pathology Laboratory, Inc v Commr*, 118 TC 84 (2002) , a spinoff followed by an immediate sale of the distributed stock failed to qualify for nonrecognition treatment under *IRC § 355*, resulting in a dividend for the distributee shareholders. The court held that the best measure of fair market value was the price at which the distributed shares were sold.

(n4)Footnote 4. *IRC §§ 311(b)(2), 336(b)*.

(n5)Footnote 5. *IRC § 311(b)(3)*.

(n6)Footnote 1. *IRC § 312(a)*. If the distributed obligations have original issue discount, earnings and profits are decreased by the aggregate issue price of the obligations.

For this purpose, the adjusted basis of any property is its adjusted basis for purposes of computing earnings and profits. *IRC § 312(b)*.

(n7)Footnote 2. Accumulated earnings and profits are applied to distributions in chronological order, rather than ratably. *Treas Reg § 1.316-2(b)*.

(n8)Footnote 3. *IRC § 316(a)(2)*.

(n9)Footnote 4. *IRC § 312(b)(1)*. In no event can earnings and profits be decreased below zero.

(n10)Footnote 5. *Treas Reg 1.312-3; Treas Reg § 1.312-4, Examples (1) and (2)*.

(n11)Footnote 6. *IRC § 312(d); Treas Reg § 1.312-1(d)*.

(n12)Footnote 7. *Treas Reg § 1.312-1(d)*.



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CHAPTER 4A Fast-Pay Arrangements

1-4A Taxation of Securities Transactions 4A.syn

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§ 4A.02 Fast-Pay Arrangement, Fast-Pay Stock and Benefited Stock Defined

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CHAPTER 4A Fast-Pay Arrangements

1-4A Taxation of Securities Transactions § 4A.01

§ 4A.01 Introduction

IRC Section 7701(l) gives the Internal Revenue Service the ability to prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of such parties where it is determined that the recharacterization is appropriate to prevent avoidance. Final regulations relating to fast-pay arrangements were issued in January 2000, effective for tax years ending after February 26, 1997.



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CHAPTER 4A Fast-Pay Arrangements

1-4A Taxation of Securities Transactions § 4A.02

§ 4A.02 Fast-Pay Arrangement, Fast-Pay Stock and Benefited Stock Defined

A fast-pay arrangement is any arrangement in which a corporation has fast-pay stock outstanding.ⁿ¹ Stock is fast-pay stock if it is structured so that dividends (as defined in *IRC Section 316*) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment, as opposed to only a return on the holder's investment.ⁿ² Unless clearly demonstrated otherwise, stock is presumed to be fast-pay stock if (1) it is structured to have a dividend rate that is reasonably expected to decline, as opposed to a dividend rate that is reasonably expected to fluctuate or remain constant, or (2) it is issued for an amount that exceeds (by more than a *de minimis* amount, as determined under the principles of *Regulations Section 1.1273-1(d)*)ⁿ³ the amount at which the holder can be compelled to dispose of the stock.

Generally, whether stock is fast-pay stock is determined based on all of the facts and circumstances, including any related agreements, such as options or forward contracts.ⁿ⁴ A related agreement includes any direct or indirect, oral or written, agreement between the holder of the stock, or between the holder of the stock and one or more other shareholders in the corporation. The determination that stock is fast-pay stock is made when the stock is issued, or for stock that is not originally fast-pay stock, whenever there is a significant modification in the terms of the stock or related agreements or a significant change in the relevant facts and circumstances. Stock is not fast pay stock solely because a redemption is treated as a dividend under *IRC Section 302(d)*,ⁿ⁵ unless there is a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement.

Benefited stock is defined by reference to fast-pay stock. With respect to any fast-pay stock, all other stock in the corporation (including any other fast-pay stock having significantly different characteristics) is benefited stock.ⁿ⁶

Example 1:

X Corp. issues 1,000 shares of *A* stock and 1,000 shares of *B* stock for \$100 a share. By its terms, a share of *B* stock is reasonably expected to pay a dividend of \$9 a share in the first ten years that it is outstanding and a \$2 dividend thereafter. If *X Corp.* liquidates, the holder of a share of *B* stock is entitled to a preference equal to the share's issue price. Otherwise, the *B* stock cannot be redeemed at either the corporation's or the shareholder's option.

When issued, the *B* stock has a dividend rate that is reasonably expected to decline from an annual rate of 9 percent of its issue price to an annual rate of 2 percent. Because of this structured declining

dividend rate, the *B* stock is fast-pay stock, while the *A* stock is benefited stock.

Example 2:

Assume the same facts as in Example 1, except that a share of *X* Corp. is reasonably expected to pay a \$9 annual dividend with respect to the *B* stock as long as it is outstanding, and *X* Corp. has the right to redeem the *B* stock for \$50 at the end of 10 years. The *B* stock is structured so that the \$100 issue price of the *B* stock exceeds by more than a *de minimis* amount the \$50 price at which the shareholder can be compelled to dispose of the stock. This makes the *B* stock fast-pay stock and the *A* stock benefited stock.

Example 3:

A Corp. issues 500 shares of common stock for \$100 a share. Under its charter, *A* Corp. can issue warrants entitling the holder to acquire the stock at a price of \$200 a share until such time as *A* Corp. adopts a plan of liquidation. Under the charter, *A* Corp. can adopt a plan of liquidation if it is approved by 80 percent of its shareholders. The stock is purchased at original issue equally by *P* Corp. and *C* Corp., a tax-exempt entity. At the time of purchase, the two shareholders agree that, annually for a period of 10 years, *A* Corp. will redeem (and *C* Corp. will tender) 20 shares of stock in exchange for \$250 a share and 20 warrants. It is anticipated that, under *IRC Sections 302 and 301*, the annual payment to *C* Corp. will be treated as a dividend.

Considering all of the facts and circumstances, including the agreement between *P* Corp. and *C* Corp., *A* Corp.'s redemption of *C* Corp.'s stock is undertaken with a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement. This causes the stock owned by *C* Corp. to be fast-pay stock and the stock owned by *P* Corp. to be benefited stock.

FOOTNOTES:

(n1)Footnote 1. A fast-pay arrangement is any arrangement in which a corporation has fast-pay stock outstanding for any part of its taxable year. *Treas Reg § 1.7701(l)-3(b)(1)*.

(n2)Footnote 2. *Treas Reg § 1.7701(l)-3(b)(2)(i)*.

(n3)Footnote 3. See § 17.02A[1].

(n4)Footnote 4. *Treas Reg § 1.7701(l)-3(b)(2)(ii)*.

(n5)Footnote 5. Redemptions are discussed in Ch 5.

(n6)Footnote 6. *Treas Reg § 1.7701(l)-3(b)(3)*.



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CHAPTER 4A Fast-Pay Arrangements

1-4A Taxation of Securities Transactions § 4A.03

§ 4A.03 Recharacterization of Fast-Pay Arrangements

If the corporation that has a fast-arrangement is either a regulated investment company (RIC) or a real estate investment trust (REIT), the fast-pay arrangement is automatically recharacterized.ⁿ¹ If the corporation is neither a RIC nor a REIT, the Commissioner can exercise discretion to recharacterize the fast-pay arrangement if it is determined that a principal purpose for the structure of the fast-pay arrangement is tax avoidance; the determination applies to all parties to the fast-pay arrangement, including transferees.ⁿ²

A fast-pay arrangement that is recharacterized is treated as an arrangement directly between the benefited shareholders and the fast-pay shareholders.ⁿ³ The resulting relationships are as follows:

- (1) The relationship between the benefited shareholders and the fast-pay shareholders is deemed to be one in which the benefited shareholders issue financial instruments (the financing instruments) directly to the fast-pay shareholders in exchange for cash equal to the fair market value of the fast-pay stock at the time of issuance (taking into account any related agreements).ⁿ⁴ The financing instruments have the same terms as the fast-pay stock. Therefore, the timing and amount of payments made with respect to the financing instruments always match the timing and amount of distributions made with respect to the fast-pay stock.
- (2) The benefited shareholders are deemed to contribute to the corporation the cash they receive for issuing the financing arrangements.ⁿ⁵ Distributions made with respect to the fast-pay stock are distributions made by the corporation with respect to the benefited stock.
- (3) The corporation is the paying agent for the benefited shareholders with respect to the financing instruments, but has no other relationship to the fast-pay shareholders.ⁿ⁶

Example 4:

Assume the same facts as in Example 1, except that (i) the issuer of the stock is a REIT, (ii) during the first ten years of the REIT's existence, persons holding a majority of the *B* shares must consent before the REIT can take any action that would result in the REIT liquidating or dissolving, merging or consolidating, losing its REIT status, or selling substantially all of its assets, and (iii) after the ten-year period, the REIT can take the specified actions without consent of the *B* shareholders if the shareholders

receive \$40 for their *B* stock.

The arrangement is a fast-pay arrangement because of the reasonably expected decline in dividend rate and the provision that the \$100 issue price of the *B* shares exceeds the \$40 price at which the shareholders can be compelled to dispose of the stock. Because the issuer is a REIT, the arrangement is recharacterized automatically as follows:

- (1) The *A* stock shareholders are treated as issuing financing instruments to the *B* stock shareholders in exchange for \$100,000 (\$100, the fair market value of each *B* share, multiplied by 1,000, the number of shares).
- (2) The *A* stock shareholders are treated as contributing \$200,000 to the REIT (the sum of the \$100,000 received for the financing instruments, and the \$100,000 actually paid for the *A* stock) in exchange for the *A* stock.
- (3) Each distribution with respect to the *B* stock is treated as a distribution with respect to the *A* stock.
- (4) The *A* stock shareholders are treated as making payments with respect to the financing instruments, with the REIT being treated as the paying agent of the financing instruments for the *A* stock shareholders.

Example 5:

Assume the same facts as in Example 3. Because *A Corp.* is neither a RIC nor a REIT, there is no automatic recharacterization. Instead, the fast-pay arrangement will be recharacterized only if the Commissioner determines that tax avoidance is a principal purpose for the structure of the fast-pay arrangement.

The regulations contain a special basis adjustment rule to ensure that unrealized gain on benefited stock is not inappropriately eliminated. Because the regulations do not apply to taxable years ending before February 27, 1997 (pre-effective years), a benefited shareholder will have economic income, but not taxable income, attributable to pre-effective years if the form of a fast-pay arrangement is respected for those years. The economic income is reflected as unrealized gain in the benefited stock. Thus, if a recharacterized fast-pay arrangement involved amounts accrued or paid in pre-effective years, a benefited shareholder must decrease its basis in any benefited stock by the amount that (i) its income attributable to the benefited stock (reduced by deductions attributable to the financing instruments) for pre-effective years, computed by recharacterizing the fast-pay arrangement and by treating the financing arrangements as debt, exceeds (ii) its income attributable to such stock for pre-effective years, computed without application of the recharacterization rules.ⁿ⁷

Example 6:

In June 1996, *A*, a calendar year taxpayer, acquired shares of REIT *R* benefited stock for \$30,000. In December 1996, *A* received dividends of \$200. Assume that, under the recharacterization rules, *A*'s 1996 income attributable to the benefited stock is \$2,400, *A*'s 1996 deduction attributable to the financing instruments is \$1,000, and *A*'s basis in the benefited stock is \$50,000. These facts require a \$1,200 reduction in *A*'s basis in the benefited stock. This is the amount by which *A*'s 1996 net income from the fast-pay arrangement as recharacterized (\$2,400 income less \$1,000 deduction) exceeds *A*'s income from the fast-pay arrangement computed without the recharacterization rules (\$200 dividends attributable to the benefited stock).

A taxpayer is prohibited from affirmatively using the automatic recharacterization rules if a principal purpose for using the rules is the avoidance of any tax imposed by the Internal Revenue Code.ⁿ⁸ With respect to such a taxpayer, the Commissioner may depart from the automatic recharacterization rules and treat (for all purposes of the Code) the fast-pay arrangement in accordance with its form or its economic substance. For example, if a foreign person acquires fast-pay stock in a REIT and a principal purpose for the acquisition is the reduction of U.S. withholding taxes by applying the automatic recharacterization rules, the Commissioner may, for purposes of determining the foreign person's U.S. tax consequences (including withholding tax) depart from the automatic recharacterization rules and treat the foreign person as holding fast-pay stock in the REIT.

For periods prior to April 1, 2000, a taxpayer can limit the amount of taxable income attributable to a recharacterized fast-pay arrangement to the taxable income that results if the fast-pay arrangement is recharacterized under either *Notice 97-21*ⁿ⁹ or the general recharacterization rules.ⁿ¹⁰ The recharacterization must be consistent for all such periods.

A shareholder that limits taxable income to the amount determined under *Notice 97-21* must include as an adjustment to taxable income that excess, if any, of the amount determined according to the general recharacterization rules over the amount determined under *Notice 97-21*.ⁿ¹¹ The adjustment must be made in the shareholder's first taxable year that includes April 1, 2000. The shareholder's books and records must include a statement identifying each fast-pay arrangement for which an adjustment must be made and providing the amount of the adjustment for each fast-pay arrangement.

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.7701(l)-3(c)(1)(i)*. RICs and REITs are discussed in Ch 12 and Ch 13, respectively.

(n2)Footnote 2. *Treas Reg § 1.7701(l)-3(c)(1)(ii)*.

(n3)Footnote 3. *Treas Reg § 1.7701(l)-3(c)(2)*. If there are multiple classes of benefited stock, the recharacterization rules apply among the different classes as appropriate to match the economic substance of the fast-pay arrangement. *Treas Reg § 1.7701(l)-3(c)(3)(ii)*.

(n4)Footnote 4. *Treas Reg § 1.7701(l)-3(c)(2)(i)*. The character of the financing instrument (eg, stock or debt) is not specified in the regulations, and must be determined under general tax principles looking at all of the facts and circumstances. *Treas Reg § 1.7701(l)-3(c)(3)(i)*.

(n5)Footnote 5. *Treas Reg § 1.7701(l)-3(c)(2)(ii)*. This results in an increase in the basis of the benefited shares.

(n6)Footnote 6. *Treas Reg § 1.7701(l)-3(c)(2)(iii)*.

(n7)Footnote 7. *Treas Reg § 1.7701(l)-3(c)(3)(iv)*.

(n8)Footnote 8. *Treas Reg § 1.7701(l)-3(d)*.

(n9)Footnote 9. 1997-1 CB 407 .

(n10)Footnote 10. *Treas Reg § 1.7701(l)-3(g)(2)(i)*. Examples utilizing this election can be found in *Treas Reg § 1.7701(l)-3(g)(2)(iii)*.

(n11)Footnote 11. *Treas Reg § 1.7701(l)-3(g)(2)(ii)*.



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CHAPTER 4A Fast-Pay Arrangements

1-4A Taxation of Securities Transactions § 4A.04

§ 4A.04 Transactions Affecting Benefited Stock

In addition to any consideration actually paid and received upon a sale of benefited stock, the buyer is deemed to pay, and the seller is deemed to receive, the amount necessary to terminate the seller's position in the financing instruments at fair market value.ⁿ¹ In addition, the buyer is deemed to issue financing instruments to the fast-pay shareholders in exchange for the amount necessary to terminate the seller's position in the financing instruments. If the transaction affecting the benefited stock is other than a sale, the parties to the transaction must make appropriate arrangements to take into account the fast-pay arrangement.ⁿ²

Example 7:

Assume the same facts as in Examples 1 and 4. Near the end of Year 6, a person holding one share of *A* stock sells it for \$140 to a buyer who is unrelated to the REIT or to any of the *B* stock shareholders. At the time of sale, the amount needed to terminate the seller's position in the financing instrument is \$80.

The seller's amount realized is \$220, the sum of \$140 (the selling price) and \$80 (the amount needed to terminate the seller's position in the financing instrument at fair market value). The seller's gain realized is \$20 (\$220 amount realized less \$200 basis); the seller has no income or deduction with respect to terminating the seller's position in the financing instruments.

The buyer's basis is the same as the seller's amount realized, namely, \$220. In addition, the buyer is treated as issuing financing instruments to the fast-pay shareholders in exchange for \$80, the amount needed to terminate the seller's position in the financing instruments at fair market value.

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.7701(l)-3(c)(3)(iii)(A)*.

(n2)Footnote 2. *Treas Reg § 1.7701(l)-3(c)(3)(iii)(B)*.



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CHAPTER 4A Fast-Pay Arrangements

1-4A Taxation of Securities Transactions § 4A.05

§ 4A.05 Reporting Requirements

A corporation (other than a controlled foreign corporation, a foreign personal holding company, or a passive foreign investment company) that has fast-pay stock outstanding at any time during the taxable year must attach a statement to its federal income tax return for the taxable year that says, "This fast-pay stock disclosure statement is required by section 1.7701(l)-3(f) of the income tax regulations."ⁿ¹ The statement must also identify the corporation that has outstanding fast-pay stock and must contain the date on which the fast-pay stock was issued, the terms of the fast-pay stock, and (to the extent the filing person knows or has reason to know such information) the names and taxpayer identification numbers of the shareholders of any stock that is not traded on an established securities market.

If a controlled foreign corporation (CFC) has fast-pay stock outstanding at any time during its taxable year (during which time it was a CFC), each controlling U.S. shareholder must attach the required statement to the shareholder's Form 5471 for the CFC's taxable year.ⁿ² If a foreign personal holding company (FPHC) has fast-pay stock outstanding at any time during its taxable year (during which time it was a FPHC), each U.S. citizen or resident who is an officer, director, or 10-percent shareholder of the FPHC must attach the statement to his or her Form 5471 for the FPHC's taxable year.ⁿ³

In the case of a passive foreign investment company (PFIC) that has fast-pay stock outstanding at any time during its taxable year (during which it was a PFIC), each shareholder that has elected to treat the PFIC as a qualified electing fund and knows or has reason to know that the PFIC has outstanding fast-pay stock must attach the required statement to its Form 8621 for the PFIC's taxable year.ⁿ⁴

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.7701(l)-3(f)(1)(i), (2).*

(n2)Footnote 2. *Treas Reg § 1.7701(l)-3(f)(1)(ii).* For a discussion of controlled foreign corporations, see § 20.04, *infra*.

(n3)Footnote 3. *Treas Reg § 1.7701(l)-3(f)(1)(iii).* Foreign personal holding companies are the subject of § 20.03, *infra*.

(n4)Footnote 4. *Treas Reg § 1.7701(l)-3(f)(1)(iii).* Each shareholder owning 10 percent or more of the stock of the PFIC (by vote or value) is presumed to know that the PFIC has issued fast-pay stock.

A discussion of passive foreign investment companies can be found in § 20.05A, *infra* .



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CHAPTER 5 Distributions in Redemption of Stock

1-5 Taxation of Securities Transactions 5.syn

§ 5.syn Synopsis to Chapter 5: Distributions in Redemption of Stock

§ 5.01 Introduction

§ 5.02 Redemptions Under Section 302

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[b] Attribution to and From Partnerships.

[c] Attribution to and From Estates.

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CHAPTER 5 Distributions in Redemption of Stock

1-5 Taxation of Securities Transactions § 5.01

§ 5.01 Introduction

A sale of stock to a third party will either completely terminate the shareholder's interest in the corporation or reduce both his absolute and proportionate interests in the equity of the corporation. A redemption of his stock, that is, the acquisition of the stock by the corporation in exchange for its property,ⁿ¹ can have the same effect. However, a redemption need not produce any change in the percentage of outstanding stock which the shareholder continues to own. A pro rata redemption of a portion of the holdings of all stockholders will produce a change only in the number of shares owned by each; the proportionate interest of each shareholder will not be disturbed.

As a matter of policy, the same tax treatment should be afforded the selling stockholder and the redeeming stockholder, if the effect of the disposition is the same. This is the view that Congress has taken in legislating the tax consequences of redemptions. Where the redemption is in complete termination of the shareholder's holdings, is substantially disproportionate with respect to the shareholder, or is not essentially equivalent to a dividend, the redemption will be treated as an exchange, thus producing capital gain. Where the redemption serves only to remove corporate profits and is essentially equivalent to a dividend distribution, it will be taxed as a dividend.

FOOTNOTES:

(n1)Footnote 1. *IRC § 317(b)*.



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CHAPTER 5 Distributions in Redemption of Stock

1-5 Taxation of Securities Transactions § 5.02

§ 5.02 Redemptions Under Section 302

[1] Constructive Ownership of Stock

Suppose the stock of a corporation is owned equally by a taxpayer and his wife. If half of the taxpayer's shares are redeemed and the effect of the redemption measured only by reference to the shares actually owned by the taxpayer, it is obvious that there has been a significant change in the taxpayer's interest in the corporation. Where prior to the redemption he owned one-half of the outstanding stock, he now owns one-third. If, however, the ownership by husband and wife is viewed as ownership by a single person, the redemption produced no change in ownership; husband and wife continue to own 100 percent of the outstanding stock of the corporation.

Congress deemed it more significant to consider the effect of a redemption in terms of the stock ownership of an economic unit than to look merely at the actual ownership of the redeeming shareholder. This is achieved through attribution--stock owned by one person is treated as constructively owned by another if the two stand in a specified relationship to each other. However, in no event is attribution required unless the constructive ownership rules are expressly made applicable.ⁿ¹

[a] Family Attribution. Under *IRC Section 318(a)(1)*, an individual is deemed to own the stock owned by his spouse,ⁿ² his children,ⁿ³ his grandchildren, and his parents. Special note should be taken of the fact that attribution may flow in only one direction between certain family relationships. Thus, while a grandfather will constructively own the stock owned by his grandchildren, they will not be deemed the owners of his stock. Furthermore, unlike other constructive ownership provisions of the Code,ⁿ⁴ there is no attribution between brothers and sisters.

Stock constructively owned by one family member through application of the family attribution rules is not considered owned by him for the purpose of reattributing ownership to still another family member.ⁿ⁵ But if shares are constructively owned by an individual by reason of some other attribution rule, those shares may be reattributed to another family member.ⁿ⁶ For example, if *A*, his son *B*, and his grandson *C* each owned 100 shares of *X Corp* stock, *A* and *B* would each be considered the owner of 300 shares (100 actually, 200 constructively), while *C* would be considered as owning only 200 shares (his 100 shares and the shares owned by *B*). If, in addition, *B* were considered the owner of another 50 shares due, say, to the trust attribution rules, those 50 shares would in turn be attributed to *A* and *C* under the family attribution rules.

[b] Attribution to and From Partnerships. Stock owned by a partnership is considered as owned proportionately

by its partners,ⁿ⁷ while stock owned by the partners is attributed in its entirety to the partnership.ⁿ⁸ The proportion attributed from partnership to partner is based upon the percentage interest of the partner in the partnership--a partner having a 50 percent interest in the partnership will constructively own 50 percent of each stock holding of the partnership.ⁿ⁹

Stock owned by a partner and therefore attributed to the partnership cannot then be reattributed from the partnership to another partner.ⁿ¹⁰ To illustrate, if *A* and *B* have equal interests in a partnership, and each also owns 100 shares of *X* Corp stock, the shares owned by *A* and *B* will be constructively owned by the partnership, but neither partner will be considered as owning more than the 100 shares that he actually owns.

Reattribution is permitted where the partnership is the actual owner and the partner, the constructive owner.ⁿ¹¹ Thus, if *A* has a 50 percent interest in a partnership which owns 100 shares of *X* Corp stock, the fifty shares constructively owned by *A* by reason of the partnership-partner attribution rule will also be constructively owned by any person (including any entity) to whom shares owned by *A* must be attributed.

[c] Attribution to and From Estates. The rules governing attribution to and from estates are the same as those imposed on partners and partnerships. Stock owned by an estate is considered as owned proportionately by its beneficiaries; stock owned by a beneficiary is constructively owned by the estate.ⁿ¹²

If stock owned by the decedent at his death is subject to administration for the purpose of paying claims against the estate and administration expenses, it will be treated as owned by the estate for the purpose of applying the attribution rules relating to estates. A local law providing for vesting of property in the decedent's heirs or legatees immediately upon death will not produce a contrary result.ⁿ¹³

A critical determination is whether a person is a beneficiary. The Regulations provide that the term "includes any person entitled to receive property of a decedent pursuant to a will or pursuant to laws of descent and distribution."ⁿ¹⁴ They further provide that a person loses beneficiary status (1) when he has received all the property to which he is entitled, (2) when he no longer has a claim against the estate by reason of having been a beneficiary, and (3) when there is only a remote possibility that the estate will find it necessary to seek a contribution from him to satisfy claims against the estate or payment of administration expenses.ⁿ¹⁵

Clearly, then, a residuary legatee will be a beneficiary until estate administration is concluded.ⁿ¹⁶ And it would seem that a specific legatee of a solvent estate would cease to be a beneficiary after his bequest is satisfied. However, as *Estate of Webber v. United States*ⁿ¹⁷ shows, mere payment of a legacy is not sufficient to remove one from beneficiary status. In *Webber*, satisfaction of the bequest preceded redemption of shares owned by the estate, which, in turn, preceded the estate's payment of estate and inheritance taxes. Under local law, the legatee was required to reimburse the estate for his proportionate share of all such taxes, something he failed to do until after the redemption. The claim which the estate had against the legatee for reimbursement of taxes was held sufficient to keep him in beneficiary status and to impute the shares owned by him to the estate.

Finally, in order to be a beneficiary, one must have a direct present interest in property held by the estate or in income produced by such property. This makes the life tenant of a testamentary trust a beneficiary, but denies beneficiary status to one whose interest is limited to a remainder interest, even where the interest is vested.ⁿ¹⁸

As in the case of partnerships and partners, shares attributed from individual (beneficiary) to entity (estate) cannot be reattributed, but reattribution is permitted when attribution runs from entity to individual.ⁿ¹⁹

[d] Attribution to and From Trusts. Stock owned by a trust (other than a tax-exempt employees' trust) will be constructively owned by its income beneficiaries and remaindermen in proportion to their respective actuarial interests in the trust.ⁿ²⁰ For example, if a trust owns 100 shares of *X* Corp. stock and, on an actuarial basis, the income

beneficiary has a 40 percent interest in the trust, and the remainderman a 60 percent interest therein, the income beneficiary will be considered to be the owner of forty shares of X Corp. stock and the remainderman considered the owner of sixty shares.

If the trust is considered a grantor trust under the provisions of *IRC Sections 671-678* of the Code, stock owned by the trust will be attributed to the person treated as the owner of the trust under said section.ⁿ²¹ It is unclear whether attribution to the grantor or other person treated as the substantial owner of a trust eliminates attribution to the beneficiaries of such trust. The only type of trust expressly excepted from the operation of *IRC Section 318(a)(2)(B)(i)* is "an employees' trust described in section 401(a) which is exempt from tax under section 501(a)." The legislative history would appear to make trust-beneficiary attribution applicable even in the case of grantor trusts, for, according to the Senate Report:

"[The] rule applies to ... all trusts including those relating to grantors and others treated as substantial owners but does not apply to employees' trusts described in section 401[a] which are exempt from tax under section 501(a)."ⁿ²²

The trust will be considered the constructive owner of stock directly or indirectly owned by a beneficiary, unless the beneficiary's interest in the trust (1) is a contingent interest and (2) taking into account the maximum exercise of discretion by the trustee in favor of the beneficiary, has an actuarial value which does not exceed 5 percent of the value of the trust property.ⁿ²³ If the beneficiary's interest is vested, his stock is attributed to the trust, irrespective of the value of the interest.ⁿ²⁴ Attribution is likewise required where the interest is contingent provided the actuarial value of the interest exceeds 5 percent of the value of the trust. It would appear that since the Code does not specify when an interest is vested or contingent, local law characterizations presumably control. However, the Service has ruled that, for purposes of *IRC Section 318*, an interest conditioned on survivorship is always contingent.ⁿ²⁵

Stock owned by the grantor or other person treated as the substantial owner of a grantor trust will be attributed to the trust.ⁿ²⁶ Here, too, it is unclear whether attribution from a grantor precludes attribution from a beneficiary.

Following the mold cast for partnerships and estates, stock constructively owned by a trust through attribution from a beneficiary or grantor will not be considered as owned by the trust for the purpose of making another the constructive owner.ⁿ²⁷ Stock attributed from a trust to a beneficiary or grantor is subject to further attribution.ⁿ²⁸

[e] Attribution to and From Corporations. Attribution of stock from corporation to shareholder and from shareholder to corporation will occur only when the shareholder owns, actually and constructively, at least 50 percent in value of the stock of the corporation.ⁿ²⁹ The ownership attributed from corporation to shareholder is proportionate to the shareholder's interest in the corporation; a shareholder owning 70 percent in value of the stock of the corporation will constructively own 70 percent of stock owned by the corporation.ⁿ³⁰ On the other hand, if attribution from shareholder to corporation is required at all, it is a total attribution of all stock owned by the shareholderⁿ³¹ with one exception--a corporation will not be deemed the constructive owner of its own stock.ⁿ³²

Any stock constructively owned by the corporation by attribution from a shareholder will not be reattributed from the corporation to any other shareholder.ⁿ³³ Stock owned by the corporation and attributed to a shareholder can again be attributed.ⁿ³⁴ For example, suppose A and B, unrelated persons, each own 50 percent of the stock of X Corp., and B and X Corp. each own 50 percent of the stock of Y Corp. If each corporation has 100 shares outstanding, the following will be the manner in which the shares of X Corp. and Y Corp. stock are actually and constructively owned:

Owner	X Corp. Stock	Y Corp. Stock
A	50 shares	25 shares
B	50 shares	75 shares
X Corp.	--	100shares

Y Corp.	50 shares	--

The X Corp. stock owned by A and B is actually owned by them. The X Corp. stock owned by Y Corp. is constructively owned by attribution from B, a 50 percent stockholder. Although X Corp. actually and constructively owns 100 shares of Y Corp. stock, only the fifty shares actually owned may be attributed proportionately to A and B. The fifty shares of Y Corp. stock constructively owned by X Corp. by attribution from B cannot be reattributed to A. Therefore, A constructively owns twenty-five shares of Y Corp stock (50 percent of fifty shares) while B actually owns fifty shares, and constructively owns twenty-five shares, of Y Corp. stock.

[f] The Effect of Options on Attribution. A person having an option to acquire stock is deemed the owner of such stock for the purpose of applying the attribution rules of *IRC Section 318*.ⁿ³⁵ So, if A has an option to acquire 100 shares of stock and A is B's father, B will be the constructive owner of the 100 shares through application of the option rule and the family attribution rule.

We saw before that stock constructively owned by a person by operation of the family attribution rule could not be reattributed to another family member. Thus, while A's son, B, will be the constructive owner of stock owned by A, B's son, C, will not be. If, however, B has an option to acquire A's stock, C will be the constructive owner of any shares subject to the option. B is considered as owning the stock under the option rule and not the family attribution rule.ⁿ³⁶

Another facet of the option ownership rule affects reattribution of stock constructively owned by an entity (partnership, estate, trust, or corporation). For example, we have seen that if A and B each own 50 percent of the stock of X Corp., and A also owns 100 shares of Y Corp. stock, X Corp. will be the constructive owner of the 100 shares of Y Corp. stock owned by A, but B will not be considered the owner of any Y Corp. shares. On the other hand, if X Corp. has an option to purchase A's Y Corp. stock, B will be considered the owner of the Y Corp. shares. Reattribution under *IRC Section 318(a)(2)(C)* of stock constructively owned by the corporation under *IRC Section 318(a)(3)(C)* is not precluded if the corporation also constructively owns stock under the option rules of *IRC Section 318(a)(4)*.ⁿ³⁷

An interesting application of *IRC Section 318(a)(4)* is presented by *Sorem v. Commissioner*,ⁿ³⁸ where employees holding stock options were considered as owning the stock for which they held options even though the stock was unissued. The unissued stock subject to the options was then included in the total stock outstanding for the purpose of testing the tax consequences of a transaction involving other shareholders. The Service will not follow *Sorem* insofar as it stands for the proposition that the total outstanding stock of a corporation includes unissued stock subject to options held by persons whose stock is not being redeemed or whose stock is not constructively owned by a redeeming shareholder.ⁿ³⁹

[2] Redemptions Treated as Exchanges of Stock

Under *IRC Section 302(a)*, a redemption of stock will "be treated as a distribution in part or full payment in exchange for the stock" if the redemption is (1) not essentially equivalent to a dividend, (2) substantially disproportionate with respect to the shareholder, (3) in complete redemption of all of the stock of the corporation owned by the shareholder, or (4) from a noncorporate shareholder in partial liquidation of the distributing corporation.ⁿ¹ With *IRC Section 302(a)* providing the necessary exchange requirement, a redemption meeting one of the prescribed tests will qualify as a capital transaction provided the redeemed stock constitutes a capital asset in the hands of the shareholder.ⁿ²

Two of the categories of redemptions--the substantially disproportionate redemption and the complete redemption of all stock owned by the shareholder--are "safe harbor" provisions, i.e., they are:

"[I]ntended to prescribe specific conditions from which the taxpayer may ascertain whether a given redemption will be taxable at rates applicable to the sale of assets or as a distribution of property not in

redemption of stock subject to Section 301."ⁿ³

The third category, the distribution not essentially equivalent to a dividend, is the taxpayer's last refuge, one which he should seek only if he cannot steer a course into the safe harbor. One thing is fairly certain: The shelter afforded by this category will be reached only after travel upon the stormy sea of litigation.

[a] Redemptions Not Essentially Equivalent to a Dividend

"It has taken several weeks of study to gain a fair comprehension of the applicable law from the myriad of judicial writings on this intricate statute [the predecessor of Section 302(b)(1)]. It makes one shudder to realize that ordinarily a question of fact of this kind is to be submitted to a jury if a jury is insisted upon."ⁿ⁴

Much of the difficulty which attended the determination of dividend equivalency under the 1939 Code stemmed from the fact that stock redemptions were included within the terms of the partial liquidation provisions. This led many courts to consider, as part of their decisional criteria, the presence or absence of a bona fide corporate business purpose,ⁿ⁵ and, in some cases, whether the transaction was the result of, or resulted in, a contraction of the corporation's business or narrowed its activities.ⁿ⁶ The commingling of corporate level factors with criteria which tested the redemption on the shareholder level, e.g., whether the transaction was pro rata among the shareholders or resulted in a substantial change in the ownership or control of the corporation,ⁿ⁷ led Congress to separate the provisions governing redemptions of stock from those concerned with partial liquidations. Although the rules for partial liquidations are once again united with those concerned with nonliquidating redemptions, it is clear that the testing criteria are different.

In its original version of the 1954 Code, the House eliminated the dividend equivalency test for nonliquidating redemptions and granted capital gain treatment just to substantially disproportionate redemptions and complete redemptions. The Senate, viewing the House approach as unduly restrictive,ⁿ⁸ reinserted the then prevailing rule that a redemption would be treated as an exchange, and not as a dividend, if it was not essentially equivalent to a dividend. In so doing, the Senate Finance Committee stated:

"The test intended to be incorporated in the interpretation of [*IRC Section 302(b)(1)*] is in general that currently employed under section 115(g)(1) of the 1939 Code. Your Committee further intends that in applying this test for the future that the inquiry will be devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation."ⁿ⁹

By differentiating stock redemptions from partial liquidations, Congress seemingly removed any consideration of business purpose from the test of dividend equivalency under *IRC Section 302(b)(1)*. Yet even after the enactment of the 1954 Code, certain courts were willing to give at least some weight to the business motivation behind the distribution and redemption.ⁿ¹⁰ Indeed, on the appellate level, only the Second Circuit refused to inquire into the motive for the redemption; it looked strictly at the net effect of the distribution at the shareholder level, i.e., to see if the redemption produced the same result as the payment of a dividend.ⁿ¹¹ If it did, the distribution would be considered to have the effect of a dividend.

The death blow to business purpose as a criterion in determining dividend equivalency was finally dealt by the Supreme Court in *United States v. Davis*,ⁿ¹² a 1970 case involving the redemption of preferred stock which the taxpayer had originally purchased in order to increase the corporation's working capital, and thereby to qualify the corporation for a loan from a government agency. After the loan was repaid, the preferred stock was redeemed in accordance with a prior understanding. At the time of the redemption, the shareholders of the corporation were the redeeming shareholder, his son, and his daughter. In reversing the Sixth Circuit, which had held that the distribution was not essentially equivalent to a dividend on the ground that the redemption was the final step in a course of action which had a legitimate business

purpose, the Court looked to the legislative history quoted above and concluded that

"[B]y making the sole inquiry relevant for the future the narrow one whether the redemption could be characterized as a sale, Congress was apparently rejecting past court decisions that had also considered factors indicating the presence or absence of a tax-avoidance motive. ... We conclude that the Court of Appeals was therefore wrong in looking for a business purpose and considering it in deciding whether the redemption was equivalent to a dividend. Rather, we agree with the Court of Appeals for the Second Circuit that 'the business purpose of a transaction is irrelevant in determining dividend equivalence' under § 302(b)(1). *Hasbrook v. United States*, 343 F2d 811, 814 (1965)."n13

Dividend equivalence now means exactly that. If a redemption has the effect of a transfer of property from corporation to shareholder without any change in the shareholder's control over the corporation or his rights to its future earnings, the distribution will be essentially equivalent to a dividend; the presence of a good business motive for the distribution will not change the result. A redemption will come within *IRC Section 302(b)(1)* only if it results "in a meaningful reduction of the shareholder's proportionate interest in the corporation."n14

Application of the *Davis* criterion for dividend equivalence may not create as great a change in future results as might be expected. It had earlier been suggested that

"Despite the words used in most of [the] cases, ... the holdings in all but the exceptional case decided under section 302(b)(1) and its predecessor under the 1939 Code can be resolved by the application of one objective test: there must be a significant modification of shareholder interests."n15

Davis gives little aid in determining how great a departure from pro rata redemption is required before a reduction in shareholder interest is meaningful, since the taxpayer there actually and constructively owned 100 percent of the common stock of the corporation before and after the redemption of his preferred shares. And while *Davis* does make it clear that the attribution rules of *IRC Section 318(a)* apply to redemptions tested under *IRC Section 302(b)(1)*, a view previously advanced by the Regulationsn16 and by judicial decisions,n17 it does not indicate whether the constructive ownership rules are to be rigidly applied, or whether other facts and circumstances may be taken into account in determining whether a reduction is significant.

The role of attribution in determining dividend equivalence can be illustrated by the case of the father and son who each own 50 percent of the common stock of a corporation. A redemption of one-half of the father's shares would reduce his actual ownership to 33 1/3 percent, but would not affect his actual and constructive ownership; that would remain at 100 percent because of the family attribution rules. Strict application of these rules would mandate a finding of dividend equivalence, for there would be no reduction in the shareholder's interest in the corporation. But suppose conflict between father and son made the father's interest in fact a minority interest. Should this additional circumstance produce any change in result?

Prior to *Davis*, the Tax Court had on occasion relied on other facts and circumstances to circumvent strict application of the *IRC Section 318(a)* attribution rules and find a distribution not essentially equivalent to a dividend. In *Parker v. Commissioner*,n18 a change in actual ownership from 49.7 percent to 28.7 percent was matched by a reduction in actual and constructive ownership of only one percent. Nevertheless, because of a sharp and continuing disagreement between father and son, the court was able to conclude that the redemption brought about a significant change in control and, thus, that the redemption was not essentially equivalent to a dividend. Similar emphasis on other circumstances produced capital gain for the taxpayer in *Estate of Squier v. Commissioner*,n19 where direct ownership was reduced from 50.09 percent to 41.27 percent, and constructive ownership from 63.30 percent to 56.82 percent. The existence of a substantial minority interest (43.18 percent) held by an unrelated party, together with a sharp cleavage between the executor of the estate and those whose stock was attributed to it, led the Tax Court to decide that "the redemptions herein in fact resulted in a crucial reduction of the estate's *control* over the corporation."n20

In *Haft Trust v. Commissioner*,²¹ the Tax Court relied on *Davis* to conclude that the attribution rules of *IRC Section 318(a)* are to be applied irrespective of the personal relationships which exist among members of a family. In the opinion of the court, an interpretation of the statute which makes applicability of the attribution rules dependent upon whether there is discord among family members would frustrate the legislative purpose behind the rules and be inconsistent with the language of the statute and the rationale of *Davis*. The First Circuit reversed²² and remanded the *Haft Trust* case for a consideration of the effect of family hostility on the attribution rules.²³ The appellate court refused to find that *Davis* required an unyielding application of *IRC Section 318(a)*. Instead, it felt that *IRC Section 302(b)(1)* and *Davis* allow consideration of the facts and circumstances of each case.

The flexible approach suggested by the First Circuit and taken by the Tax Court prior to *Davis* seems more in keeping with the reason for the inclusion of *IRC Section 302(b)(1)* in the 1954 Code, namely, not to unduly restrict the ability of the taxpayer to achieve capital gain treatment when the redemption of his stock looks more like a sale than a dividend. If the presumptions underlying the constructive ownership rules are rebutted by the existence of other facts, mechanical application of these rules would seem to be unwarranted.²⁴ However, until the Supreme Court resolves this issue, one can expect the Service to press its contention that strict application of *IRC Section 318(a)* is required in determining dividend equivalence.²⁵

When does a redemption produce a "meaningful reduction in the shareholder's proportionate interest in the corporation"? Certainly it does not occur when the corporation has a single class of stock and the redemption is pro rata;²⁶ or the redeemed share holder's actual and constructive interest either increases²⁷ or remains unchanged and no special circumstances affecting application of the attribution rules are present.²⁸ In each instance, the amount received on the redemption would be the same as the amount which would have been received if a dividend were paid on the stock actually and constructively owned by the shareholder, and in each case the redemption bears the hallmark of a dividend--a distribution of earnings and profits which causes no change in basic relationships either between the shareholder and the corporation or between the shareholder and the other shareholders of the corporation.

Obviously, then, the question of whether a reduction in ownership interest is meaningful will be presented only when the redemption is not pro rata. Here one encounters difficulty for the courts, with rare exception, have failed to articulate the significance to be accorded to a particular alteration in stock ownership. A number of illustrations will point up the problem. In *Sorem v. Commissioner*,²⁹ the redemption changed the interests of two 50 percent shareholders to 43.77 percent and 37.91 percent, respectively, a reduction of 6.23 percent in one case and 12.09 percent in the other. In *Friend v. United States*,³⁰ the reduction was from 73 percent to 66 percent, a change of 7 percent. The redemption in *Leleux v. Commissioner*³¹ changed the shareholder's ownership ratio from 75 percent to 53.5 percent, while in *Estate of Squier v. Commissioner*,³² it went from 50.09 percent to 41.27 percent. The *Sorem* and *Squier* redemptions were held to be not essentially equivalent to a dividend; the *Friend* and *Leleux* distributions were considered to have the effect of a dividend.

The only rational basis for the difference in result rests with the retention of control in *Leleux* and *Friend* and the loss of control through the redemptions in *Sorem* and *Squier*.³³ Indeed, the Service has ruled that a redemption which results in a loss of dominant voting rights is one which produces a meaningful reduction and a distribution not essentially equivalent to a dividend.³⁴ But should retention of control automatically signal dividend equivalence? Clearly not, it would seem, if, as *Davis* states, the sole inquiry is whether the redemption can be characterized as a sale. Retention of control may be a factor in determining the presence or absence of a tax avoidance motive, but we have seen that *Davis* now makes motive an irrelevant consideration when testing a distribution to see if it has the effect of a dividend.³⁵

The point at which a change in the ownership ratio of a minority shareholder becomes significant is less obscure. If there is a decrease in voting and participation rights, the redemption should be accorded capital gains treatment, and the Service has so ruled.³⁶ However, there are cases in which dividend equivalence was found even though the redemption produced a reduction in interest.³⁷ And if one looks to some of the language employed by the courts, such

as the following, it would be impossible for any redemption from a minority shareholder to qualify under *IRC Section 302(b)(1)*:

"Prior to the redemption in this case, the taxpayer was a minority stockholder and could only exercise control by aligning himself with one or more of the other stockholders. After the redemption, he was still a minority stockholder who could only exercise control by aligning himself with other stockholders."³⁸

There can be no doubt that a redemption of a minority stockholder's shares can qualify for capital gain treatment under *IRC Section 302(b)(1)*. Any indication to the contrary is patently wrong. Indeed, the Service once argued that Congress intended to limit the provision to redemptions of nonvoting preferred stock and redemptions from minority shareholders.³⁹ It now considers such redemptions to be one of the purposes underlying the enactment of *IRC Section 302(b)(1)*.⁴⁰

A more definite pattern of decision emerges when the corporation has an issue of preferred stock outstanding and shares of that class are redeemed. Such a redemption will be essentially equivalent to a dividend if the shares are redeemed from a sole stockholder,⁴¹ or pro rata from a group of stockholders whose ownership of preferred is in the same proportion (or very close to the same proportion) as their ownership of common stock.⁴² Where the ownership of preferred does not parallel the holding of common, a redemption of preferred, even if pro rata, is likely to qualify under *IRC Section 302(b)(1)*.⁴³ To illustrate, in *Revenue Ruling 68-547*,⁴⁴ the preferred and common were owned by approximately 300 shareholders, but the shareholders owning common stock owned only 12 percent of the preferred. The redemption was held not to have the effect of a dividend, even as to the principal shareholder of the corporation who owned (actually and constructively) 60 percent of the common stock and 7 percent of the preferred. A comparable result was reached in *Revenue Ruling 56-540*,⁴⁵ where, of a total of 570 shareholders, 191 owned common stock, 313 owned preferred stock, while just sixty-six owned both common and preferred. Since the shareholders holding both classes of stock owned only 25 percent of the outstanding issue of preferred stock, a pattern of stock ownership between the holders of the two classes of stock did not exist, and so the redemption fit within *IRC Section 302(b)(1)*.

The extent of common stock ownership will not affect the non-dividend quality of a preferred stock redemption as long as there is no proportional relationship between the holding of common stock and the holding of preferred. Thus, in *Revenue Ruling 55-462*,⁴⁶ a redemption of fourteen of the fifteen preferred shares owned by one of two 50 percent shareholders was held to be not essentially equivalent to a dividend; the other shareholder held one share of preferred stock. In fact, while the *Davis* case was before the Sixth Circuit, the Government conceded that the redemption would have passed muster had it taken place while an unrelated party owned 50 percent of the stock.⁴⁷

An interesting variation on the usual form of redemption of stock in a corporation with a multiclass capitalization was presented by *Himmel v. Commissioner*,⁴⁸ where the taxpayer constructively owned 50 percent of the corporation's common stock and actually owned all of its voting and nonvoting preferred stock. A redemption of a portion of the taxpayer's nonvoting preferred stock was held by the Second Circuit to be not essentially equivalent to a dividend. In reaching this conclusion, the court looked not only at voting power (unchanged by the redemption), but also at the shareholder's right to participate in the profits of the corporation and his interest in the net worth of the corporation, and found significant changes produced by the redemption. However, the Service is of the opinion that, since *Himmel* was decided before the *Davis* case, it fails to reflect the development in the law represented by the *Davis* limitation on the applicability of *IRC Section 302(b)(1)* where there is no meaningful reduction in the shareholder's proportionate interest in the corporation.⁴⁹

The determination of dividend equivalence remains a question of fact to be determined by reference to the facts and circumstances of each case and not by the application of a hard and fast rule of law. The task of future cases will be to show the effect of the facts and circumstances of a particular situation on the significance of the reduction in proportionate interest produced by the redemption in issue.

[b] Substantially Disproportionate Redemptions. Under *IRC Section 302(b)(2)*, a redemption will avoid the possibility of dividend consequences under *IRC Section 301*, and be considered a distribution in exchange for the stock, if the redemption is substantially disproportionate with respect to the shareholder. A redemption will be so treated only if (1) immediately after the redemption the shareholder owns less than 50 percent of the voting stock of the corporation,ⁿ⁵⁰ (2) the proportion of voting stock (including voting preferred stock) owned by the shareholder immediately after the redemption is less than 80 percent of the proportion which he owned immediately prior to the redemption,ⁿ⁵¹ and (3) the proportion of common stock (voting and nonvoting) owned by the shareholder immediately after the redemption is less than 80 percent of the proportion which the shareholder owned immediately prior to the redemption.ⁿ⁵² The operation of *IRC Section 302(b)(2)* can be seen in the following illustration:

Example:

A and B each own 100 of the 200 shares of outstanding stock of X Corp. The corporation redeems twenty of A's shares. Although following the redemption, A owns less than 50 percent of the voting stock of the corporation, the redemption will not be substantially disproportionate since the percentage of the corporation's stock which he owns after the redemption (80/180 or 44.4 percent) is more than 80 percent of the percentage that he owned prior to the redemption (100/200 or 50 percent). For the redemption to have qualified under *IRC Section 302(b)(2)*, the corporation would have had to redeem 34 shares,ⁿ⁵³ making the post-redemption ownership percentage 39.8 percent, a ratio less than 80 percent of the 50 per cent interest owned before the redemption.ⁿ⁵⁴

The foregoing example also assumed that there was only one class of common stock outstanding. If there is more than one class of common stock, the fair market value of all of the common stock determines whether the requisite reduction in common stock ownership has occurred.ⁿ⁵⁵ The Service has taken the position that an aggregate, and not a class-by-class, approach should be used in testing whether the third prong of the substantially disproportionate test has been met.ⁿ⁵⁶

Example:

X Corp. has outstanding 100 shares of voting common stock and 300 shares of nonvoting common stock. Shareholder A owns 60 shares of voting stock and all of the shares of nonvoting stock; persons unrelated to A own the rest of the voting shares. A share of voting stock and a share of nonvoting stock are of approximately equal value. A redeems 30 of his voting shares and 270 of his nonvoting shares in a single transaction.

The redemption reduces A's percentage of voting stock from 60 percent (60 of 100 shares) to 43 percent (30 of 70 shares), satisfying the first two substantially disproportionate tests. If the third test were applied on a class-by-class basis, the redemption would fail to qualify; A still owns all of the outstanding nonvoting common stock. By applying the fair market value test on an aggregate basis, the third test is also satisfied. Before the transaction, A owned 90 percent of the total fair market value of all of the outstanding X Corp. common stock (360 of 400 shares stated to be of approximately equal value). After the redemption, A owns 60 percent of the total fair market value of X common stock (30 of 70 voting shares, 30 of 30 nonvoting shares). The percentage of common stock owned after the redemption is less than 80 percent of the percentage owned before the transaction.

The foregoing example assumed that A and B were unrelated persons. However, *IRC Section 302(c)(1)* calls for application of the attribution rules of *IRC Section 318(a)* in determining stock ownership, so that if A and B were, say, husband and wife, A would constructively own B's 100 shares both before and after the redemption and would be unable to qualify the redemption under *IRC Section 302(b)(2)*.

In addition, the example was cast in terms of a redemption from a single shareholder. Where the redemption covers

stock held by more than one person, the requirements of *IRC Section 302(b)(2)* are applied to each shareholder separately, making it possible for a redemption to be substantially disproportionate with respect to one shareholder, and not with respect to another.ⁿ⁵⁷ For example, if the corporation had redeemed 50 shares from *A* and ten shares from *B*, the redemption from *A* would fit the definition of a substantially disproportionate redemption (*A* would own roughly 36 percent of the outstanding shares of the corporation following the redemption as compared to 50 percent before the redemption), but the redemption from *B* would not; following the redemption *B* would own 90 of the 140 outstanding shares of stock, or more than 50 percent of the voting stock of the corporation.

Alert to the possibility that a nonqualifying multishareholder redemption could be made substantially disproportionate by staggering the time of each component distribution, Congress made *IRC Section 302(b)(2)* inapplicable to any redemption made pursuant to a plan calling for a series of redemptions "resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder."ⁿ⁵⁸ Using the facts of the original example to illustrate, a redemption of 35 shares from *A* in June would qualify as a substantially disproportionate redemption,ⁿ⁵⁹ as would an August redemption of 40 shares from *B*,ⁿ⁶⁰ if both could be viewed as independent transactions. However, if the distributions were merely steps in a plan to redeem 75 shares, neither redemption would fit within *IRC Section 302(b)(2)*.ⁿ⁶¹

Since a substantially disproportionate redemption contemplates a reduction in the shareholder's ownership of voting stock, a redemption of nonvoting preferred stock alone can never be substantially disproportionate.ⁿ⁶² Such a redemption can qualify for capital treatment if it takes place in conjunction with a redemption covered by *IRC Section 302(b)(2)*.ⁿ⁶³ A redemption of voting preferred stock alone, or of both voting and nonvoting preferred stock, can qualify under *IRC Section 302(b)(2)* only if the shareholder owns no common stock. Otherwise the shareholder will be called upon to meet the 80 percent requirement relative to common stock, and be unable to do so.

[c] Complete Redemptions. A redemption is treated as an exchange of stock if it is in complete redemption of all of the shareholder's stock in the corporation.ⁿ⁶⁴ This does not represent a change in the law as it existed prior to the 1954 Code; complete redemptions were considered to be not essentially equivalent to a dividend.ⁿ⁶⁵ The major contribution of the 1954 legislation comes in the clarification of the consequences of a complete redemption of a shareholder's interest in a situation where there is family ownership of other shares of stock in the corporation. *IRC Section 302(c)(2)* eliminates family attribution (but not any other form of attribution) in determining whether a complete redemption has been effected, provided there is compliance with certain prescribed conditions. Thus, if all of the shares actually owned by the shareholder are redeemed, and the only shares he constructively owns are considered so owned because of the family attribution rules of *IRC Section 318(a)(1)*,ⁿ⁶⁶ the redemption will meet the complete redemption test of *IRC Section 302(b)(3)*. But, if the shareholder constructively owns additional shares because of the application of some other attribution rule, the distribution cannot be considered a complete redemption.

Since family attribution waiver may be the only route to capital gains treatment, it is important to note that there are instances in which one, not the record owner of shares, has been deemed the stockholder for purposes of *IRC Section 302*. For example, a redemption of stock placed in a voting trust is a redemption from the holder of the voting trust certificates and not from the trust,ⁿ⁶⁷ while a redemption from a grantor trust is deemed a redemption from the person treated as the owner under the grantor trust rules.ⁿ⁶⁸

The extent to which one can carry family attribution waiver was the subject of controversy prior to the Tax Equity and Fiscal Responsibility Act of 1982. The Service was of the view that *IRC Section 302(c)(2)* eliminated family attribution only when the individual to whom shares would be attributed was the one whose stock was being redeemed.ⁿ⁶⁹ The Tax Court applied the waiver rule even when family attribution was part of a chain of attribution.ⁿ⁷⁰ To illustrate, suppose that stock in a corporation was owned by an individual, his son, and a trust in which the son was sole beneficiary. If all of the stock actually owned by the son and the trust was redeemed, it is clear that the distribution to the son qualified as a complete termination. However, when it came to the trust, the Service took the position that the father's stock must be attributed to the son and then to the trust. The Tax Court applied the waiver rule to ban attribution

from father to son, thereby preventing attribution from beneficiary to trust.ⁿ⁷¹ The 1982 legislation permits an entity to waive the family attribution rules if the entity and those through whom ownership is attributed to the entity ("related parties") join in the waiver.ⁿ⁷² Thus, in the sample given, the trust and son can waive family attribution if both meet the conditions of *IRC Section 302(c)(2)*.

The first prescribed condition upon which waiver of family attribution is predicated prohibits the distributee from retaining an interest in the corporation (including an interest as an officer, director, or employee) other than an interest as a creditor, or from acquiring any noncreditor interest (other than stock acquired by bequest or inheritance) within ten years from the date of the redemption.ⁿ⁷³ If an entity joins in waiving the family attribution rules, it, too, is prohibited from holding or acquiring an interest during the ten-year period following distribution.ⁿ⁷⁴

The interest-retention rule is strictly construed. Thus, waiver of attribution was precluded where the taxpayer continued as trustee of a voting trust,ⁿ⁷⁵ and where the distributee shareholder became custodian of shares of stock of the distributing corporation under the Uniform Gifts to Minors Act.ⁿ⁷⁶ However, a prohibited interest is not acquired if the former shareholder is named as the executor of an estate, or trustee of a testamentary trust, that owns stock in the corporation; the interest in such case is acquired by bequest or inheritance.ⁿ⁷⁷

It is unclear whether the statute is intended to proscribe any interest as an officer, director, or employee, or whether it is directed at active interests or those which bring financial reward to the distributee. The Service's position is unyielding: a person has an interest if he occupies the status of a director or employee, even if his powers are limited.ⁿ⁷⁸ On the other hand, the Tax Court refuses to hold that *IRC Section 302(c)(2)(A)(i)* contains a *per se* prohibition against the retention of any noncreditor interest, and, instead, focuses on whether the shareholder maintains a financial stake in, or exerts managerial control over, the corporation.ⁿ⁷⁹

A person will be deemed to have the permitted creditor interest only if his rights with respect to the corporation are not greater or broader in scope than necessary for the enforcement of his claim.ⁿ⁸⁰ The obligation that the distributee receives from the corporation must be evidence of a true debt and must not accord rights or contain terms that are commonly associated with a proprietary interest,ⁿ⁸¹ e.g., the debt cannot be subordinate to the claims of general creditors, nor can payment of the principal sum be dependent upon the earnings of the corporation.ⁿ⁸²

A second prerequisite for waiver is the filing of an agreement to notify the Service of any acquisition of an interest (other than the acquisition of stock by bequest or inheritance) within the ten-year period following the redemption.ⁿ⁸³ The regulations call for the agreement to be attached to a timely filed return for the taxable year in which the redemption occurs,ⁿ⁸⁴ a requirement which the Service once viewed as mandatory.ⁿ⁸⁵ However, the Service now permits a reasonable extension of time to file if it is established, to the satisfaction of the district director of the district in which the distributee resided at the time of filing the return for the taxable year in which the distribution occurred, that (1) there was reasonable cause for failing to file the agreement within the prescribed time, and (2) the request for extension is filed within a time that the district director considers reasonable under the circumstances.ⁿ⁸⁶

Family attribution will not be waived if (1) any portion of the stock redeemed was acquired, directly or indirectly, within the prior ten-year period from a person whose stock the taxpayer constructively owns under *IRC Section 318(a)*, or (2) at the time of the redemption stock in the corporation is held by a person whose ownership is attributable to the taxpayer and who acquired any stock in the corporation, directly or indirectly, from the taxpayer within the ten-year period preceding the redemption, unless the stock so acquired is redeemed along with the taxpayer's stock.ⁿ⁸⁷ Waiver is still possible if the distributee can show that his acquisition of stock from the related party or the related party's acquisition of stock from him "did not have as one of its principal purposes the avoidance of Federal income tax."ⁿ⁸⁸ The difference between an acquisition that is in furtherance of a tax avoidance scheme and one that is not can be seen by comparing (1) a gift of stock from father to son followed soon after by a redemption of the son's shares, the gift having been made in contemplation of the redemption and for the sole purpose of placing funds in the hands of the son, with (2) a gift of stock from father to son made for the purpose of inducing the son to enter the family business,

redemption coming only after the son left the employ of the corporation. The second situation is the one illustrative of an acquisition not motivated by an avoidance purpose.ⁿ⁸⁹

[d] Determining the Amount of Gain or Loss. The computation of gain or loss realized on a redemption of stock which qualifies as an exchange of stock, by virtue of *IRC Section 302(a)*, follows the pattern prescribed for all dispositions of property--the amount realized is compared with the adjusted basis of the stock. If the shareholder owns shares with varying bases and he can adequately identify the different lots, he can successfully control gain or loss by choosing the shares to be redeemed. But is this the only means by which the shareholder can exercise control over the tax consequences of the redemption, or is it also possible for him to achieve a desired result by choosing the number of shares to be redeemed? Put another way, can the consideration received on the redemption be greater or less than the market value of the surrendered shares? The Service has ruled that

"If a shareholder surrenders stock to a corporation for less than its fair market value, such surrender may be gift or compensation to the shareholders who remain interested in the corporation. Conversely, if a corporation pays more than fair market value for its stock, the payment may be compensation to the shareholder surrendering stock or may be a gift to him from the shareholders who remain interested in the corporation."ⁿ⁹⁰

Notwithstanding its ruling, the Service has not pressed the argument in litigation. An explanation may lie in the fact that many of the cases in which the consideration paid was an amount other than the fair market value of the stock involved redemptions which could be treated as exchanges only if found not essentially equivalent to a dividend, and that, in those cases, the Government focused solely on the issue of dividend equivalence.ⁿ⁹¹

A second problem concerns the deductibility of losses sustained in redemptions. Since such losses are incurred in a transaction entered into for profit, they meet the test of deductibility for individuals contained in *IRC Section 165(c)(2)*. However, if the shareholder owns directly or indirectly more than 50 percent of the outstanding stock of the corporation prior to the redemption, the loss will be disallowed by *IRC Section 267(a)(1)*.ⁿ⁹² The exception found therein for losses incurred in corporate liquidations has been held inapplicable to stock redemptions.ⁿ⁹³

[3] Redemptions Not Treated as Exchanges

Any redemption which cannot qualify as an exchange of stock will be subject to the rules of *IRC Section 301*.ⁿ¹ If the corporation has sufficient earnings and profits, the entire distribution will be taxed as a dividend. To the extent that earnings and profits are insufficient to cover the distribution, the basis of the shareholder's stock will be reduced, with any excess of the distribution over basis treated as a payment in exchange for the stock.

Of interest is the effect on basis of a redemption taxed wholly as a dividend. The problem does not arise in the ordinary distribution; the shareholder receiving the distribution continues to hold all his shares. But a different situation is presented when a redemption has the effect of a dividend, for here the shareholder has parted with some of his shares. The question posed is whether the basis of the surrendered shares is forever lost or whether it is transferred to the remaining shares. The only guide to the treatment of basis is found in the regulations, which direct "proper adjustment of the basis of the remaining stock ..." ⁿ² and which show by way of example that "proper adjustment" is achieved by adding the basis of the redeemed shares to the basis of the shares remaining after the distribution.ⁿ³

Suppose, however, application of the attribution rules causes a complete redemption of the shareholder's stock to be taxed as a dividend. Here, the regulations call for a shift of the "lost" basis to the shares owned by the attributing stockholder.ⁿ⁴

Recently proposed regulations would replace the reassignment of basis rules in *Treasury Regulation Section 1.302-2(c)* with new rules for determining the basis of stock remaining in the hands of a shareholder after a redemption which is

treated as "essentially equivalent to a dividend."⁵

When the redeemed shareholder continues to own stock in the corporation after the "essentially equivalent to a dividend" redemption, and the remaining shares are the same class of stock as the redeemed shares, any unused basis in the redeemed shares is added to the basis of the shareholder's remaining shares. Mechanically, the proposed regulations accomplish this reassignment by assuming a hypothetical recapitalization ("E" reorganization) in which the redeemed shareholder surrenders all the stock he owned directly in the redeemed class before the redemption, including the redeemed shares, and receives in exchange the number of shares he actually holds after the redemption. Basis is then assigned to the remaining shares under the rules of *IRC Section 358* and *Treasury Regulation Section 1.358-2*.⁶ The net result is similar to existing law except that, unlike the current regulations, the proposed regulations do not permit reassignment of basis if the redeemed shareholder's remaining shares are in a different class of stock from the shares that were redeemed.

When the redeemed shareholder either does not directly own any remaining shares in the corporation after the redemption, or does not own any shares of stock of the same class as the redeemed shares, the proposed regulations treat the redeemed shares as having been disposed of at a loss equal to their basis on the date of the redemption.⁷ The amount, character and source of the loss are determined on the date of the redemption,⁸ but the loss itself is not taken into account until the "inclusion date."⁹ The inclusion date occurs on the earlier of (1) the first date on which the facts are such that the redemption would have qualified as a "sale or exchange" under the criteria of *IRC Sections 301(b)(1), (b)(2) or (b)(3)* had the same facts been in existence on the actual date of the redemption, or (2) the first date on which all classes of the redeeming corporation's stock become worthless within the meaning of *IRC Section 165(g)*.¹⁰

Note that if a redemption is "essentially equivalent to a dividend" but the redeeming corporation has no current or accumulated earnings and profits, or the redemption price exceeds its earnings and profits, the non-dividend portion of the redemption distribution first reduces the basis in the stock to zero, and then is treated as a gain from the sale or exchange of property. *IRC Sections 301(c)(2) and (c)(3)*. The proposed regulations provide that the redeemed shareholder must treat the redemption proceeds as though they were distributed in respect of all of the shareholder's stock in the redeemed class, not merely the shares actually redeemed, on a pro rata basis.¹¹

The principles of the proposed regulations are illustrated in the following examples:

Example 1:

A owns 100 shares of Corporation X's one class of stock. 50 shares (Block 1) were acquired for \$2 a share (\$100) and 50 shares (Block 2) were acquired at a later date for \$4 per share (\$200). The remaining 100 shares of Corporation X are owned by B, A's wife. On December 31, 2009, X redeems all of A's Block 2 shares for \$6 per share (\$300). On the date of the redemption, X has no current or accumulated earnings and profits.

The redemption does not qualify as a "sale or exchange" under *IRC § 302(b)* because of A's remaining ownership of X stock as well as his constructive ownership of B's stock. However, X had no earnings and profits so the redemption proceeds are effectively taxed as though received in a "sale or exchange" under *IRC § 301(c)(2) and (c)(3)*. The proposed regulations treat the \$300 redemption proceeds as if distributed pro rata with respect to each share of X's 100 shares of stock (since all are in the same class), a distribution of \$3 per share (\$300/100). Since A's Block 1 shares have a basis of \$2 per share, A applies \$2 of the \$3 per share distribution to reduce the basis of the Block 1 shares to zero, leaving him with a gain of \$1 per Block 1 share or a total gain of \$50. The \$3 per share deemed distribution reduces the \$4 basis in A's Block 2 shares to \$1, leaving each of his 50 Block 2 share with a reduced basis of \$1 per share. A is further deemed to have exchanged all of his pre-redemption Block 1 and Block 2 shares for 50 "new" shares (i.e., the number of shares he has left) of Corporation X stock pursuant to an "E" reorganization/recapitalization. Under the principles of Proposed *Treasury Regulation Section 1.358-2*,

one half of A's 50 "new" shares inherits the post-redemption basis of his Block 1 shares, *i.e.*, zero, while the total basis of his Block 2 shares (\$50) is assigned pro rata to the remaining half ($\$50/25 \text{ shares} = \$2 \text{ per share}$).ⁿ¹²

Example 2:

The facts are the same as Example 1, except that on December 31, 2010, when X still has no current or accumulated earnings and profits, Corporation X redeems A's remaining 50 shares for \$.80 per share or \$40. A does not file an agreement described in *IRC Section 302(c)(2)(A)(iii)* waiving family attribution under *IRC Section 318*. Two years later, on December 31, 2012, B sells all of her stock in Corporation X to Z, an unrelated party.

As in the previous example, the tax consequences of the redemption of A's stock are determined by *IRC Section 301(c)(2)* and *(c)(3)*, and the proceeds are deemed distributed pro rata to each of A's 50 shares (\$.80 per share). Since half of A's shares have a zero basis, A has a \$20 gain on those shares ($25 \times \$.80 = \$20$). The remaining half (25 shares) have a basis of \$2 per share, leaving A with a net loss of \$1.20 per share ($\$.80 - \$2$) or a total loss of \$30 ($25 \text{ shares} \times \$1.20 \text{ per share}$). While the \$20 gain is taxable in 2010, the \$30 loss must be deferred until the "inclusion date." In the example, the inclusion date occurs in 2012, when B, A's wife, sells her stock to an unrelated party. Since B's shares have been sold outside the family they can no longer be attributed to A, and would not have been attributable to A on the redemption date had B's shares been sold on that date. Note, however, that although the loss deduction is deferred until 2012, the amount, character and source of the loss are determined as of December 31, 2010, the date on which A's shares were actually redeemed.ⁿ¹³

Example 3:

The facts are the same as Example 1 except (1) A's Block 2 shares represent preferred stock of X, and (2) X's earnings and profits are sufficient to cover the entire \$300 redemption price for the preferred.

In this example, the entire \$300 would be taxable to A as a dividend under *IRC § 301(c)(1)*. No part of A's basis of \$4 per share in the 50 shares of preferred would be deducted from the proceeds, nor would such basis be assigned to A's Block 1 common shares since the common is a different class of stock. A's \$200 basis in the 50 redeemed preferred shares becomes a "deferred loss" which cannot be taken into account until the inclusion date.ⁿ¹⁴

The proposed regulations leave open questions as to what happens to a deferred loss when the redeemed shareholder is a flow-through entity: a partnership, trust, or S corporation. The primary issue under study is whether an "outside" basis adjustment in an ownership interest in such an entity should reflect the deferred loss at the time of a dividend equivalent redemption or whether such an adjustment should await the inclusion date.^{n14.1}

On the final inclusion date, the redeemed shareholder is permitted to take into account the loss attributable to the basis of the redeemed stock, reduced by the amount of any loss taken into account on an accelerated loss inclusion date.ⁿ¹⁵ On an accelerated loss inclusion date, the redeemed shareholder is permitted to take into account the loss attributable to the basis of the redeemed stock to the extent of the lesser of (i) the amount of the loss reduced by the amount of any loss previously taken into account on an accelerated loss inclusion date, or (ii) the amount of gain recognized with respect to stock of the redeeming corporation that must be taken into account by the shareholder on the accelerated loss inclusion date.ⁿ¹⁶ Any loss attributable to the basis of the redeemed stock that has not been permitted to be taken into account is treated as a net operating loss carryforward or a capital loss carryforward, as applicable.ⁿ¹⁷ In applying the net operating loss carryforward and capital loss carryforward rules, the loss attributable to the basis of the redeemed stock is treated as occurring in the taxable year in which the shareholder is permitted to take the loss into account, not the taxable year of the redemption.ⁿ¹⁸ If the redeemed shareholder is a corporation, any loss attributable to the basis of redeemed stock is not reflected in the corporation's earnings and profits before it is taken into account.ⁿ¹⁹

[4] Effect of Redemptions on Other Shareholdersⁿ¹

Suppose that the outstanding stock of *X Corp.* is owned equally by *A* and *B*. Does a redemption of all of *A*'s stock have any tax effect on *B*? The answer turns on *B*'s relationship to the redemption, i.e., whether the redemption takes place at a time when *B* is subject to an unconditional obligation to purchase *A*'s stock. If he is, then the redemption will produce dividend income for *B*; ⁿ² if he is not, it will be without tax consequence for him.ⁿ³

The important determination is whether the continuing shareholder's obligation has become primary and unconditional at the time of the redemption, since dividend treatment will not automatically ensue from the fact that the corporation, in purchasing the shares, satisfies the remaining shareholder's executory contractual obligation.ⁿ⁴ Thus, if *A* and *B* had agreed that *B* would purchase *A*'s stock when *A* left the employ of *X Corp.* or when *A* died, *B*'s obligation would become primary and unconditional immediately upon the termination of *A*'s employment or upon his death.ⁿ⁵ If *B* were to assign his purchase contract to *X Corp.* prior to the happening of the specified event, a later redemption of *A*'s stock by the corporation would have no tax effect on *B*; an assignment after the event would give him a dividend.

On the other hand, an executory obligation can be so cast that it becomes unconditional only if the obligor takes further action with respect to his promise to purchase. For example, if *B* agrees that upon *A*'s death, he will either purchase *A*'s shares or vote the stock for liquidation, the existence of the ability to liquidate prevents the promise from becoming unconditional.ⁿ⁶ (But if after *A*'s death, *B* enters into a binding agreement to purchase the stock from *A*'s estate, a subsequent redemption of the shares will produce a dividend for *B*.) A similar result will obtain if the contract gives *A*'s estate the right to sell shares to anyone, and this right has not been foreclosed at the time of redemption.ⁿ⁷ Finally, the redemption will not adversely affect *B*, if his promise creates only a secondary liability, e.g., if he agrees to purchase the shares from *A*'s estate only in the event the corporation fails to do so.ⁿ⁸

Dividend consequences can be avoided, even though the continuing shareholder's promise appears to be primary and unconditional, if he is able to prove that he was acting merely as an agent or conduit for the real obligor, the corporation.ⁿ⁹ The claim is easier made than sustained; the burden of proving agency rests upon the taxpayer.ⁿ¹⁰

A number of cases have involved the redemption of closely held corporation stock from tax-exempt organizations to which the stock had been donated.ⁿ¹¹ In each of these cases, the Commissioner argued that the redemption saddled the contributing taxpayer with dividend income. In each, his attack proved singularly unsuccessful. Although the redemption was contemplated, the donee was never under an obligation to offer the shares to the corporation. Thus, in fact and in substance, the organization was the shareholder whose stock was redeemed.

See § 1.03[2][e] above for a discussion of the effect of a redemption of stock as part of a property settlement attendant upon a divorce.

FOOTNOTES:

(n1)Footnote 1. *IRC* § 318(a); see generally Wolfberg, "Understanding the Attribution Rules: A Guide Through a Confusing Area: A Checklist," 30 *NYU Inst on Fed Tax* 1313 (1972); Goldstein, "Attribution Rules: Undue Multiplicity, Complexity Can Create Liabilities," 15 *Tul Tax Inst* 384 (1966); Ringel, Surrey & Warren, "Attribution of Stock Ownership in The Internal Revenue Code," 72 *Harv L Rev* 209 (1958).

(n2)Footnote 2. A person is not the spouse of another for purposes of *IRC* § 318(a) if legally separated under a decree of divorce or separate maintenance. *IRC* § 318(a)(1)(A)(i).

(n3)Footnote 3. A legally adopted child of an individual is treated as the individual's child by blood. *IRC* § 318(a)(1)(B).

(n4)Footnote 4. *IRC* §§ 267(c)(2), (4), 544(a)(2).

(n5)Footnote 5. *IRC § 318(a)(5)(B)*. This prevents attribution from brother to brother through a parent, an attribution not contemplated by *IRC § 318(a)(1)*. *Treas Reg § 1.318-4(b)*.

(n6)Footnote 6. *IRC § 318(a)(5)(A)*. Unless otherwise provided, stock constructively owned by a person is deemed actually owned by such person, and may be reattributed if one of the constructive ownership rules of *IRC § 318(a)* is applicable.

(n7)Footnote 7. *IRC § 318(a)(2)(A)*.

(n8)Footnote 8. *IRC § 318(a)(3)(A)*. The provision was held constitutional in *Bloch v US*, 261 F Supp 597, 606 (SD Tex 1966) , *affd per curiam* 386 F2d 839 (5th Cir 1967) . A partnership which has ceased business, but continues in existence to collect moneys due, continues to be subject to the attribution rules. *Baker Commodities, Inc v Commr*, 48 TC 374 (1967) , *affd* 415 F2d 519 (9th Cir 1969) , *cert denied* 397 US 988 .

(n9)Footnote 9. *Treas Reg § 1.318-2(c)*, *Ex (1)*.

(n10)Footnote 10. *IRC § 318(a)(5)(C)*.

(n11)Footnote 11. *IRC § 318(a)(5)(A)*. In applying this rule, and not for the purpose of determining whether its stock is constructively owned by any person, an S corporation is treated as a partnership and its shareholders as the partners thereof. *IRC § 318(a)(5)*.

(n12)Footnote 12. *IRC §§ 318(a)(2)(A)*, *318(a)(3)(A)*. The beneficiary's proportionate interest in the estate is measured as of the date of redemption. This takes into account any fluctuations in that interest between death and redemption. *Rev Rul 58-111*, 1958-1 CB 173 .

(n13)Footnote 13. *Treas Reg § 1.318-3(a)*.

(n14)Footnote 14. *Id*.

(n15)Footnote 15. *Id*; *Est of Weiskopf v Commr*, 77 TC 135 (1981) .

(n16)Footnote 16. *Rev Rul 60-18*, 1960-1 CB 145 ; see also *Rev Rul 71-261*, 1971-1 CB 108 , and *Rev Rul 67-24*, 1967-1 CB 75 (stock owned by beneficiary of unfunded residuary trust attributed to trust and then to estate).

(n17)Footnote 17. 404 F2d 411 (6th Cir 1968) , *affg* 263 F Supp 703 (ED Ky 1967) .

(n18)Footnote 18. *Treas Reg § 1.318-3(a)*, *Exs (1) and (2)*.

(n19)Footnote 19. *IRC § 318(a)(5)(A)*, *(C)*.

(n20)Footnote 20. *IRC § 318(a)(2)(B)(i)*; *Treas Reg § 1.318-3(b)*. The factors and methods prescribed in the Estate Tax Regulations for use in ascertaining the value of an interest for estate tax purposes are to be used in determining a beneficiary's actual interest in a trust.

A valid, binding renunciation of a beneficiary's interest in a trust will eliminate attribution under *IRC § 318(a)(2)(B)*. *Rev Rul 71-211*, 1971-1 CB 112 .

If a surviving spouse is entitled to all the income from a trust for life and has a power of appointment over the corpus of the trust, and if the surviving spouse's children are the takers in default of the exercise of the power, attribution must be computed as if the surviving spouse exercised the power in favor of the children, so that they will be considered the beneficiaries of the trust, unless there is evidence that the power has been differently exercised. *Rev Proc 77-37*, 1977-2 CB 568 .

(n21)Footnote 21. *IRC § 318(a)(2)(B)(ii); Rev Rul 72-471, 1972-2 CB 201 .*

(n22)Footnote 22. *S Rep No 1622, 83rd Cong, 2d Sess, 253 (1954).*

(n23)Footnote 23. *IRC § 318(a)(3)(B)(i).*

(n24)Footnote 24. *Treas Reg § 1.318-2(c), Ex (2).*

(n25)Footnote 25. *Rev Rul 76-213, 1976-1 CB 92 .*

(n26)Footnote 26. *IRC § 318(a)(3)(B)(ii).*

(n27)Footnote 27. *IRC § 318(a)(5)(C).*

(n28)Footnote 28. *IRC § 318(a)(5)(A).*

(n29)Footnote 29. *IRC §§ 318(a)(2)(C), 318(a)(3)(C); Treas Reg § 1.318-1(b)(3).* The 50 percent ownership requirement is changed in some cases, eg, *IRC § 304* and *IRC § 856*.

(n30)Footnote 30. *IRC § 318(a)(2)(C).*

(n31)Footnote 31. *IRC § 318(a)(3)(C).*

(n32)Footnote 32. *Treas Reg § 1.318-1(b)(1).*

(n33)Footnote 33. *IRC § 318(a)(5)(C).*

(n34)Footnote 34. *IRC § 318(a)(5)(A).* In applying this rule, and not for the purpose of determining whether its stock is constructively owned by any person, an S corporation is treated as a partnership and its shareholders as the partners thereof. *IRC § 318(a)(5).*

(n35)Footnote 35. *IRC § 318(a)(4).* An option to acquire its own stock will not make a corporation the owner thereof for the purpose of reattributing such stock. *Rev Rul 69-562, 1969-2 CB 47 .*

(n36)Footnote 36. *IRC § 318(a)(5)(A), (D).*

(n37)Footnote 37. *IRC § 318(a)(5)(A), (C); Treas Reg § 1.318-4(c)(2).* This applies to partnerships, trusts, and estates as well as corporations.

(n38)Footnote 38. *334 F2d 275 (10th Cir 1964) . Accord, Northwestern Steel & Supply Co v Commr, 60 TC 356 (1973) .*

(n39)Footnote 39. *Rev Rul 68-601, 1968-2 CB 124 .* The Ruling also permits warrants to purchase stock and convertible debentures to be considered options if the shareholder has the right to acquire the stock at his election. An option exercisable only after the lapse of a fixed period of time is still an option for purposes of *IRC § 318(a)(4)*. *Rev Rul 89-64, 1989-1 CB 91 .*

The Sixth Circuit used the fact that an unrelated person held options to purchase stock of the corporation to find that a redemption produced a meaningful reduction in ownership. *Patterson Trust v US, 729 F2d 1089 (6th Cir 1984) .*

(n40)Footnote 1. *IRC § 302(b)(1)-(4).* Partial liquidations became subject to the redemption provisions as part of the Tax Equity and Fiscal Responsibility Act of 1982. The amendment affects distributions made after Aug 31, 1982. See Ch 6, for a discussion of partial liquidations.

Rev Proc 86-18, 1986-1 CB 551 , reprinted in Appendix B, sets forth the information to be included in a request for ruling under *IRC § 302*.

The Service will not issue rulings as to whether *IRC § 302(b)* applies if the consideration consists entirely or partly of a promise to pay an amount based or contingent upon future earnings, or if after the redemption, the corporation will use property owned by the shareholder and payments for such use depend on future earnings or are subordinate to claims of general creditors. Payments for the use of property are not considered to be dependent upon future earnings merely because they are based on a fixed percentage of sales or receipts. *Rev Proc 2009-3, 2009-1 IRB 107* . The no-ruling policy also applies if the shareholder's stock is placed in escrow to secure payment of notes given as part of the consideration, with the possibility that the stock will be returned to the shareholder upon the happening of specified defaults.

Rulings as to the tax effect of a redemption of stock for notes will not ordinarily be issued if the payments on the notes are to be made over a period of more than 15 years.

(n41)Footnote 2. *Worthy v Commr*, 62 TC 303 (1974) (redemption of stock not acquired for investment produced ordinary compensation income).

(n42)Footnote 3. HR Rep No 1337, 83d Cong, 2d Sess 73 (1954).

(n43)Footnote 4. *Wilson v US*, 154 F Supp 341, 343 (NDNY 1957) , *affd* 257 F2d 534 (2d Cir 1958) , *cert denied* 358 US 893 . See also Bonovitz, "Distributions (not) Equivalent to a Dividend: Business Contractions: Redemptions: Partial Liquidation Aspects," 28 *NYU Inst on Fed Tax* 731 (1970); Moore, "Dividend Equivalency--Taxation of Distributions in Redemption of Stock," 19 *Tax L Rev* 249 (1964); Bittker, "Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954," 9 *Stan L Rev* 13, 41-45 (1956); Murphy, "Dividend Equivalency--The End of the Beginning?" 10 *Tax L Rev* 213 (1954); Note, "Redemptions and Partial Liquidations Under the 1954 Internal Revenue Code: The Dividend Equivalence Test," 103 *U Pa L Rev* 936 (1955).

An argument that share redemptions of publicly held stock should be treated as dividends can be found in Chirelstein, "Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares," 78 *Yale L J* 739 (1969). Another view is Bacon, "Share Redemptions by Publicly Held Companies: A New Look at Dividend Equivalence," 26 *Tax L Rev* 283 (1971).

(n44)Footnote 5. Eg, *US v Fewell*, 255 F2d 496 (5th Cir 1958) ; *Keefe v Cote*, 213 F2d 651 (1st Cir 1951) ; *contra*, *Northup v US*, 240 F2d 304 (2d Cir 1957) .

(n45)Footnote 6. Eg, *US v Fewell*, 255 F2d 496 (5th Cir 1958) ; *Jones v Griffin*, 216 F2d 885 (10th Cir 1954) .

(n46)Footnote 7. Additional criteria considered by the courts included whether the initiative for the redemption came from the corporation or redeeming shareholders; whether earnings and profits were available for dividends and the prior dividend history of the corporation; and whether the redeemed stock was canceled and retired or held as treasury stock.

(n47)Footnote 8. S Rep No 1622, 83d Cong, 2d Sess 44-45 (1954).

(n48)Footnote 9. *Id* at 234. Not to be considered in making the determination of dividend equivalence is the fact that the distribution fails to satisfy the "safe harbor" redemption provisions. *IRC § 302(b)(5)*.

(n49)Footnote 10. *Kerr v Commr*, 326 F2d 225 (9th Cir 1964) , *cert denied* 377 US 963 ; *Commr v Berenbaum*, 369 F2d 337 (10th Cir 1966) ; *Bradbury v Commr*, 298 F2d 111 (1st Cir 1962) ; *Sorem v Commr*, 334 F2d 275 (10th Cir 1964) ; *Herzog v Commr*, TC Memo 1963-303 . This did not necessarily mean victory for the taxpayer; the presence of a bona fide business purpose standing alone was insufficient to overcome the net effect of the distribution.

(n50)Footnote 11. *Hasbrook v US*, 343 F2d 811 (2d Cir 1965) , cert denied 382 US 834 ; *Levin v Commr*, 385 F2d 521 (2d Cir 1967) ; *Blount v Commr*, 425 F2d 921 (2d Cir 1969) . The First Circuit was willing to apply the strict net effect test if the corporation had only one shareholder. *Wiseman v US*, 371 F2d 816 (1st Cir 1967) . The Third Circuit had adopted this test for cases arising under the 1939 Code. Eg, *Kessner v Commr*, 248 F2d 943 (3d Cir 1957) .

(n51)Footnote 12. 397 US 301 (1970) .

(n52)Footnote 13. 397 US at 311-312 .

(n53)Footnote 14. 397 US at 313 .

A meaningful reduction was found in *McDonald v Commr*, 52 TC 82 (1969) , where a redemption of the taxpayer's preferred stock was coupled with an exchange of his common stock for voting stock of another corporation. The Service's concession that the exchange and redemption were separate transactions led the Tax Court to decide a single issue, namely, the tax effect of the redemption. The Service is now of that view that there was only one transaction in which stock was acquired for stock and cash, and that *McDonald* was presented to the court on the basis of an improper characterization of the facts; it will not treat the case as an appropriate precedent. *Rev Rul 75-360, 1975-2 CB 110* .

(n54)Footnote 15. Moore, N 4, *supra*, at 252.

(n55)Footnote 16. *Treas Reg § 1.302-2(b)*.

(n56)Footnote 17. Eg, *Bradbury v Commr*, N 8, *supra*; *Estate of Squier v Commr*, 35 TC 950 (1961) , *nonacq 1978-2 CB 4* .

(n57)Footnote 18. *TC Memo 1961-176* .

(n58)Footnote 19. N 17, *supra*.

(n59)Footnote 20. *Id* at 955-956. Emphasis in the original.

(n60)Footnote 21. 61 TC 398 (1973) .

(n61)Footnote 22. 510 F2d 43 (1st Cir 1975) .

(n62)Footnote 23. No further proceedings were reported. The point was raised again in *Benjamin v Commr*, 66 TC 1084 (1976) , *affd* 592 F2d 1259 (5th Cir 1979) , but the Tax Court did not have to reach a decision on the issue for it found that the taxpayer retained absolute control of the corporation. *Haft Trust, Parker*, and *Squier* were distinguished on their facts.

The Service will not follow the decision in *Haft Trust*. *Rev Rul 80-26, 1980-1 CB 66* .

(n63)Footnote 24. Rigid application of the attribution rules is warranted when the redemption is tested under *IRC § 302(b)(2)*, or *IRC § 302(b)(3)*, for the question to be resolved in such case is not the effect of the distribution, but whether a specifically described test has been met.

(n64)Footnote 25. The Supreme Court did not consider this issue in *Davis* since there was no indication of disagreement between the taxpayer and his children.

The Tax Court continues to hold that family discord does not nullify the attribution rules, but recognizes that hostility can be relevant in determining whether a reduction in stock ownership is meaningful. *Cerone v Commr*, 87 TC (1986); *Metzger Trust v Commr*, 76 TC 42 (1981) , *affd* 693 F2d 459 (5th Cir 1982), *cert denied* 463 US 1207 .

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(n65)Footnote 26. *US v Davis*, N 12, *supra*; *Television Indus, Inc v Commr*, 284 F2d 322 (2d Cir 1960) ; *Tabery v Commr*, 354 F2d 422 (9th Cir 1965) ; *Est of Freeman v Commr*, TC Memo 1964-306 ; *Treas Reg* § 1.302-2(b).

(n66)Footnote 27. *Title Ins & Trust Company v US*, 484 F2d 462 (9th Cir 1973) ; *Brown v US*, 345 F Supp 241 (SD Ohio 1972) , *affd* 32 AFTR2d 73-5712 (6th Cir 1973) , *cert denied* 414 US 1011 ; *Sawelson v Commr*, 61 TC 109 (1973) . The increase in interest resulted from the fact that stock owned by other shareholders was redeemed as well.

(n67)Footnote 28. Eg, *Bradbury v Commr*, N 10, *supra*; *Kerr v Commr*, N 10, *supra*; *Humphrey v Commr*, 39 TC 199 (1962) ; *Est of Runnels v Commr*, 54 TC 762 (1970) .

(n68)Footnote 29. See § 5.02[1], N 38, *supra*.

(n69)Footnote 30. 226 F Supp 814 (D Mass 1964) , *affd* 345 F2d 761 (1st Cir 1965) .

(n70)Footnote 31. 54 TC 408 (1970) . The case was decided less than three weeks prior to the Supreme Court's decision in *Davis*. The Tax Court based its decision in part on the absence of a business purpose and the lack of corporate contraction.

(n71)Footnote 32. N 17, *supra*.

(n72)Footnote 33. Retention of control also resulted in dividend equivalence in *Gloninger v Commr*, TC Memo 1963-310 , *affd per curiam* 339 F2d 211 (3d Cir 1964) ; *Levin v Commr*, N 11, *supra*; and *Rev Rul* 56-182, 1956-1 CB 157 . Loss of control was considered significant in *Rickey v US*, 592 F2d 1251 (5th Cir 1979) , *Parker*, N 18, *supra*; and *Ferris v US*, 135 F Supp 286 (Ct Cl 1955) .

A reduction in ownership from 78 percent to 50 percent was held to be a meaningful reduction in *REP Sales, Inc v US*, 57 AFTR2d 86-1282 (SD W Va 1986) ; the transaction had the effect of converting a controlling percentage into an equal interest. See also *Patterson Trust v US*, 729 F2d 1089 (6th Cir 1984) , where a reduction from 80 percent to 62.8 percent was meaningful since the taxpayer no longer held the two thirds vote necessary for control.

(n73)Footnote 34. *Rev Rul* 76-364, 1976-2 CB 91 ; *Rev Rul* 75-502, 1975-2 CB 111 . Other factors to consider besides the right to vote and exercise control are the right to participate in current earnings and accumulated surplus and the right to share in net assets on liquidation.

(n74)Footnote 35. Although *Davis* concerned a taxpayer who sought to overcome the net effect of the distribution, the tenor of the decision is that motive is irrelevant in all events. Thus, a redemption which produced a meaningful reduction should not be treated as the equivalent of a dividend because no business purpose was present.

(n75)Footnote 36. *Rev Rul* 76-385, 1976-2 CB 92 (interest in publicly listed corporation minimal); *Rev Rul* 75-512, 1975-2 CB 112 (19 percent reduction in interest; *Rev Rul* 56-183, 1956-1 CB 161 (stockholding decreased from 11 percent to 9 percent).

(n76)Footnote 37. Eg, *Bloch v US*, 261 F Supp 597 (SD Tex 1966) , *affd per curiam* 386 F2d 839 (5th Cir 1967)

(n77)Footnote 38. *Bloch v US*, 261 F Supp at 612-613 .

(n78)Footnote 39. The argument was advanced in *Parker v Commr*, N 18, *supra*.

(n79)Footnote 40. *Rev Rul* 76-385 , N 36, *supra*, citing S Rep No 1622, 83rd Cong, 2d Sess 44-45 (1954).

(n80)Footnote 41. *Ringmaster, Inc v Commr*, TC Memo 1962-187 ; *Plimer v Commr*, TC Memo 1961-218 . See also *Est of Lammerts v Commr*, 54 TC 420 (1970) , where the shares were redeemed from a person who actually and constructively owned all of the stock of the corporation. However, on appeal, the parties in *Lammerts* stipulated that the

transaction was governed by *IRC § 303* (§ 5.03, *infra*). *Lammerts v Commr*, 456 F2d 681 (2d Cir 1972) .

(n81)Footnote 42. *Ballenger v US*, 301 F2d 192 (4th Cir 1962) ; *Commr v Berenbaum*, N 10, *supra*; *Heman v Commr*, 283 F2d 227 (8th Cir 1960) ; *Rev Rul 59-258*, 1959-2 CB 105 .

(n82)Footnote 43. *Rev Rul 77-426*, 1977-2 CB 87 .

(n83)Footnote 44. 1968-2 CB 123 .

(n84)Footnote 45. 1956-2 CB 177 .

(n85)Footnote 46. 1955-2 CB 221 .

(n86)Footnote 47. 408 F2d 1139 (6th Cir 1969) ; see also *Commr v Est of Antrim*, 395 F2d 430 (4th Cir 1968) . In *Rev Rul 56-521*, 1956-2 CB 174 , a redemption of preferred stock from the sole owner of the common stock of a corporation was considered a dividend, but not so the redemption of preferred from his brother and sister.

(n87)Footnote 48. 338 F2d 815 (2d Cir 1964) .

(n88)Footnote 49. *Rev Rul 85-106*, 1985-32 CB 116 (no change in shareholder's actual and constructive ownership of voting and nonvoting common stock following redemption of preferred stock).

(n89)Footnote 50. *IRC § 302(b)(2)(B)*. The Regulations provide a general rule that stock which does not have voting rights until the happening of an event, such as a default in the payment of dividends on preferred stock, will not be considered voting stock until the happening of the specified event. *Treas Reg § 1.302-3(a)*. See also *Cornwall v Commr*, 48 TC 736 (1967) , *acq* 1968-1 CB 2 , where the redemption did not fit *IRC § 302(b)(2)* although the post-redemption ownership percentage was less than 80 percent of the preredemption percentage; voting rights were not keyed to stock ownership.

(n90)Footnote 51. *IRC § 302(b)(2)(C)*.

(n91)Footnote 52. *Id.* A redemption of voting preferred stock from a shareholder who owns no common stock can qualify as a substantially disproportionate redemption, if the tests prescribed by *IRC § 302(b)(2)* are met. *Rev Rul 81-41*, 1981-1 CB 121 .

(n92)Footnote 53. If:

X represents the number of shares which must be redeemed;

T represents the total shares outstanding prior to the redemption; and

S represents the number of shares owned by the shareholder prior to the redemption;

the number of shares which must be redeemed in a single shareholder redemption in order to make the postredemption percentage exactly 80 percent of the preredemption percentage is:

$$X = \frac{ST}{5T - 4S}$$

Since the statute requires the proportion of ownership to be less than 80 percent of the proportion owned before the

redemption, the next full share above the number indicated by the formula must be redeemed in order to satisfy the 80 percent requirement. (Eg, if $X = 43$, redeem 44; if $X = 43.2$, still redeem 44).

(n93)Footnote 54. The regulations state that the requirements of *IRC § 302(b)(2)* are to be applied "only with respect to stock which is issued and outstanding in the hands of the shareholders." *Treas Reg § 1.302-3(a)*. This would seem to preclude any reference to treasury stock. Yet in *Bloch v US*, N 37, *supra*, the court tested the redemption by considering treasury stock as outstanding stock. However, since the redemption was not disproportionate whether or not treasury stock was so considered, the court did not have to rule on the effect of treasury stock on the disproportionateness of the redemption.

(n94)Footnote 55. *IRC § 302(b)(2)(C)*.

(n95)Footnote 56. *Rev Rul 87-88, 1987-2 CB 81*. The Service opined:

To conclude otherwise would require that, notwithstanding a redemption of one class of common stock in an amount sufficient to reduce the shareholder's aggregate common stock ownership by more than 20 percent in value, every other class of common stock owned by the shareholder must be subject to a redemption.

(n96)Footnote 57. *Treas Reg § 1.302-3(a)*. Formulas for computing the shares required to be redeemed in multishareholder redemptions can be found in Ginsburg, "How to Compute Multiple Substantially Disproportionate Stock Redemptions," 37 *Taxes* 387 (1959); Price, "The Disproportionate Redemption Formula," *Id* at 633; Freret, "A Simplified Computation for Substantially Disproportionate Stock Redemptions," *Id* at 767.

X corporation had one class of stock owned by four unrelated individuals. *A* owned 1,466 shares, *B* owned 210 shares, *C* owned 200 shares, and *D* owned 155 shares. The corporation had a repurchase agreement that required each shareholder other than *A* to tender his shares to the corporation in the event he ceased to be actively connected with the business. On January 1, *B* informed *A* that he intended to resign on March 22. On March 15, *A* redeemed 902 of his shares, causing his stock ownership to fall below 50 percent for the period of time until *B*'s stock was redeemed. Although standing alone, the redemption from *A* was substantially disproportionate, the Service ruled that the two redemptions had to be considered in the aggregate when the first shareholder's redemption was undertaken with knowledge of the impending redemption of the second's shares, despite the absence of any specific agreement between the two. *Rev Rul 85-14, 1985-1 CB 92*.

(n97)Footnote 58. *IRC § 302(b)(2)(D)*. The Service has stated that, for this purpose, the plan "may not be so infinitely elastic that it can encompass any separate and unrelated redemptions however closely in time proximity they occur with respect to each other but neither is it so narrow in scope that minds must be found to have embarked upon a common adventure before redemptions can be lashed to its yoke." *Ltr Rul 8316019*.

(n98)Footnote 59. Before the redemption, *A* would own 50 percent of the voting stock, while after the redemption he would own 39.4 percent.

(n99)Footnote 60. The preredemption proportion would be 100/165 or 60.6 percent; the post-redemption proportion would be 60/125 or 48 percent.

(n100)Footnote 61. Following the total redemption, *A*'s percentage would be 65/125 (greater than 50 percent and therefore automatically disqualified). *B* would still own only 48 percent of the outstanding stock, but this would be compared with the 50 percent he owned prior to the series of redemptions.

(n101)Footnote 62. *Treas Reg § 1.302-3(a)*.

(n102)Footnote 63. *Id.* The preferred stock cannot be *IRC* § 306 stock (see § 7.02, *infra*).

Capital treatment will also be available where the nonvoting preferred is the only stock the taxpayer owns; the redemption in such case works a complete termination of his interest.

(n103)Footnote 64. *IRC* § 302(b)(3).

(n104)Footnote 65. *Treas Reg* 111, § 29.115-9 (1951); *Zenz v Quinlivan*, 213 F2d 914 (2d Cir 1954) ; *Summerfield v US*, 145 F Supp 104 (ED Mich 1956) , *affd* 249 F2d 446 (6th Cir 1957) ; *Tiffany v Commr*, 16 TC 1443 (1951) , *acq* 1957-1 CB 5 ; *Rev Rul* 54-458, 1954-2 CB 167 .

(n105)Footnote 66. An attempt to use the waiver rule failed when it was held that the redemption was from an estate and not from its sole beneficiary, the remaining shareholder's mother. *Rev Rul* 68-388, 1968-2 CB 122 .

(n106)Footnote 67. *Rev Rul* 71-262, 1971-1 CB 110 .

(n107)Footnote 68. *Rev Rul* 72-471, 1972-2 CB 201 .

(n108)Footnote 69. *Rev Rul* 72-472, 1972-2 CB 202 , declared obsolete in *Rev Rul* 2003-99, 2003-37 IRB 388 .

(n109)Footnote 70. *Crawford v Commr*, 59 TC 830 (1973) , *acq* 1984-1 CB 1 . See also *Johnson Trust v Commr*, 71 TC 941 (1979) , *acq* 1984-1 CB 1 .

(n110)Footnote 71. The Fifth Circuit went even further and permitted the filing of a waiver by an estate to prevent attribution to the estate from its beneficiaries who were actual owners of the stock. *Rickey v US*, 592 F2d 1251 (5th Cir 1979) . The amendment is intended to overrule *Rickey*.

(n111)Footnote 72. *IRC* § 302(c)(2)(C), applicable to distributions after Aug 31, 1982. Conf Rep No 97-760, 97th Cong, 2d Sess 545 (1982).

(n112)Footnote 73. *IRC* § 302(c)(2)(A)(i), (ii). The leasing of property by the former shareholder to the corporation is not the retention of an interest. *Rev Rul* 77-467, 1977-2 CB 92 ; *Rev Rul* 70-639, 1970-2 CB 74 . See also *Hurst v Commr*, 124 TC 16 (2005) .

A redeemed shareholder's right to receive payments under an unfunded pension agreement after the redemption was not the retention of a prohibited interest where the payments related to pre-redemption employment. The payments were not dependent on the corporation's earnings and the ex-shareholder's pension claim was not subordinate to general creditors. *Rev Rul* 84-135, 1984-2 CB 80 .

Retention of an interest in a parent or subsidiary is equally prohibited. *Treas Reg* § 1.302-4(c). However, retention or acquisition of an interest will not be fatal if the redemption can also qualify as a substantially disproportionate redemption, as a partial liquidation, or a distribution which is not essentially limited to a dividend. *IRC* § 302(b)(5).

The prohibition applies to the redeemed shareholder. Members of his family can retain or acquire such interests. *Rev Rul* 71-562, 1971-2 CB 173 . Moreover, waiver of attribution is unnecessary if attribution does not exist after the redemption. *Rev Rul* 76-524, 1976-2 CB 94 .

(n113)Footnote 74. *IRC* § 302(c)(2)(C)(i)(I). The entity and related parties will be jointly and severally liable if any of them acquired an interest within the ten-year period. *IRC* § 302(c)(2)(C) (i)(II). Any tax deficiency resulting from the breach of the condition will be collected from a related party only when it cannot be assessed against or collected from the entity. Conf Rep No 97-760, 97th Cong, 2d Sess 545 (1982).

Disagreement between a father and son led to a redemption of the father's stock. Although the father resigned from his positions as president and a director, he continued to be employed by the corporation. This retained interest prevented waiver of the family attribution rules and turned the distribution into a dividend. The Tax Court continued to hold that there was no family hostility exception to the application of the attribution rules. *Cerone v Commr*, 87 TC 1 (1986).

(n114)Footnote 75. *Rev Rul 71-426*, 1972-2 CB 173. See also *Ltr Rul 199914017*, where the Service ruled that, if shareholders who had their stock in a family corporation redeemed became members of the trustee succession committees for trusts that continued to own stock in the corporation, the shareholders would be treated as retaining an interest in the corporation.

(n115)Footnote 76. *Rev Rul 81-223*, 1981-2 CB 83.

(n116)Footnote 77. *Rev Rul 79-334*, 1979-2 CB 127; *Rev Rul 72-380*, 1972-2 CB 201.

(n117)Footnote 78. *Rev Rul 70-104*, 1970-1 CB 66; *Rev Rul 59-119*, 1959-1 CB 68; but see *Rev Rul 54-408*, 1954-2 CB 165, approving employment for a limited time to train other employees. The later ruling concerned a redemption covered by the 1939 Code.

(n118)Footnote 79. *Lynch v Commr*, 83 TC 597 (1984), *revd* 801 F2d 1176 (9th Cir 1986); *Seda v Commr*, 82 TC 484 (1984); *Est of Lennard v Commr*, 61 TC 554 (1974), *nonacq* 1978-2 CB 3.

The Ninth Circuit rejected the reasoning of the Tax Court in *Lynch* as undermining congressional intent to promote tax certainty, and reversed. 801 F2d 1176 (9th Cir 1986).

(n119)Footnote 80. *Treas Reg § 1.302-4(d)*. In the enforcement of his rights, a creditor may acquire the assets of the corporation, but not its stock. *Treas Reg § 1.302-4(e)*. It should be noted that the Service will not issue rulings as to whether *IRC § 302(b)* applies if the consideration consists entirely or partly of notes of the corporation, and the shareholder's stock is held in escrow or as security for payment of the notes with the possibility that he will recapture the stock in the future upon the happening of specified defaults. *Rev Proc 2009-3*, 2009-1 CB 107 (§ 3.01(31)).

The redeemed taxpayers in *Hurst v Commr*, 124 TC 16 (2005), did not retain a prohibited interest even though the promissory notes issued to them were subject to cross-default clauses and were secured by the buyers' stock, which could be seized and sold in the event of a default in payment. There was credible evidence that the transactions were consistent with common practice in seller-financed transactions.

(n120)Footnote 81. *Treas Reg § 1.302-4(d)*; see also *Duerr v Commr*, 30 TC 944 (1958), where the court considered debentures received by the taxpayer as the equivalent of the preferred stock redeemed. The question of identity between debt obligation and stock redeemed should be considered in every redemption, not only those in which a waiver of family attribution is sought.

(n121)Footnote 82. *Treas Reg § 1.302-4(d)*. *Dunn v Commr*, 70 TC 715 (1978), *affd* 615 F2d 578 (2d Cir 1980), involved a deferral of payments beyond the due date. The Tax Court refused to accept the Service's argument that the deferral produced a situation in which the taxpayer's claim was voluntarily subordinated to the claims of general creditors.

(n122)Footnote 83. *IRC § 302(c)(2)(A)(iii)*. In *Rev Rul 71-138*, 1971-1 CB 109, the stock of a corporation was owned equally by *H* and his son, *S*. However, since *H* resided in a community property state, *H*'s wife, *W*, was considered a distributee of one half of the proceeds of the redemption and, accordingly, was required to file the agreement called for by *IRC § 302(c)(2)(A)(iii)*. An entity-related party waiver requires all to join in the agreement. *IRC § 302(c)(2)(C)(i)(I)*.

The statute of limitations on assessment does not run until the completion of one year following notification of the

acquisition of a forbidden interest.

(n123)Footnote 84. *Treas Reg § 1.302-4(a)*. The taxpayer must also retain copies of income tax returns and any other records indicating the tax which would have been payable had the redemption been treated as a distribution subject to *IRC § 301*. *Treas Reg § 1.302-4(b)*.

An executor can file the required agreement if the shareholder dies before the due date of the return for the taxable year in which the redemption occurs. *Rev Rul 77-93, 1977-1 CB 80*.

(n124)Footnote 85. The same conclusion was reached in *Archbold v US, 201 F Supp 329 (DNJ 1962)*, *affd per curiam 311 F2d 228 (3d Cir 1963)*. *Contra, US v Van Keppel, 321 F2d 717 (10th Cir 1963)*; *Cary v Commr, 41 TC 214 (1963)*, *nonacq 1964-2 CB 8*; *Pearce v US, 226 F Supp 702 (WDNY 1964)*.

(n125)Footnote 86. *Treas Reg § 1.302-4(a)(2)*.

(n126)Footnote 87. *IRC § 302(c)(2)(B)*. A partition of stock held as community property into separate interests was followed by a redemption from one of the spouses. The partition was not an acquisition of stock within the meaning of *IRC § 302(c)(2)(B)*. *Rev Rul 82-129, 1982-2 CB 76*.

(n127)Footnote 88. *IRC § 302(c)(2)(B)*. The regulations state that a transfer will not be deemed to have tax avoidance as one of its principal purposes merely because the transferee is in a lower tax bracket than the transferor. *Treas Reg § 1.302-4(g)*.

The rule is designed to prevent a taxpayer from extracting earnings and profits at capital gain rates while still exercising control over the affairs of the corporation.

(n128)Footnote 89. *Rev Rul 56-584, 1956-2 CB 179*. *Rev Rul 56-556, 1956-2 CB 177*; *Rev Rul 57-387, 1957-2 CB 225*; *Rev Rul 77-293, 1977-2 CB 91*; *Rev Rul 79-67, 1979-1 CB 128*; and *Rev Rul 85-19, 1985-1 CB 94*, contain additional examples of transfers not having tax avoidance as a principal purpose. The Service will not rule whether an acquisition or disposition has, or does not have, as one of its principal purposes the avoidance of federal income taxes, unless the facts and circumstances are materially identical to those set forth in the cited rulings. *Rev Proc 2009-3, 2009-1 IRB 107*.

(n129)Footnote 90. *Rev Rul 58-614, 1958-2 CB 920, 921*. The additional payment could also be held to be a dividend.

It has long been the Service's position that, in the absence of a prior and independent dividend declaration, the total consideration paid in the redemption of preferred stock with dividend arrearages enters the computation of the amount realized, so that no part of the distribution can be treated as a dividend. *Rev Rul 69-131, 1969-1 CB 94*, *superseding Sol Mem 4181, IV-2 CB 12 (1925)*. This position was approved in *Cummins Diesel Sales Corp v US, 323 F Supp 1114 (SD Ind 1971)*, *affd per curiam 459 F2d 668 (7th Cir 1972)*. If the dividend is declared before the redemption, the amount paid to satisfy the dividend obligation is taxed as a dividend. *Rev Rul 75-320, 1975-2 CB 105*; *Rev Rul 69-130, 1969-1 CB 93*, *superseding GCM 5180, VII-2 CB 110 (1928)*.

(n130)Footnote 91. Eg, *Keefe v Cote, 213 F2d 651 (1st Cir 1954)* (price \$4 above book value); *Commr v Snite, 177 F2d 819 (7th Cir 1949)* (price below market value, but equal to price which holders of employee stock options would pay).

(n131)Footnote 92. See Ch 2.

(n132)Footnote 93. *McCarthy v Conley, 341 F2d 948 (2d Cir 1965)*, *cert denied 382 US 838*; *Rev Rul 57-387, 1957-2 CB 225*. See also Ch 2.

(n133)Footnote 1. *IRC § 302(d)*. The operation of *IRC § 301* is discussed in Ch 4.

(n134)Footnote 2. *Treas Reg § 1.302-2(c)*.

(n135)Footnote 3. *Treas Reg § 1.302-2(c), Exs (1), (3)*.

(n136)Footnote 4. *Treas Reg § 1.302-2(c), Ex (2)*. The problem is discussed more fully in Royal, "Recovery of Basis in Non-Qualifying Stock Redemptions Under Sections 302 and 304," 4 *Va Tax Rev* 85 (1984).

(n137)Footnote 5. REG-143686-07, 74 *FR* 3509-3526, 2009-8 *IRB* 579, (January 21, 2009). The proposed regulations replace regulations proposed in 2002, REG 150313-01, 67 *FR* 64331 (October 18, 2002), but withdrawn in 2006 (71 *FR* 20044 (April 19, 2006)). The new version is derived in basic concept from the 2002 proposal, but is intended to provide a uniform set of rules for all dividend-equivalent distributions, whether received in a direct redemption under *IRC § 302*, an *IRC § 304* redemption through related corporations, or a tax-free reorganization exchange. See Preamble to REG-143686-07.

(n138)Footnote 6. *Prop Treas Reg § 1.302-5(a)(2)*.

(n139)Footnote 7. *Prop Treas Reg § 1.302-5(a)(3)*.

(n140)Footnote 8. *Prop Treas Reg § 1.302-5(d)*.

(n141)Footnote 9. *Prop Treas Reg § 1.302-5(a)(3)*.

(n142)Footnote 10. *Prop Treas Reg § 1.302-5(b)(4)*.

(n143)Footnote 11. *Prop Treas Reg § 1.302-5(a)(1)*.

(n144)Footnote 12. *Prop Treas Reg § 1.302-5(e), Ex 1*.

(n145)Footnote 13. *Prop Treas Reg § 1.302-5(e), Ex 2*.

(n146)Footnote 14. See *Prop Treas Reg § 1.302-5(e), Exs 3 and 4*.

(n147)Footnote 14.1. See *Prop Treas Reg § 1.302-5(c)* and Preamble to Proposed Regulations.

(n148)Footnote 15. *Prop Treas Reg § 1.302-5(c)(1)*.

(n149)Footnote 16. *Prop Treas Reg § 1.302-5(c)(2)*.

(n150)Footnote 17. *Prop Treas Reg § 1.302-5(d)(1)*.

(n151)Footnote 18. *Prop Treas Reg § 1.302-5(d)(2)*. If an estate or trust terminates before it is permitted to take into account all of the loss attributable to the basis of redeemed stock, the amount of loss not taken into account is allowed as a deduction to the beneficiaries under *IRC § 642(h)*.

(n152)Footnote 19. *Prop Treas Reg § 1.302-5(d)(4)*.

(n153)Footnote 1. Redemptions pursuant to periodic redemption plans can produce dividend consequences for the remaining shareholders. See Ch 4.

(n154)Footnote 2. *Rev Rul* 69-608, 1969-2 *CB* 42 ; *Wall v US*, 164 *F2d* 462 (4th *Cir* 1947) ; *Sullivan v US*, 363 *F2d* 724 (8th *Cir* 1966) , *cert denied* 387 *US* 905 ; *Zipp v Commr*, 259 *F2d* 119 (6th *Cir* 1958) , *cert denied* 359 *US* 934 . See also *Apschnikat v US*, 421 *F2d* 910 (6th *Cir* 1970) . The test is actually whether the redemption of the other

shareholder's stock is a distribution which is essentially equivalent to a dividend to the remaining shareholder. This permits the shareholder to argue that the distribution should be taxed as an exchange under *IRC § 302(b)(1)*, but his chances of success seem slim.

A corporation's discharge of its sole shareholder's obligation to purchase the stock of another corporation did not produce income for the shareholder in *Citizens Bank & Trust Co v US*, 580 F2d 442 (Ct Cl 1978) . The stock had a value greater than the price paid so that there was no depletion of assets, as was the case in *Wall and Sullivan*.

(n155)Footnote 3. *Rev Rul 69-608*, 1969-2 CB 42 ; *Rev Rul 59-286*, 1959-2 CB 103 ; *Rev Rul 58-614*, 1958-2 CB 920 ; *Niederkrome v Commr*, 266 F2d 238 (9th Cir 1958) , *cert denied* 359 US 945 ; *Holsey v Commr*, 258 F2d 865 (3d Cir 1958) ; *Ward v Rountree*, 193 F Supp 154 (MD Tenn 1961) ; *Edenfield v Commr*, 19 TC 13 (1952) , *acq* ; 1953-1CB 4 ; *Priester v Commr*, 38 TC 316 (1962) ; see also *Tracy v US*, 1966 US Dist LEXIS 9856 (CD Cal 1966) (purchaser of stock not in receipt of dividend where not obligated to buy shares redeemed from selling shareholder).

Shareholders were not in receipt of dividend income when the corporation redeemed stock pursuant to a contract that called for the purchase of the stock by the shareholders "or their assigns." *Buchholz Mortuaries, Inc v Commr*, TC Memo 1990-269 .

A corporation's redemption of stock from a shareholder's ex-wife did not produce a constructive dividend for the shareholder. Under the divorce arrangement, the wife agreed to look first to the corporation for payment for her shares, making the taxpayer's obligation secondary. *Edler v Commr*, TC Memo 1982-67 , *affd* 727 F2d 857 (9th Cir 1984) . The reverse was true in *Hayes v Commr*, 101 TC 593 (1993) , resulting in a constructive dividend for the husband and a tax-free transaction for the wife under *IRC § 1041*.

(n156)Footnote 4. *Rev Rul 69-608*, 1969-2 CB 42 ; *Rev Rul 59-286*, 1959-2 CB 103 .

(n157)Footnote 5. *Rev Rul 69-608*, 1969-2 CB 42 ; *Sullivan v US*, 363 F2d 724 (8th Cir 1966) , *cert denied* 387 US 905 .

(n158)Footnote 6. *Rev Rul 59-286*, 1959-2 CB 103 .

(n159)Footnote 7. *Rev Rul 69-608*, 1969-2 CB 42 ; *cf SK Ames, Inc v Commr*, 46 BTA 1020 (1942) , *acq* 1942-1 CB 1 .

(n160)Footnote 8. *Rev Rul 69-608*, 1969-2 CB 42 ; but see *Deutsch v Commr*, 38 TC 118 (1962) (redemption treated as a distribution to the remaining shareholder; his obligation was to purchase the stock or cause the corporation to redeem it).

(n161)Footnote 9. *Fox v Harrison*, 145 F2d 521 (7th Cir 1944) ; *Ciaio v Commr*, 47 TC 447 (1967) , *acq* 1967-2 CB 2 ; *Bunton v Commr*, TC Memo 1968-3 .

(n162)Footnote 10. *Cf McGinty v Commr*, 325 F2d 850 (2d Cir 1963) ; *Edmister v Commr*, 46 TC 651 (1966) , *affd per curiam* 391 F2d 584 (6th Cir 1968) .

In *Probst v Commr*, TC Memo 1970-328 , the agency argument was first advanced in the taxpayer's reply brief; the Tax Court found he was acting for himself.

(n163)Footnote 11. *Carrington v Commr*, 476 F2d 704 (5th Cir 1973) ; *Grove v Commr*, 490 F2d 241 (2d Cir 1973) ; *Behrend v US*, 31 AFTR2d P 73-406 (4th Cir 1972); *Palmer v Commr*, 62 TC 684 (1974) . The Service will follow the result in *Palmer* unless the donee is legally bound or can be compelled by the corporation to surrender the shares for redemption. *Rev Rul 78-197*, 1978-1 CB 83 . But see *Ltr Rul 9046004* where the tax consequences of a mandated redemption followed the form of the transaction, due to the application of *IRC § 1041*, discussed in Ch 1,

supra.



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Taxation of Securities Transactions

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CHAPTER 5 Distributions in Redemption of Stock

1-5 Taxation of Securities Transactions § 5.03

§ 5.03 Redemptions Under Section 303--Redemptions From a Decedent

IRS Section 303, a relief provisions enacted to prevent the need for the forced sale of closely held family businesses to large corporate enterprises solely because of the combined impact of estate and income taxes,ⁿ¹ affords exchange treatment for a redemption of stock, the value of which has been included in a decedent's gross estate, to the extent that the consideration for the redemption does not exceed the sum of (a) the estate, inheritance and other death taxes (including interest thereon) imposed because of the decedent's death,ⁿ² and (b) the amount of funeral and administration expenses (but not debts of the decedent) allowable as a deduction to the estate of the decedent under *IRC Section 2053* (or under *IRC Section 2106* if the decedent is a nonresident alien).ⁿ³ *IRC Section 303* has no effect on a redemption which can qualify as an exchange under *IRC Section 302(a)*. Its sphere of influence lies in the area of redemptions which would otherwise be taxed as distributions under *IRC Section 301*.ⁿ⁴

A redemption of stock is treated as an exchange under *IRC Section 303* only if the following conditions are met:

- (1) The value of the stock must be included in the decedent's gross estate for federal estate tax purposes.ⁿ⁵ The reason for inclusion is unimportant; the necessity for inclusion is.
- (2) The value of *all* of the stock of the redeeming corporation included in the gross estate of the decedent must amount to more than 35 percent of the value of the decedent's gross estate, less losses, debts, and funeral and administration expenses.ⁿ⁶ If more than 20 percent in value of the outstanding stock of each of two or more corporations is included in determining the decedent's gross estate, such stock may be considered as the stock of a single corporation for the purpose of meeting the 35 percent requirement.ⁿ⁷
- (3) The redemption distribution must be made after the decedent's death and (a) before the expiration of the three-year period of limitations for the assessment of estate tax, or within 90 days after the expiration of such period,ⁿ⁸ or (b) if a petition for redetermination of a deficiency in estate tax is timely filed with the Tax Court, at any time before the expiration of sixty days from the date on which the decision of the Tax Court becomes final.ⁿ⁹ However, the filing of a groundless petition, that is, one filed solely for the purpose of extending the period during which distribution can be made, will not increase the period within which *IRC Section 303* will be applicable.ⁿ¹⁰ If an election is made to extend the time for payment of estate taxes, the redemption period is also extended until the due date of the last installment.ⁿ¹¹ This correlates the special treatment of *IRC Section 303* with the extended payment

election of *IRC Section 6166* and allows the corporation to build up liquid assets and redeem stock so that payment of estate taxes might be made at any time during the installment payment period.ⁿ¹² However, in the case of any redemption distribution made more than four years and 90 days after the decedent's death, capital gains treatment is limited to the lesser of (a) the amount of qualifying death taxes and funeral and administration expenses that are unpaid immediately before the distribution, or (b) the amount of such taxes and expenses that are paid within one year after the distribution.ⁿ¹³

IRC Section 303 is applicable only to the extent that the interest of the shareholder is reduced directly or indirectly or through a binding obligation to contribute toward the payment of debts, expenses, or taxes.ⁿ¹⁴ Thus, *IRC Section 303* will not apply unless the party whose shares are redeemed actually has a liability for federal estate tax, state death taxes, or funeral and administration expenses in an amount at least equal to the amount of the distribution.

There is no requirement that the distribution be in cash. The distribution of a corporate note payable within the applicable period will satisfy the statutory requirement.ⁿ¹⁵ Furthermore, there is no prohibition against a series of redemptions. All distributions made within the statutory period (and which do not exceed the amount specified in *IRC Section 303(a)*) can qualify as *IRC Section 303* redemptions.ⁿ¹⁶ However, where there is more than one distribution in redemption of stock, the distributions are to be applied against the total amount qualifying under *IRC Section 303* in the order in which the distributions are made.ⁿ¹⁷ For this purpose, all redemption distributions are taken into account, including those granted capital gain treatment by some other provision of the Code.ⁿ¹⁸ To illustrate:

Example:

The gross estate of a decedent has a value of \$1,000,000; the taxable estate amounts to \$600,000; death taxes and funeral and administration expenses total \$300,000. Included in the gross estate is closely held corporation stock valued at \$500,000. During the first year of administration, one-half of the stock is redeemed for \$250,000. During the second year, an additional one-quarter (or one-half of the balance) is redeemed for \$125,000. The first distribution qualifies for *IRC Section 303* treatment irrespective of whether the transaction can be treated as an exchange under *IRC Section 302(a)*. Of the second distribution, only \$50,000 can come under the umbrella of *IRC Section 303*.

Where stock in a closely held corporation is subject to the generation-skipping transfer occurring at the same time as and as a result of the death of an individual:

- (1) the stock is deemed to be included in the estate of such individual;
- (2) all death taxes imposed because of the generation-skipping transfer are treated as imposed because of the individual's death;ⁿ¹⁹
- (3) the period of distribution is measured from the date of the generation-skipping transfer; and
- (4) the relationship of the value of the stock to the value of the decedent's estate is measured with reference solely to the amount of the generation-skipping transfer.ⁿ²⁰

FOOTNOTES:

(n1)Footnote 1. HR Rep No 1337, 83d Cong, 2d Sess, 36 (1954); HR Rep No 2319, 81st Cong, 2d Sess, 63-64 (1950).

(n2)Footnote 2. *IRC § 303(a)(1)*.

(n3)Footnote 3. *IRC § 303(a)(2)*. Whether an expense can be considered an administration expense for the purpose of *IRC § 303* is to be decided under federal law. *Majerus v Coyle*, 254 F Supp 214 (ND Ill 1966) .

A distribution in redemption of stock to which *IRC § 303* applies is not treated as a disposition of any portion of a qualified family-owned business interest under *IRC § 2057(f)(1)(B)*. *Ltr Rul 200242025* .

(n4)Footnote 4. *Rev Rul 71-527, 1971-2 CB 174* (transaction otherwise a *IRC § 304* redemption taxed as a distribution under *IRC § 301*); *Rev Rul 71-261, 1971-1 CB 108* (attribution rules prevented resort to *IRC § 302(a)* capital gain treatment).

(n5)Footnote 5. *IRC § 303(a)*. If stock included in the gross estate could have been redeemed under *IRC § 303* were it not for the fact that the stock was exchanged for other stock, the new stock can be redeemed under the same conditions as the old, provided the basis of the new stock is a substituted basis (determined with reference to the basis of the old stock). *IRC § 303*; *Rev Rul 87-132, 1987-2 CB 82* ; *Rev Rul 77-377, 1977-2 CB 111* ; but see *Rev Rul 69-594, 1969-2 CB 44* (decendent owned stock of X Corp and Y Corp; X Corp stock exchanged for Y Corp stock; redemption could not qualify under *IRC § 303* since neither the value of X Corp stock nor the value of Y Corp stock alone met the percentage requirements of *IRC § 303(b)(2)(A)*).

(n6)Footnote 6. *IRC § 303(b)(2)(A)*. If the estate elects the alternative valuation prescribed by *IRC § 2032*, all values must be determined on the applicable valuation date. *Treas Reg § 1.303-2(b)*.

Although *IRC § 2035*, relating to gifts in contemplation of death, does not generally require that post-1981 gifts made within three years of death be included in the gross estate of the donor, shares of stock given as gifts within the three-year period are counted in determining whether the decedent met the stock ownership requirement. However, the capital gain treatment granted by *IRC § 303* extends only to shares actually owned by the decedent at death. *Rev Rul 84-76, 1984-1 CB 91* .

(n7)Footnote 7. *IRC § 303(b)(2)(B)*. Stock, which at the decedent's death, represented the surviving spouse's interest in property held by the decedent and the surviving spouse as community property, or as joint tenants, tenants by the entirety, or tenants in common, is treated as having been included in determining the value of the decedent's gross estate.

(n8)Footnote 8. *IRC § 303(b)(1)(A)*. If the estate tax return is filed before the due date, the period is measured from the due date of the return, not the filing date. *Rev Rul 69-47, 1969-1 CB 94* . If the return is filed after the due date, the redemption period runs from the filing date. *Rev Rul 73-204, 1973-1 CB 170* . *Rev Rul 69-47, 1969-1 CB 94*

(n9)Footnote 9. *IRC § 303(b)(1)(B)*. This provision can only extend the period prescribed in *IRC § 303(b)(1)(A)*; it cannot shorten it. *Rev Rul 66-246, 1966-2 CB 108* .

(n10)Footnote 10. *Treas Reg § 1.303-2(e)*.

(n11)Footnote 11. *IRC § 303(b)(1)(C)*.

(n12)Footnote 12. HR Rep No 94-1380, 94th Cong, 2d Sess 35-36 (1976).

(n13)Footnote 13. *IRC § 303(b)(4)*.

(n14)Footnote 14. *IRC § 303(b)(3)*.

(n15)Footnote 15. *Rev Rul 65-289, 1965-2 CB 86* .

(n16)Footnote 16. *Rev Rul 67-425, 1967-2 CB 134* .

(n17)Footnote 17. *Treas Reg § 1.303-2(g)(1)*; *Rev Rul 72-188, 1972-1 CB 383* , modified by *Rev Rul 86-54, 1986-1 CB 356* .

(n18)Footnote 18. *Treas Reg* § 1.303-2(g)(1).

(n19)Footnote 19. The generation-skipping tax is treated as an estate tax for this purpose.

(n20)Footnote 20. *IRC* § 303(d).



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CHAPTER 5 Distributions in Redemption of Stock

1-5 Taxation of Securities Transactions § 5.04

§ 5.04 Redemptions Under Section 304--Redemptions by Related or Affiliated Corporations

Suppose that A owns all of the outstanding stock of both X Corp. and Y Corp. Whether A redeems one-half of his X Corp. shares or sells them to Y Corp., the economic result is the same. The issue posed is whether the tax consequences of the sale should equal those of the redemption--in this case, a distribution which has the effect of a dividend.

Prior to the 1954 Code, there was no statutory authority for treating the transaction other than as a sale.ⁿ¹ The Internal Revenue Service did at one time rule, that under the 1939 Code, such a sale would be considered the equivalent of a dividend to the shareholder.ⁿ² However, the ruling was subsequently revokedⁿ³--the Service could not sustain its position in the courts.ⁿ⁴

The 1954 Code broadened the scope of related corporation redemptions by adding specific rules to govern the tax treatment of stock transactions involving the stock of affiliated corporations other than parent and subsidiary. The purpose of the new provision was to insure "that where the effect of the sale is in reality the distribution of a dividend, such sale shall be taxed as such."ⁿ⁵

[1] Acquisition by a Related Corporation Other Than a Subsidiary

If one or more persons (whether related by blood or not)ⁿ¹ own at least 50 percent of the voting stock, or at least 50 percent of the value of the outstanding stock, of each of two corporations,ⁿ² and one of the corporations acquires stock in the other from such person or persons, the transaction will be treated as a redemption of stock of the acquiring corporation.ⁿ³ However, the determination as to whether the redemption meets the tests prescribed by *IRC Section 302(b)* is made by reference to the stock of the issuing corporation (the corporation whose stock was sold).ⁿ⁴ If the redemption cannot be considered an exchange,ⁿ⁵ it must be treated as a distribution to which *IRC Section 301* applies. The amount of dividend income and the source thereof is determined by assuming that the distribution was made by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits.ⁿ⁶ In this way, dividend treatment ensues to the extent of the aggregate earnings and profits of both the acquiring corporation and the corporation whose stock is acquired.

If the transaction is treated as a distribution under *IRC Section 301*, the transferor and the acquiring corporation are treated as if (1) the transferor had transferred the stock involved in the transaction to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which *IRC Section 351(a)* applies, and (2) the

acquiring corporation had then redeemed the stock it treated as having issued. Therefore, under *IRC Section 362*, the acquiring corporation's basis in the stock is equal to the basis the transferor had in the stock, and under *IRC Section 358*, the transferor's basis in the stock of the acquiring corporation deemed issued to the transferor in the deemed transaction to which *IRC Section 351(a)* applies is equal to the transferor's basis in the stock of the issuing corporation it surrendered.ⁿ⁷

If the acquiring corporation is a foreign corporation, then the amount of earnings and profits of the acquiring foreign corporation that are taken into account in applying *IRC Section 304* cannot exceed the portion of the earnings and profits that (1) is attributable to stock of the acquiring foreign corporation held by a corporation or individual who is the transferor (or a person related thereto within the meaning of *IRC Section 267(b)* or *707(b)*) and who is a United States shareholder (within the meaning of *IRC Section 951(b)*) of such corporation, and (2) was accumulated during periods in which the stock was owned by such person while the acquiring corporation was a controlled foreign corporation.ⁿ⁸

Example:

X Corp and *Y Corp* each have 100 shares of common stock outstanding. The stock of each corporation is owned equally by two unrelated persons, Andy and Bob. Andy sells 20 shares of his *X Corp* stock to *Y Corp*. After the sale, Andy will own 30 shares of *X Corp* stock directly and ten shares constructively by reason of his 50 percent ownership of *Y Corp* stock. Since Andy's percentage of ownership of *X Corp* stock after the sale (40/100 or 40 percent) is exactly 80 percent and not less than 80 percent of his ownership percentage before the sale, the redemption will not meet the substantially disproportionate test of *IRC Section 302(b)(2)*.ⁿ⁹ If the redemption cannot come within *IRC Section 302(b)(1)* and be considered a distribution which is not essentially equivalent to a dividend, the dividend consequences of the transaction will be determined as if it were a distribution by *Y Corp* to the extent of its earnings and profits and then as a distribution by *X Corp*.ⁿ¹⁰

Suppose that Andy, owning all of the stock of *X Corp* and *Y Corp*, transfers all of his *X Corp* shares to *Y Corp* in exchange for more stock in the latter plus cash. Clearly the transaction fits the description of a "brother-sister" corporation redemption found in *IRC Section 304(a)(1)*, but just as clearly it is a transaction which falls within the terms of *IRC Section 351*. If *IRC Section 304* is the controlling provision, the distribution of cashⁿ¹¹ would, under the fact situation given, be essentially equivalent to a dividend since there would be no change in Andy's percentage ownership of *X Corp* stock (Andy would actually own 100 percent before the transfer and constructively own 100 percent after the transfer). If *IRC Section 351* governs, Andy would recognize any gain realized on the exchange only to the extent of the lesser of the amount of such gain or the amount of cash ("boot") received.

The problem posed is an abbreviated version of the fact situation presented in *Haserot v. Commissioner*. The Tax Court, in its initial decision,ⁿ¹² found *IRC Section 351* controlling by looking to the "except as otherwise provided in this chapter ..." language found in *IRC Sections 301(a)* and *302(d)*. In its concluding paragraph, the court stated:

"[S]ince that amount will in either event be taxed as a long-term capital gain, it is not necessary for us to determine in this proceeding whether that result is arrived at via section 351 or via sections 304 and 302(a)."ⁿ¹³

The Government appealed, pressing its contention that *IRC Section 304(a)* applied to the transaction in issue. The Sixth Circuit remanded the matter to the Tax Court for it to determine whether the distribution in redemption had the effect of a dividend.ⁿ¹⁴ The absence of dividend equivalence would dispose of the issue in favor of the taxpayer without the need to resolve the conflict.

On remand,ⁿ¹⁵ the Tax Court found the distribution essentially equivalent to a dividend. However, because a majority of the judges felt that the remand limited the court to a consideration of the specific issue of dividend equivalence, the original decision was reaffirmed. The Commissioner once again appealed. This time the Sixth Circuit found itself in

agreement with the Tax Court's determination that *IRC Section 351* controlled the transaction.ⁿ¹⁶

After the Service had taken a firm stand against the position adopted by the Sixth Circuit,ⁿ¹⁷ a view with which the Ninth Circuit agreed,ⁿ¹⁸ Congress resolved the issue for transfers occurring after August 31, 1982 by providing that *IRC Section 304* overrides *IRC Section 351* (and so much of *IRC Sections 357* and *358* as relate to *IRC Section 351*) when both can apply.ⁿ¹⁹ However, *IRC Section 351* will continue to apply to the extent the transaction consists of an exchange of stock for stock in the acquiring corporation, or the additional consideration for the transfer consists of acquisition indebtedness--a liability incurred by the transferor to acquire the stock which is assumed by the acquiring corporation or to which the stock is subject.ⁿ²⁰ The exclusion for acquisition indebtedness does not extend to cases in which the debt is incurred to purchase stock from a person whose ownership is attributable to the transferor under *IRC Section 318(a)*. This restriction is removed if there is a termination of the interest of the related person in both the acquiring and issuing corporations, and the related person does not reacquire an interest in either corporation for ten years and files an agreement with the Service similar to the one required under *IRC Section 302(c)(2)* (discussed in § 5.02[2][c], *supra*).

A further exception is provided in the case of the receipt of securities in a bank holding company, as an incident of the formation of the company, by any shareholder who owns less than 10 percent in value of the stock of the company.ⁿ²¹ For the rule to apply, (1) the bank holding company must acquire stock constituting control of a bank within two years after control of the bank was acquired, (2) the acquisition of control of the bank and the transfer to the bank holding company must be pursuant to a plan, and (3) shareholders of the bank holding company who receive distributions of property cannot have control of the company.

[2] Acquisition by a Subsidiary of the Stock of Its Parent

IRC Section 304(a)(2) treats the acquisition by a subsidiary of the stock of its parent as a redemption of the parent corporation's stock.ⁿ¹ If the redemption cannot qualify as an exchange under the standards contained in *IRC Section 302(b)* (applied by looking to the stock of the parent corporation),ⁿ² the amount of dividend income will be determined by assuming that the distribution was made first by the subsidiary to the extent of its earnings and profits and then by the parent to the extent of its earnings and profits.ⁿ³ The stated rule applies to stock acquired after June 18, 1984. For earlier years, the dividend determination was made by reference to the earnings and profits of the parent corporation, computed as if the amount paid by the subsidiary for the stock was first distributed to the parent and then distributed by the parent to the transferor.

An interesting phenomenon occurs whenever a person has actual control of each of two corporations. Because of the attribution rules, each of the controlled corporations will also be the parent of the other. This means that the redemption can fit *IRC Section 304(a)(1)* and *IRC Section 304(a)(2)*, which, before 1984, could have yielded different amounts of dividend income. The regulations treat a brother-sister corporation redemption as just that and not as a parent-subsidiary redemption as well.ⁿ⁴ However, it has been pointed out that the decided *IRC Section 304(a)(1)* cases have never had to face the problem of overlapping coverage, since, in each case, the acquiring corporation had sufficient earnings and profits to cover the distribution.ⁿ⁵

[3] Basis Adjustments in Redemptions by Related Corporations

[a] Section 304(a)(1) Transactions. Assume that A has control of both X Corp. and Y Corp. and that he has a basis of \$100,000 for the stock of each corporation. If A sells one-half of his X Corp. stock to Y Corp. in a transaction found to be essentially equivalent to a dividend, A's basis in his Y Corp. shares will be increased by \$50,000, the basis of the shares surrendered by him.ⁿ¹ What effect the transaction has on the basis of the X Corp. shares remaining in A's hands is nowhere specified, but it would seem logical to set the basis of these shares at \$50,000 and thereby compensate for the step-up in basis of the Y Corp. shares.

Suppose that, after the transaction, the transferor owns no stock in either the issuing or acquiring corporation. What happens to the basis of the transferred shares? According to the Service, it disappears. However, under proposed regulations, shareholder will be able to take into account any loss attributable to unutilized basis.ⁿ²

If the redemption qualifies as an exchange under *IRC Section 302*, A's basis for his Y Corp. shares will remain unchanged.ⁿ³ Since one-half of A's original basis for his X Corp. stock will enter into the computation of gain or loss realized on the exchange, the remaining X Corp. shares will have an aggregate basis of \$50,000.

The basis of the X Corp. shares in the hands of the acquiring corporation likewise depends on the tax consequences of the redemption, since under *IRC Section 362(a)*, the governing provision,ⁿ⁴ the acquiring corporation's basis is the same as the transferor's basis, increased in the amount of any gain recognized to the transferor on the transaction. Thus, if the distribution is taxed wholly as a dividend, the transferor recognizes no gain on the transfer and the acquiring corporation's basis will be exactly the same as the transferor's.

[b] Section 304(a)(2) Transactions. The shareholder whose stock is the subject of a *IRC Section 304(a)(2)* transaction that is found to have the effect of a dividend is directed by the Regulations to add the basis of the stock sold to the subsidiary to the basis of any retained shares of the parent corporation's stock.ⁿ⁵ If the redemption qualifies as an exchange, the transferor's basis in the remaining shares should be determined in accordance with the usual basis provisions. The taxpayer is thereby placed in the same position, basis-wise, as he would have been had his shares been redeemed by the parent corporation in a "true" redemption.

The Regulations are silent when it comes to the manner in which the subsidiary determines its basis in the acquired stock. It has been suggested that the subsidiary take over the shareholder's basis in the surrendered stock whenever the redemption is treated as a dividend.ⁿ⁶ However, the contribution to capital concept which underlies the use of substituted basis in a *IRC Section 304(a)(1)* transaction finds no application in a parent-subsidiary redemption. Coupling this with the lack of guidelines to the contrary may indicate that the subsidiary's basis in the acquired shares will be its cost.ⁿ⁷ While there may be disagreement as to the subsidiary's basis for stock acquired in *IRC Section 304(a)(2)* redemptions which have the effect of a dividend, there should be no argument that the general basis rules must apply when the redemption is treated as an exchange.

[c] Intragroup Transactions. Under *IRC Section 304(b)(4)*, if stock from one member of an affiliated group is transferred to another member of the group in a transaction governed by *IRC Section 304(a)*, "proper adjustments" must be made in the bases of intragroup stock and in the earnings and profits of any member of the group to the extent necessary to carry out the purposes of *IRC Section 304*.ⁿ⁸ For example, suppose that subsidiary X sells the stock of appreciated subsidiary Y to Z (a sister corporation in an affiliated group) in a transaction that is treated as a dividend by Z to X and a contribution of the Y stock to the capital of Z. Adjustments must be made to the stock bases of members of the group so that neither X, Z, nor any other corporation that is part of the same chain of corporations (excluding the common parent) can thereafter be sold without the recognition of the built-in appreciation in the Y stock at the time of the initial transaction.ⁿ⁹

FOOTNOTES:

(n1)Footnote 1. Legislation enacted in 1950 did treat the purchase by a subsidiary of the stock of its parent as a distribution of assets from parent to subsidiary followed by a redemption by the parent of its own stock.

(n2)Footnote 2. *Rev Rul 55-15, 1955-1 CB 361* .

(n3)Footnote 3. *Rev Rul 59-97, 1959-2 CB 684* . This ruling has been rendered obsolete because of the enactment of *IRC § 304, Rev Rul 72-620, 1972-2 CB 651* .

(n4)Footnote 4. *Westerhaus Co v Commr, TC Memo 1957-218* was the case which precipitated the revocation. Other cases holding for the taxpayer included *Commr v Pope, 239 F2d 881 (1st Cir 1957)*; and *Cramer v Commr, 20 TC*

679 (1953) , *acq* 1960-1 CB 4 .

(n5)Footnote 5. HR Rep No 1337, 83rd Cong, 2d Sess 37 (1954). See generally, Shores, "Section 304 and the Limits of Statutory Law," *16 Va Tax Rev* 455 (1997); Marans, "Section 304: The Shadowy World of Redemptions Through Related Corporations," *22 Tax L Rev* 161 (1967); Lanahan, "Redemptions to Pay Death Taxes: Redemptions Through the Use of Related Corporations (Sections 303, 304)," *15 NYU Inst on Fed Tax* 493 (1957).

(n6)Footnote 1. The taxpayer in *Coates Trust v Commr*, 480 F2d 468 (9th Cir 1973) , *cert denied* 414 US 1045 , contended that the phrase "one or more persons" referred to one person plus those persons whose stock would be attributed to him under IRC § 318. The court disagreed and saw the phrase as indicating an attempt to expand the scope of IRC § 304(a)(1) beyond the family relationship to include unrelated persons who act in concert.

(n7)Footnote 2. The constructive ownership rules of IRC § 318(a) are applicable in determining stock ownership. Attribution to and from corporations is made by changing the 50 percent limitation contained in IRC §§ 318(a)(2)(C) and 318(a)(3)(C) to 5 percent. Further, in applying the latter section, where the stock owned by or for a shareholder is less than 50 percent in value of the corporation's stock, attribution of ownership from the shareholder to the corporation is limited to the proportion of the value of the corporation's outstanding stock owned by the shareholder. IRC § 304(c)(3). Thus, if A owned 40 percent of X Corp's voting stock and Z Corp owned the remaining 60 percent, and if A owned 25 percent of the stock of Z Corp as well, he would own directly and indirectly 55 percent of the voting stock of X Corp.

The value test is applied to the aggregate of all classes of stock of the corporation, not on a class-by-class basis. *Rev Rul* 89-57, 1989-1 CB 90 .

Under *Treas Reg* § 1.318-1(b)(1), a corporation cannot constructively own its own stock. This prevented the sale to a related corporation in *Rev Rul* 74-605, 1974-2 CB 97 , from coming within IRC § 304(a)(1).

The absence of legal title to stock sold to a related corporation did not prevent the Tax Court from applying IRC § 304 to the transaction in *Maher v Commr*, 55 TC 441 (1970) . The taxpayer had purchased the stock under an agreement that required the placing of the stock in escrow as security for payment of the purchase price; this sufficed to make him the owner of the stock for IRC § 304 purposes.

(n8)Footnote 3. IRC §§ 304(a)(1), 304(c)(1).

Taxpayers sold all of their shares in one wholly owned corporation to another in exchange for notes payable over a period of years. Application of IRC §§ 318 and 304(a)(1) turned the sale into a redemption that was essentially equivalent to a dividend. This meant that the entire "sales" price was includable in income in the year of the transaction, not as the notes were paid. *Brams v Commr*, 734 F2d 290 (6th Cir 1984) ; *Cox v Commr*, 78 TC 1021 (1982) .

Treas Reg § 1.1502-80 provides that a post-July 23, 1991 acquisition of stock of a corporation by one member of a consolidated group from another member is not subject to IRC § 304. Instead, the transaction is treated as a deferred intercompany transfer as provided in *Treas Reg* § 1.1502-13.

For purposes of determining the amount constituting a dividend and the source thereof, the Service may treat a corporation (deemed acquiring corporation) as having acquired for property the stock of a corporation (issuing corporation) acquired by another corporation (acquiring corporation) that is controlled by the deemed acquiring corporation, if one of the principal purposes for organizing or funding the acquiring corporation, through capital contributions or debt, is to avoid application of IRC § 304 to the deemed acquiring corporation. *Temp Treas Reg* § 1.304-4T(a). The examples contained in the regulations illustrate the application of the provision to controlled foreign corporations.

(n9)Footnote 4. *IRC § 304(b)(1); Rev Rul 71-563, 1971-2 CB 175* . The attribution rules of *IRC § 318(a)* are applicable since the redemption is tested under *IRC § 302*. Here attribution between corporation and shareholder is applied without regard to the 50 percent limitation contained in *IRC §§ 318(a)(2)(C) and 318(a)(3)(C)*. The 5 percent threshold ownership condition used in determining control is inapplicable here.

When two or more persons are in control of the issuing corporation after application of the constructive attribution rules, the tests prescribed by *IRC § 302* are applied to the controlling person who transferred the issuing corporation's stock in the *IRC § 304* redemption. *Merrill, Lynch & Co. v Comm'r, 131 TC No 19 (2008)* . For example, assume P owns 100% of the stock of X and Y, and X owns 100% of the stock of Z. As part of an integrated transaction, X sells all its Z stock to Y for fair market value, and immediately thereafter P sells all its X stock to an unrelated purchaser outside the corporate group. X's sale of Z stock to Y is treated as a redemption of Y's stock under *IRC § 304*, but whether the redemption is treated as a dividend or an exchange under *IRC § 302* is determined by pre- and post-sale ownership of Z by its "controlling person." There are two "controlling persons" of Z in this case, P and X. Focusing on P, the redemption proceeds should be treated as a dividend since P constructively owns all of Z's stock before and after the transaction, but looking at X, the redemption should be treated as an exchange because X owns none of Z's stock at the end of the integrated transaction, actually or constructively. *Merrill, Lynch* holds that only X's ownership is relevant for purposes of applying *IRC § 302(b)* because X was the actual transferor of Z's stock in the *IRC § 304* redemption, so that under *IRC § 302* the redemption is taxable as an exchange.

(n10)Footnote 5. A redemption under *IRC § 304* may qualify for capital gain treatment via the application of *IRC § 303*. *Rev Rul 71-527, 1971-2 CB 174* .

(n11)Footnote 6. *IRC § 304(b)(2)*. The provision applies to transactions after June 18, 1984. For earlier transactions, the dividend determination was made by assuming that the distribution went from issuing corporation to acquiring corporation and then to the transferor.

(n12)Footnote 7. *Prop Treas Reg § 1.304-2(a)(3)*. In applying *Prop Treas Reg § 1.302-5* to any unutilized basis of the transferor in the stock of the acquiring corporation treated as redeemed, the acquiring corporation is treated as the redeeming corporation and the transferor as the redeemed shareholder. See § 5.02[4] for a discussion of *Prop Treas Reg § 1.302-5*.

If, pursuant to *IRC § 304(a)(1)*, a US person is treated as transferring stock of a domestic or foreign corporation to a foreign corporation in exchange for stock of the transferee corporation in a transaction to which *IRC § 351(a)* applies, the deemed *IRC § 351* exchange is not a transfer to a foreign corporation subject to *IRC § 367(a)*. *Treas Reg § 1.367(a)-3(a)*. The same holds true if, pursuant to *IRC § 304(a)(1)*, a foreign acquiring corporation is treated as acquiring the stock of a foreign acquired corporation in a transaction to which *IRC § 351(a)* applies. *Treas Reg § 1.367(b)-4(a)*.

(n13)Footnote 8. *IRC § 304(b)(5)(A)*.

Payment of a deemed dividend under *IRC § 304(a)(1)* to a foreign corporation is subject to withholding under *IRC § 1442* to the extent the dividend is derived from US sources. The normal 30% withholding rate applies unless reduced by treaty. *Rev Rul 92-85, 1992-2 CB 69* . A deemed dividend received by a domestic corporation from foreign sources qualifies for the deemed-paid foreign tax credit. *Rev Rul 91-5, 1991-1 CB 114* , amplified by *Rev Rul 92-86, 1992-2 CB 69* .

(n14)Footnote 9. The corporation-shareholder attribution rules prevent a *IRC § 304* redemption from becoming a complete redemption under *IRC § 302(b)(3)* whenever the transferor has direct ownership of a portion of the stock of the acquiring corporation.

(n15)Footnote 10. For examples of *IRC § 304* redemptions found to be essentially equivalent to a dividend, see

Kerr v Commr, 326 F2d 225 (9th Cir 1964) , cert denied 377 US 963 ; *Wiseman v US*, 259 F Supp 90 (D Me 1966) , affd per curiam 371 F2d 816 (1st Cir 1967) ; *Blaschka v US*, 393 F2d 983 (Ct Cl 1968) ; *Coates Trust v Commr*, 55 TC 501 (1970) , affd 480 F2d 468 (9th Cir 1973) , cert denied 414 US 1045 ; *Vinnell v Commr*, 52 TC 934 (1969) . The redemption was held not to be essentially equivalent to a dividend in *Sorem v Commr*, 334 F2d 275 (10th Cir 1964) ; and *Salvatori v US*, 18 AFTR2d 5876 (SD Calif 1966) .

(n16)Footnote 11. IRC § 305(a) would treat the receipt of stock as a tax-free stock dividend unless one of the exceptions contained in IRC § 305(b) was applicable. See Ch 4.

(n17)Footnote 12. 41 TC 562 (1964) , nonacq 1966-2 CB 7 .

(n18)Footnote 13. 41 TC at 572 .

(n19)Footnote 14. 355 F2d 200 (6th Cir 1965) .

(n20)Footnote 15. 46 TC 864 (1966) .

(n21)Footnote 16. *Commr v Stickney*, 399 F2d 828 (6th Cir 1968) (the change in the title of the action resulted from the taxpayer's death during the pendency of the proceedings). The Seventh Circuit reached the same conclusion as the Tax Court and Sixth Circuit in *Gunther v Commr*, 909 F2d 291 (6th Cir 1990) .

(n22)Footnote 17. Rev Rul 73-2, 1973-1 CB 171 . See also Rev Rul 78-422, 1978-2 CB 129 (assumption of liabilities of transferor corporation governed by IRC § 304(a)(1), not IRC § 357(a)(1)). The enactment of IRC § 304(b)(3)(A) has rendered the two rulings obsolete. Rev Rul 95-71, 1995-2 CB 323 .

(n23)Footnote 18. *Coates Trust v Commr*, 480 F2d 468 (9th Cir 1973) , cert denied 414 US 1045 .

(n24)Footnote 19. IRC § 304(b)(3)(A). In determining whether persons in control of the issuing corporation are in control of the acquiring corporation, all transferors of stock must be counted even though some of them receive only stock and not other property from the acquiring corporation. IRC § 304(c)(2)(B).

(n25)Footnote 20. IRC § 304(b)(3)(B). The exception for acquisition indebtedness applies to an extension, renewal, or refinancing of the debt.

The tax consequences of the existence of the indebtedness will be governed by IRC §§ 357 and 358.

(n26)Footnote 21. IRC § 304(b)(3)(C), (D). The attribution rules of IRC § 318 apply in determining the extent of a shareholder's ownership. IRC § 304(b)(2)(D)(i), (c)(3).

For this purpose, any assumption of, or acquisition of stock subject to, acquisition indebtedness is treated as a distribution of property.

(n27)Footnote 1. A corporation qualifies as the parent of another corporation if it owns 50 percent of the voting stock or 50 percent of the value of the outstanding stock of such other corporation. IRC § 304(c)(1).

Stock of a parent corporation was exchanged for stock of its subsidiary and cash pursuant to a plan of reorganization. The Tax Court relied on the definition of property found in IRC § 317(a) (money, securities, and other property, but not stock in the distributing corporation) to hold that the stock portion of the transaction did not fall within IRC § 304(a)(2). *Bhada v Commr*, 89 TC 959 (1987) , affd 892 F2d 39 (6th Cir 1989) ; see also *Caamano v Commr*, 879 F2d 156 (5th Cir 1989) .

(n28)Footnote 2. IRC § 304(b)(1).

(n29)Footnote 3. *IRC § 304(b)(2)*. In *Rev Rul 69-261, 1969-1 CB 94*, the Service held that a wholly owned subsidiary's purchase of its parent's stock from the sole shareholder of the parent resulted in a constructive dividend to the parent and to the shareholder. It abandoned that position in *Rev Rul 80-189, 1980-2 CB 106*, to conform to the consensus of the courts. *Webb v Commr, 572 F2d 135 (5th Cir 1978)*, *affg per curiam 67 TC 293 (1976)*; *Broadview Lumber Co v US, 561 F2d 698 (7th Cir 1977)*; *Virginia Metals Corp v Commr, 67 TC 372 (1976)*.

(n30)Footnote 4. *Treas Reg § 1.304-2(c)*.

(n31)Footnote 5. Marans, "Section 304: The Shadowy World of Redemptions Through Related Corporation," 22 *Tax L Rev* 161 (1967).

(n32)Footnote 1. *Treas Reg § 1.304-2(a)*; *Rev Rul 71-563, 1971-2 CB 175*. See *Rev Rul 71-527, 1971-2 CB 174*, applying the Regulations to an *IRC § 304* transaction treated as an *IRC § 303* redemption.

(n33)Footnote 2. *Prop Treas Reg § 1.302-5*, discussed in § 5.02[4]; *Prop Treas Reg § 1.304-2(a)(3)*.

(n34)Footnote 3. *Treas Reg § 1.304-2(a)*. Conceptual consistency requires the Regulations to call for an increase in basis (reflecting the idea that the transaction is a contribution to the capital of the acquiring corporation) followed by an immediate decrease in basis.

(n35)Footnote 4. *Treas Reg § 1.304-2(a)*.

(n36)Footnote 5. *Treas Reg § 1.304-3(a)*. *Prop Treas Reg § 1.302-5* will apply to any of the shareholder's unutilized basis in the stock of parent corporation. In applying the regulation, the parent corporation is treated as the redeeming corporation and the shareholder as the redeemed shareholder. *Prop Treas Reg § 1.304-3(a)*.

(n37)Footnote 6. Marans, "Section 304: The Shadowy World of Redemptions Through Related Corporation," 22 *Tax L Rev* 161, 172 (1967); Diamond, " 'Brother-Sister Corporations'--Sale of Stock or Other Assets, And Other Problems," 1959 *So Calif Tax Inst* 109, 129.

(n38)Footnote 7. The Internal Revenue Service took this position in *Rev Rul 80-189, 1980-2 CB 106*.

(n39)Footnote 8. The provision applies generally to distributions after Dec 15, 1987. However, the effective date is deferred until Jan 1, 1993 if the transaction is between corporations that were members of the same affiliated group on Dec 15, 1987, or became members of the same group before Jan 1, 1989, pursuant to a binding written contract or tender offer in effect on Dec 15, 1987.

(n40)Footnote 9. The example is taken from the Conference Report, HR Rep No 100-495, 100th Cong, 1st Sess 969-970 (1987).



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CHAPTER 5 Distributions in Redemption of Stock

1-5 Taxation of Securities Transactions § 5.05

§ 5.05 Effect of Redemptions on the Distributing Corporation

[1] Gain or Loss on the Distribution

IRC Section 311(b)(1) requires the recognition of gain when appreciated property (other than an obligation of the distributing corporation) is distributed to a shareholder in redemption of all or part of his stock.ⁿ¹ The manner in which the shareholder treats the redemption is unimportant when considering the tax consequences to the corporation. The only exception is a distribution by a regulated investment company (RIC) in redemption of its stock upon demand by the shareholder.ⁿ²

In determining the amount of gain to be recognized on a redemption falling within *IRC Section 311(b)(1)*, no offset is permitted for losses realized on the distribution of depreciated property as part of the transaction.ⁿ³ The character of the gain is a function of the nature of the property distributed.ⁿ⁴

Gain must also be recognized in the case of a redemption distribution by a foreign corporation of a United States real property interest, except when the basis of the distributed property in the hands of the distributee is the same as the adjusted basis of the property before the distribution increased by the amount of any gain recognized by the distributing corporation.ⁿ⁵

[2] Effect on Earnings and Profits

A redemption distribution treated as a dividend under *IRC Section 301* will have the same effect on the distributing corporation's earnings and profits as any ordinary dividend distribution.ⁿ¹ A redemption treated as an exchange has a different impact on earnings and profits. *IRC Section 312(n)(7)* provides that "the part of the distribution which is properly chargeable to earnings and profits shall be an amount which is not in excess of the earnings and profits of the corporation accumulated after February 28, 1913, attributable to the stock so redeemed." Thus, if 20 percent of the corporation's stock is redeemed, earnings and profits are reduced by 20 percent, but in no event can the reduction be greater than the amount of the distribution.ⁿ²

If the corporation has more than one class of stock, its earnings and profits should be allocated among the different classes in determining the amount by which a redemption of all or part of one class reduces earnings and profits.ⁿ³ Generally no allocation will be made to preferred stock that is not convertible or participating to any significant extent in corporate growth. A redemption of such stock should result in a reduction of the capital account only, unless the

distribution includes dividend arrearages.ⁿ⁴

Priorities legally required as between different classes of stock may be taken into account in allocating earnings and profits between classes.ⁿ⁵

Example:

A corporation has 1,000 shares of class A common stock and 1,000 shares of class B common stock. Both classes have the same par value and were issued at the same time at the same price. The class A common has a preference as to dividends and liquidating distributions twice that of the class B common. The corporation has earnings and profits of \$120,000 and a capital account greater than \$60,000. If the corporation redeems all of the class A common for \$140,000, earnings and profits should be reduced by \$80,000 (2/3rds of \$120,000) and the capital account by \$60,000.

The rules just described apply to distributions in taxable years beginning after September 30, 1984. For preceding years, *IRC Section 312(e)*, repealed by the Tax Reform Act of 1984, provided that "the part of [the] distribution which is properly chargeable to capital account shall not be treated as a distribution of earnings and profits."ⁿ⁶

The difference in result between the new and old rules can be illustrated by the following example:

Example:

The balance sheet of a corporation shows the following information:

Assets.....	\$100,000
Liabilities.....	20,000
Capital (stated value of stock plus paid-in surplus).....	40,000
Accumulated Earnings and Profits	40,000

The corporation redeems 25 percent of the stock for \$30,000. Under the old rule, the charge to capital account would have been \$10,000, with earnings and profits reduced by \$20,000. Under the new rule, earnings and profits are reduced by \$10,000.

[3] Expenses "In Connection With" a Redemption

IRC Section 162(k) disallows a deduction for "any amount paid or incurred by a corporation in connection with the reacquisition of its stock or the stock of any related person..."ⁿ¹ These few words have spawned a surprising amount of litigation, including an issue that may be headed for the US Supreme Court.

The subsection was added to the Code by the Tax Reform Act of 1986 to clarify that Congress disapproved the result in *Five Star Mfg Co v Comm'r*,ⁿ² which allowed a corporation to deduct as an ordinary and necessary expense the cost of acquiring its stock from a dissident shareholder as a means of avoiding litigation and potential dissolution.ⁿ³ However, *IRC Section 162(k)* does not merely disallow a deduction for amounts paid by a corporation, under any circumstances, to reacquire its stock; it also disallows any expenditure incurred "in connection with" a redemption.ⁿ⁴

Are loan fees (other than interest) paid to borrow money with which to redeem stock disallowed by *IRC Section 162(k)*? The Ninth Circuit said no; such fees are incurred "in connection with" the loan transaction, not in connection with the redemption.ⁿ⁵ The Tax Court said yes; Congress intended the phrase "in connection with" to be broadly construed.ⁿ⁶ The Senate Finance Committee report illustrated the kind of incidental expenditures *IRC Section 162(k)* was intended to cover: "The committee intends that amounts subject to this provision will include amounts paid to repurchase stock,

premiums paid for the stock, legal, accounting, brokerage, transfer agent, appraisal and similar fees incurred in connection with the repurchase, *and any other expenditure that is necessary or incident to the repurchase* * * * [S Rep 99-313, at 223 (1986), 1986-3 C.B. (Vol. 3) 1, 223; emphasis added.]ⁿ⁷ Fees paid for a loan obtained solely for the purpose of redeeming the corporation's stock were, in the Tax Court's opinion, "connected with" the redemption in the "ordinary, everyday sense" of those words.ⁿ⁸ Congress ultimately resolved the loan fee issue by adding such fees to a list of expenditures for which a deduction is expressly permitted notwithstanding *IRC Section 162(k)*,ⁿ⁹ but without resolving the larger dispute over the breadth of *IRC Section 162(k)*'s "in connection with" language.

However, the scope of the "in connection with" language in *IRC Section 162(k)* was again put in issue in conflicting decisions over whether *IRC Section 162(k)* disallows deductions that would otherwise be allowable when retirement benefits paid by an employee stock ownership plan (ESOP) are funded by the taxpayer's redemption of its own stock from the ESOP.ⁿ¹⁰ Following its "strict construction" of the "in connection with" language in *IRC Section 162(k)*,ⁿ¹¹ the Ninth Circuit held that a taxpayer's redemption of its own stock from its ESOP, which used the redemption proceeds to pay retirement benefits to the taxpayer's retired employees, which retirement benefits were then deducted by the taxpayer under *IRC Section 404(k)(1)*, was not "connected with" the deduction claimed by the taxpayer because the retired employees, not the taxpayer, independently determined whether to withdraw the redemption proceeds as retirement benefits from the ESOP which is what made them deductible by the taxpayer.ⁿ¹² The Tax Court, following its broader interpretation of "in connection with" announced in *Fort Howard Paper Corp*, held that the redemption and withdrawal transactions were clearly "connected" because the deduction under *IRC Section 404(k)(1)* was conditioned on the benefits withdrawn by the retired employees being paid out of the proceeds from a redemption of the corporation's stock.ⁿ¹³ With the Courts of Appeals for the Third and Eighth Circuits taking the same view as the Tax Court,ⁿ¹⁴ the issue may ultimately be resolved by the Supreme Court.

The Tax Court has also found that payment of a shareholder's legal claim against the corporation is not necessarily "connected with" a redemption of the shareholder's stock simply because the redemption and payment of the claim occur at the same time.ⁿ¹⁵ This holding is supported by *IRC Section 162(k)*'s legislative history: "[T]he provision is not intended to deny a deduction for otherwise deductible amounts paid in a transaction that has no nexus with the redemption other than being proximate in time or arising out of the same general circumstances. For example, if a corporation redeems a departing employee's stock and makes a payment to the employee in discharge of the corporation's obligations under an employment contract, the payment in discharge of the contractual obligation is not subject to disallowance under this provision * * * Payments in discharge of other types of contractual obligations, in settlement of litigation, or pursuant to other actual or potential legal obligations or rights, may also be outside the intended scope of the provision to the extent it is clearly established that the payment does not represent consideration for the stock or expenses related to its acquisition...H. Conf. Rept. 99-841, (Vol. II), at II-168 to II-169 (1986), 1986-3 C.B. (Vol. 4) 1, 168, 169." Tax planners will therefore want to document carefully all possible independent bases for compensating the retiring shareholder (other than payment for his stock) to maximize the deductibility of payments made to such shareholders.

FOOTNOTES:

(n1)Footnote 1. *Rev Proc 81-62, 1981 CB 684* , contains a checklist setting forth the information required in a request for ruling under *IRC § 311*.

See generally Shores, "Repeal of General Utilities and the Triple Taxation of Corporate Income," 46 *Tax Lawyer* 177 (1992).

(n2)Footnote 2. *IRC § 852(b)(6)*.

(n3)Footnote 3. *Treas Reg § 1.311-2(a)(3)*.

(n4)Footnote 4. *Id.*; *Rev Rul 75-514, 1975-2 CB 116* .

(n5)Footnote 5. *IRC § 897(d)(1)(A), (B)*. The amount of gain to be recognized is the excess of the fair market value of the interest over its adjusted basis.

(n6)Footnote 1. See Ch 4.

(n7)Footnote 2. S Rep No 98-169, 98th Cong, 2d Sess, 202 (1984).

(n8)Footnote 3. HR Rep No 98-861, 98th Cong, 2d Sess, 840 (1984).

(n9)Footnote 4. HR Rep No 98-861, 98th Cong, 2d Sess, 840 (1984).

(n10)Footnote 5. HR Rep No 98-861, 98th Cong, 2d Sess, 840 (1984).

(n11)Footnote 6. The amount in excess of the proper charge to capital account reduced earnings and profits only to the extent thereof, and could not be used to create negative earnings and profits. *Est of Uris v Commr*, 605 F2d 1258 (2d Cir 1979) , *affg* 68 TC 448 (1977) .

The reduction of earnings and profits in a redemption of Section 306 stock treated as an exchange by reason of Section 303 did not include the amount of the distribution that was properly chargeable to capital account. *Rev Rul* 82-72, 1982-1 CB 57 .

(n12)Footnote 1. A person is a related person for this purpose if the person bears a relationship to the acquiring corporation specified in *IRC § 267 (c)* or *IRC § 707(b)(1)* (but substituting 10 percent for 50 percent ownership), or the related person and the acquiring corporation are engaged in trades or businesses under common control as defined in *IRC § 52(a)* and *(b)*. See *IRC § 465(b)(3)(C)*, incorporated by reference into *IRC § 162(k)(1)*. The reach of *IRC § 162(k)* was further extended in *Custom Chrome, Inc v Comm'r*, 217 F3d 1117 (9th Cir 2000) , in which a shareholder's sale of stock to an unrelated entity was turned into a redemption by application of the step transaction doctrine. In that case, a leveraged buy-out was accomplished by forming a holding company and an acquisition company, which purchased the stock of the target company from its sole shareholder. Shortly thereafter the acquisition company was merged into the target, which became a wholly owned subsidiary of the holding company. Collapsing the steps, the Court of Appeals for the Ninth Circuit held that the target had effectively acquired its own stock from its sole shareholder. As a consequence, expenses connected with the transaction were nondeductible under *IRC § 162(k)*.

(n13)Footnote 2. 355 F2d 724 (5th Cir 1966) .

(n14)Footnote 3. See S Rep 99-313, at 223, n.3 (1986), 1986-3 CB (Vol 3) 223. *Five Star Mfg's* business purpose rationale was similar to the so-called *Corn Products* doctrine under which taxpayers were allowed to disregard the capital nature of expenditures for stock and other assets if the purpose of the acquisition was business-related and not for investment. See § 2.04[2][a]. This theoretical underpinning was removed some two years after *IRC § 162(k)* was enacted when the *Corn Products* doctrine as applied by the lower courts was overturned by the Supreme Court. *Arkansas Best Corp. v Comm'r*, 485 US 212 (1988) .

(n15)Footnote 4. Other than expenses expressly excepted by *IRC § 162(k)(2)*, including interest.

(n16)Footnote 5. *In re Kroy*, 27 F3d 367 (9th Cir 1994) .

(n17)Footnote 6. H Conf Rep 99-841, at 168-169 (1986), 1986-3 CB (Vol 5) 1, 168-169, cited in *Fort Howard Paper Corp v Comm'r*, 103 TC 345, 353 (1994) .

(n18)Footnote 7. *Fort Howard Paper Corp v Comm'r*, 103 TC at 354 .

(n19)Footnote 8. *Fort Howard Paper Corp v Comm'r*, 103 TC at 351-352 .

(n20)Footnote 9. *IRC § 162(k)(2)(A)* specifically excepts from the disallowance rule, in addition to interest expense, "amounts which are properly allocable to indebtedness and amortized over the term of such indebtedness" (i.e., loan fees). It also makes clear that *IRC § 162(k)* is not intended to disallow a deduction under *IRC § 561* for any distribution that qualifies for the dividends paid deduction for purposes of the accumulated earnings and personal holding company taxes. Finally, *IRC § 162(k)* does not apply to the redemption of stock in a regulated investment company that issues only stock redeemable upon the demand of the shareholder. *IRC § 162(k)(2)(B)*.

(n21)Footnote 10. See *IRC § 404(k)*. Note that *IRC § 162(k)* is not limited to the disallowance of deductions claimed as "ordinary and necessary expenses" under *IRC § 162(a)*. *IRC § 162(k)* broadly prevents any "deduction otherwise allowable" from being "allowed under this chapter...[i.e., under Chapter 1 of Subtitle A of Title 26 of the United States Code]."

(n22)Footnote 11. See *In re Kroy*, 27 F3d 367 (9th Cir 1994) .

(n23)Footnote 12. *Boise Cascade Corp v US*, 329 F3d 751 (9th Cir 2003) .

(n24)Footnote 13. *Ralston Purina Co v Comm'r*, 131 TC No 4 (2008) .

(n25)Footnote 14. *Conopco, Inc v US*, 572 F3d 162 (3d Cir 2009); *General Mills, Inc v US*, 554 F2d 727 (8th Cir 2009) .

(n26)Footnote 15. See *Chief Industries, Inc v Comm'r*, TC Memo 2004-45 .



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CHAPTER 6 Liquidating Distributions

1-6 Taxation of Securities Transactions 6.syn

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§ 6.05 Partial Liquidations--Effect on the Liquidating Corporation



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CHAPTER 6 Liquidating Distributions

1-6 Taxation of Securities Transactions § 6.01

§ 6.01 Introduction

Viewed from the shareholder level, a distribution in redemption of stock produces the same economic effect as a liquidating distribution--the shareholder surrenders all or part of his stock in return for assets of the corporation. It follows, then, that the shareholder should be allowed to treat the proceeds of a liquidation as a payment in exchange for his stock, and this is exactly the status that has been given to liquidating distributions since 1924 (except for the period 1934-1936).ⁿ¹

One exception to the general rule that a liquidation is a fully taxable exchange provides for nonrecognition of gain or loss on the complete liquidation of a subsidiary by its parent.ⁿ² Another converts shareholder gain into ordinary income whenever the liquidation is of a "collapsible corporation."ⁿ³

FOOTNOTES:

(n1)Footnote 1. The present provision is *IRC § 331*. *Rev Proc 86-6, 1986-1 CB 546* , reprinted as Appendix H, *infra* , contains a checklist of information to be included in a request for ruling under *IRC §§ 331* and *337*.

(n2)Footnote 2. *IRC § 332*; see *§ 6.02[3]*, *infra*.

(n3)Footnote 3. *IRC § 341*.



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CHAPTER 6 Liquidating Distributions

1-6 Taxation of Securities Transactions § 6.02

§ 6.02 Complete Liquidations--Effect on the Shareholder

[1] The General Rule--Section 331(a).

Any amount distributed to a shareholder in complete liquidation of a corporation is treated as received "in full payment in exchange for the stock."ⁿ¹ To be noted is that the liquidation does not automatically produce capital gain or loss; it merely supplies the exchange component of the capital transaction formula. Still required is that the surrendered stock constitute a capital asset in the hands of the shareholder.

What is complete liquidation? The term is not defined either in *IRC Section 331* or the Regulations thereto. However, the Regulations under *IRC Section 332*, dealing with complete liquidations of subsidiaries, speak of the status of liquidation existing "when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders."ⁿ² The regulations go on to show that a liquidation can be completed prior to dissolution and that legal dissolution of the corporation is not required.ⁿ³ Since *IRC Section 332* is concerned with complete liquidations, the concept of liquidation found in the Regulations under that section should apply with equal force to all complete liquidations.ⁿ⁴

Prior to the Tax Equity and Fiscal Responsibility Act of 1982, each of a series of distributions made pursuant to a plan to redeem all of the stock of the corporation was treated as a partial liquidation. After August 31, 1982, such distributions are treated as being in complete liquidation of the corporation and, therefore, governed by *IRC Section 331(a)*.ⁿ⁵

[a] Computing Gain or Loss on the Liquidation. The gain or loss to a shareholder from a distribution in complete liquidation is determined in the same manner as any disposition of property, namely, by comparing the amount of the distribution with the basis of the surrendered stock.ⁿ⁶ According to the regulations, gain or loss is not determined in the aggregate, but rather on a share-by-share basis.ⁿ⁷ For example, assume that a shareholder, who purchased 100 shares of a corporation on March 1, 2000 at a cost of \$25 per share, and an additional 100 shares on March 1, 2001 at a cost of \$100 per share, receives a \$15,000 liquidating distribution from the corporation on June 1, 2001. The shareholder's economic gain of \$2,500 translates for tax purposes into a long-term capital gain of \$5,000 and a short-term capital loss of \$2,500.

The foregoing example assumed that the liquidating distribution was pro rata with respect to the shareholders. If this is not the case, the Service treats the liquidation as two separate transactions, the first of which is a pro rata distribution,

and the second, a payment by recipients of a lesser share to those receiving more than a pro rata portion.ⁿ⁸ The tax consequences of the payment depend "upon all of the relevant facts and circumstances which must be determined from all of the extrinsic and intrinsic evidence surrounding the transaction."ⁿ⁹

If the liquidation takes the form of a series of distributions, gain is recognized only after an amount equal to the shareholder's basis has been recovered.ⁿ¹⁰ Where the shareholder owns different blocks of stock, each distribution in the series must be allocated ratably among the different blocks in the proportion that the number of shares in a particular block bears to the number of shares outstanding, and gain recognized with respect to each specific block only after the shareholder has recovered his basis for that block.ⁿ¹¹ Once this has occurred, the portion of each subsequent distribution allocable to the specific block will be recognized as gain in its entirety. On the other hand, loss will not be recognized until the corporation has made its final distribution.ⁿ¹²

[b] The Time to Recognize Gain or Loss--"Open" and "Closed" Transactions. Suppose that X Corporation completely liquidates by making a single distribution of cash to its shareholders. It is obvious that the shareholders will recognize gain or loss on the liquidation in the taxable year of the distribution.ⁿ¹³ The identical result obtains if the corporation distributes assets in kind and the assets are readily susceptible of valuation.

Where the distribution includes assets whose value cannot be ascertained with reasonable accuracy, e.g., contingent contract rights, the transaction will remain "open" under the rule set down in *Burnet v. Logan*.ⁿ¹⁴ The taxpayer will recognize gain in the year of distribution only to the extent that the value of other assets received exceeds his basis for the stock. Additional gain will be includable when collection, sale, or other disposition converts the asset into property of ascertainable value. The important feature of the "open" transaction is that any additional gain realized is capital gain, since it is considered gain produced by the exchange of stock. Had a value been ascribed to the asset, and the liquidation "closed" in the year of distribution, any additional amount received on account of the asset could be ordinary income or capital gain, the determining factors being the character of the asset in the taxpayer's hands and the mode of disposition. If the asset has the status of a capital asset and the disposition takes the form of a sale or exchange, the additional gain will be capital gain. But if either of these requisites for capital treatment is lacking, the additional amount realized will enter gross income as ordinary income.

[c] Anticipatory Assignment of Income--Gift of Stock Followed by Liquidation. A gift of stock during the period between adoption of the plan of liquidation, but prior to actual distribution, may constitute an anticipatory assignment of the proceeds. A crucial question is whether the donee possesses sufficient voting power to call off the liquidation. If not, a court could infer that it was the donor's intention that the donee have no right other than to participate in the liquidation distribution.ⁿ¹⁵ In such case, the gift of the stock is a gift of the proceeds and nothing more.

Lack of control does not insure against a finding of anticipatory assignment. A court, applying a "realities and substance" test, could conclude that the liquidation had progressed so far as to render it unlikely that the plan of liquidation would be abandoned.ⁿ¹⁶ Courts that look to the realities and substance of events give no weight to the hypothetical possibility that the liquidation might be called off.ⁿ¹⁷

[d] Basis of Property Received. *IRC Section 334(a)* states the rule that the basis of property received in a complete liquidation in which gain or loss is recognized (or would be recognized if gain or loss was realized) will be the fair market value of the property at the time of the distribution.ⁿ¹⁸ Put another way, the basis of the property is equal to the basis of the surrendered stock, increased by the amount of any gain, and decreased by the amount of any loss, realized on the liquidation. *IRC Section 334(a)* has no application to the liquidation of a subsidiary under *IRC Section 332*; the basis of property received in such a liquidation is controlled by *IRC Section 334(b)*.

[2] Exception to the General Rule--Liquidation of a Subsidiary.

[a] Requirements of Section 332.

No gain or loss is recognized "on the receipt by a corporation of property distributed in complete liquidation of another corporation" n1 provided (1) the receiving corporation owns a prescribed percentage of the stock of the distributing corporation, and (2) the distribution is in complete cancellation or redemption of all of the stock of the distributing corporation and occurs within a specified period of time. n2 The transaction is treated like a tax-free reorganization in other respects as well, with the parent succeeding to the subsidiary's basis in properties transferred n2.1 as well as its other tax attributes (including loss carryovers). n2.2

[i] Stock Ownership Requirement. The first condition for nonrecognition calls for the recipient corporation to be the actual owner of stock (in the liquidating corporation) that possesses at least 80 percent of the total combined voting power of all classes of stock entitled to vote and has a value equal to at least 80 percent of the total value of the stock of the corporation. n3 Such ownership must be present on the date of adoption of the plan of liquidation and must continue without interruption until the distribution in liquidation is completed. n4 If the recipient corporation fails to maintain the required stock ownership continuously throughout the specified period, all distributions received under the plan of liquidation, including those received while the parent corporation is qualified with respect to the ownership of stock of the distributing corporation, will be subject to the general rule of *IRC Section 331* and not the special nonrecognition rule of *IRC Section 332(a)*. n5 Thus, even though *IRC Section 332* is not elective, it would appear possible for a parent to avoid nonrecognition at any time during the pendency of the liquidation merely by disposing of sufficient stock to reduce its holding in the subsidiary below the qualifying amount. n6

The opposite situation, an attempt to raise stock ownership to the required level, was presented in *Revenue Ruling 70-106*, n7 where the increase in the parent's stock ownership in the subsidiary was achieved by the redemption of a minority interest prior to adoption of the formal plan of liquidation. The Service denied the parent nonrecognition treatment under *IRC Section 332*, holding that "the plan of liquidation was adopted at the time [the parent corporation] reached the agreement with the minority shareholders and at such time, [the parent] owned seventy-five percent of the stock of [the subsidiary]." n8 Thus, all the shareholders, including the minority shareholders, were held to have received a distribution in liquidation governed by the provisions of *IRC Section 331*. It must be assumed that the Service found the existence of an informal plan of liquidation which antedated adoption of the formal plan. Otherwise the result seems hard to justify. It is interesting to note that the attempt would have succeeded if the stock of the minority shareholders had been purchased by the parent instead of having been redeemed by the subsidiary. A mere sale of stock between shareholders does not constitute an adoption of a plan of liquidation. n9

[ii] Distribution Requirements. The second condition of *IRC Section 332(b)* interrelates the timing of distributions with the form and content of the plan of liquidation. n10 If the transfer of assets is completed within a single taxable year of the distributing corporation, n11 adoption by the shareholders of the resolution authorizing the distribution will be considered the adoption of the plan of liquidation, even though the resolution fails to specify the time for completion of the transfer of property. n12 If the liquidation is not completed within one taxable year, the plan of liquidation must provide that the transfer of property will be completed within three years from the close of the taxable year in which the first distribution is made. n13 If the transfer of property is not completed within the specified period, none of the distributions made pursuant to the plan of liquidation will be granted nonrecognition treatment. n14 Where complete distribution does not occur within the taxable year, the Commissioner may require the taxpayer to post a bond or execute a waiver of the statute of limitations as a means of insuring the assessment and collection of taxes which will become due if *IRC Section 332* is rendered retroactively inapplicable. n15

While the apparent import of the statute is that nonrecognition of gain or loss will ensue only if the liquidating corporation is fully divested of its property within the prescribed period, the Regulations permit the retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence. n16 But if the retained property consists of operating assets, the liquidation will fall outside the ambit of *IRC Section 332*. n17

Where the liquidation consists of more than one distribution, it is essential that a status of liquidation exist from the time

of the first distribution until complete liquidation.ⁿ¹⁸ Such a status exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing the balance of its property to its shareholders.ⁿ¹⁹

[iii] Deductible Liquidating Distributions of Regulated Investment Companies and Real Estate Investment Trusts. If a corporation receives a distribution from a regulated investment company (RIC) or a real estate investment trust (REIT) that is considered as being in complete liquidation of the RIC or REIT under *IRC Section 332(b)*, the corporation must recognize and treat as a dividend from the RIC or REIT an amount equal to the deduction for dividends paid allowable to the RIC or REIT by reason of the distribution.ⁿ²⁰

[b] Basis of Property Received in a Section 332 Liquidation.

[i] General Rule. Under *IRC Section 334(b)*, property received by a parent corporation in a *IRC Section 332* liquidation will have the same basis in the hands of the parent as it had in the hands of the subsidiary except that the basis in the hands of the parent will be the fair market value of the property at the time of the distribution if (i) gain or loss is recognized by the liquidating corporation with respect to the property, or (ii) the liquidating corporation is a foreign corporation, the parent is a domestic corporation, and the parent's aggregate adjusted bases of property described in *IRC Section 362(e)(1)(B)* (see § 3.02[5]) and distributed in the liquidation otherwise would exceed the fair market value of the property immediately after the liquidation. This rule should be applied asset-by-asset and not by allocating the aggregate basis of the acquired property among the component parts in proportion to the fair market value of each asset. However, if the liquidating corporation recognizes gain or loss with respect to the property, the basis of the property in the hands of the distributee will be its fair market value at the time of distribution.

[ii] Exception to the General Rule--Section 338. Under *IRC Section 338*, a purchasing corporation can treat a stock purchase as an asset acquisition if it irrevocably elects to do so not later than the 15th day of the ninth month beginning after the month in which the "acquisition date" occurs.ⁿ²¹ The acquisition date is the date on which there is a qualified stock purchase, that is, the purchasing corporation obtains by purchase, either in a single transaction or in a series of transactions during a 12-month acquisition period, stock that possesses at least 80 percent of the total combined voting power of all classes of stock entitled to vote and has a value equal to at least 80 percent of the total value of all classes of stock of the target (subsidiary) corporation.ⁿ²² To illustrate, if the purchasing corporation acquires the requisite degree of ownership in a single purchase on one day, that day will be the acquisition date and the election period measured from that date. On the other hand, if the acquisition is in steps, the acquisition date is the day on which the specified percentage of ownership is obtained provided the steps occur within twelve months.

The term "purchase" is defined as any acquisition of stock,ⁿ²³ except (1) an acquisition of stock in a transaction which causes the basis of the stock in the hands of the acquiring corporation to be determined by reference to its basis in the hands of the transferor (as in a reorganization) or under *IRC Section 1014(a)*; (2) an acquisition of stock from a decedent; (3) an acquisition of stock in an *IRC Section 351, 354, 355, or 356*, exchange or in any other transaction described in regulations in which the transferor does not recognize the entire amount of gain or loss realized on the transaction; and (4) an acquisition of stock from a person whose ownership would be attributed to the acquiring corporation.ⁿ²⁴ A purchase also occurs if stock is acquired by purchase from a related corporation provided at least 50 percent in value of the stock of such related corporation was acquired by purchase.ⁿ²⁵ For this purpose, a corporation is a related corporation if stock owned by such corporation is treated under *IRC Section 318* as owned by the corporation acquiring the stock.ⁿ²⁶

Example

:1 X Corporation owns 90 percent of the stock of Y Corporation. On June 1, 2001, P Corporation purchased 60 percent of the stock of X Corporation. P Corporation is treated as having acquired 54 percent (60 percent of 90 percent) of Y Corporation on that date. If the purchasing corporation had purchased only 40 percent of the X stock on June 1, 2001, but then purchased an additional 20 percent of the stock one month later, it would still be treated as owning 54 percent of the stock of Y Corporation,

but such ownership would begin at the time of the second purchase.

Example

:2 On January 1, 2001, *P* Corporation purchased 75 percent in value of *X* Corporation stock. On that date, *X* owned 80 of the 2,000 shares of *Y* Corporation stock. On June 1, 2001, *X* acquired an additional 320 shares of *Y* stock. On December 1, 2001, *P* purchased 1,400 shares of *Y* stock from an unrelated party and 240 of the 400 shares of *Y* stock held by *X*.

Of the 240 shares of *Y* stock purchased by *P* from *X* on December 1, 2001, 60 of those shares are deemed to have been acquired by *P* on January 1, 2001, the date on which 60 of the 80 shares of *Y* stock held by *X* were first considered owned by *P* under *IRC Section 318(a)(2)(C)*, namely, 75 percent of 80 shares. The remaining 180 shares of *Y* stock purchased by *P* from *X* on December 1, 2001 are deemed to have been acquired by *P* on June 1, 2001, the date on which an additional 240 of the 400 shares of *Y* stock owned by *X* were first considered owned by *P* under *IRC Section 318(a)(2)(C)*, that is, 300 shares (75 percent of 400 shares) minus the 60 shares deemed owned on January 1, 2001. Because stock acquisitions by *P* sufficient for a qualified stock purchase of *X* occur within a 12-month period (60 shares constructively on January 1, 180 shares constructively on June 1, and 1,400 shares actually on December 1), a qualified stock purchase is made on December 1, 2001.

Redemptions of stock of the acquired corporation from persons unrelated to the purchasing corporation that occur during the 12-month acquisition period are taken into account as reductions in the acquired corporation's outstanding stock for purposes of determining whether the amount of stock purchased by the acquiring corporation during the 12-month period satisfies the percentage ownership requirements.ⁿ²⁷ A redemption of stock from the purchasing corporation or from any person related to the purchasing corporation is not taken into account as a reduction in the acquired corporation's outstanding stock.ⁿ²⁸

The effect of an election is to treat the target corporation as having sold all of its assets for fair market value at the close of the acquisition date in a single transaction as part of a complete liquidation, and then to treat it as a new corporation that acquired all of those assets on the subsequent day.ⁿ²⁹ (It is important to note that the target corporation does not have to be liquidated for *IRC Section 338* to apply.)ⁿ³⁰ The assets of the target corporation will have a total basis equal to the sum of the grossed-up basis of the purchasing corporation's recently purchased stock (stock in the target corporation that is held by the purchasing corporation on the acquisition date and acquired by it during the 12-month acquisition period) and the basis of its nonrecently purchased stock (any stock that is held by the purchasing corporation on the acquisition date and that is not recently purchased stock).ⁿ³¹ The purchasing corporation can step up the basis of its nonrecently purchased stock to an amount equal to the grossed-up basis of its recently purchased stock multiplied by a fraction the numerator of which is the percentage of the value of the target corporation's stock attributable to the purchasing corporation's nonrecently purchased stock, and the denominator of which is 100 percent minus the numerator, provided it elects to recognize gain as if the nonrecently purchased stock were sold on the acquisition date for an amount equal to the stepped-up basis.ⁿ³² The grossed-up basis of the recently purchased stock is an amount equal to the basis of the stock multiplied by a fraction the numerator of which is 100 percent minus the percentage of the value of the target corporation's stock attributable to nonrecently purchased stock, and the denominator of which is the percentage of the value of the target corporation attributable to the purchasing corporation's recently purchased stock.ⁿ³³ Thus, if the purchasing corporation's recently purchased stock equaled 85 percent of the value of the stock in the target corporation, and its nonrecently purchased stock amounted to 10 percent of such value, the grossing up fraction would be 90/85.

The basis as determined is allocated pursuant to the residual method.ⁿ³⁴ Under that method, basis is first reduced by cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions (Class I assets). Any remaining basis is allocated

to six different classes of assets in proportion to their fair market values. Class II assets consist of actively traded personal property within the meaning of *IRC Section 1092(d)(1)*, and certificates of deposit and foreign currency even if not actively traded.ⁿ³⁵ Class III assets are assets that the taxpayer marks to market at least annually for federal income tax purposes and debt instruments, other than (1) debt instruments issued by persons related at the beginning of the day following the acquisition date to the acquired corporation under *IRC Section 267(b)* or 707, (2) certain contingent debt instruments, and (3) debt instruments convertible into the stock of the issuer or other property. Class IV assets consist of inventory-type assets.^{n35.1} Class VI assets are all Section 197 intangibles, except goodwill and going concern value. Class VII assets are goodwill and going concern value. Class V assets are all other assets.

IRC Section 338 imposes consistency requirements whenever the purchasing corporation acquires the stock of a target corporation and one or more target affiliates and the purchases take place during a period consisting of the one-year period preceding the twelve-month acquisition period for the target corporation, plus the portion of the acquisition period up to and including the acquisition date, and the one-year period following the acquisition date--the "consistency period."ⁿ³⁶ (A corporation is a target affiliate of the target corporation if, at any time during that portion of the consistency period ending on the acquisition date of the target corporation, each of the corporations was a member of an affiliated group that had the same common parent.)ⁿ³⁷ In such case, any election made with respect to the first such purchase applies with equal force to each subsequent purchase, and no election can be made for a later purchase if one was not made with respect to the first of such purchases.ⁿ³⁸

Generally, with respect to a deemed asset sale, a target is not treated as a member of an affiliated group for consolidated return purposes. However, if an election under *IRC Section 338(h)(10)* is made, the target's deemed asset sale is included in the selling consolidated group's return, but no gain or loss is recognized the stock sale by members of the group. Absent an *IRC Section 338(h)(10)* election, there is normally double recognition of gain or loss--by the target corporation on the deemed sale of stock in the target affiliate and by the target affiliate on the deemed sale of its assets.ⁿ³⁹

A second consistency provision treats a purchasing corporation as having made an election with respect to any target corporation if, at any time during the consistency period, the purchasing corporation acquires any asset of the target corporation or target affiliate.ⁿ⁴⁰ Excepted from the scope of this second requirement is any acquisition by the purchasing corporation if the sale by the target corporation or target affiliate is in the ordinary course of its trade or business, the basis of the property acquired is determined, wholly by reference to the adjusted basis of the property in the hands of the person from whom it is acquired, the acquisition took place before September 1, 1982, the property is located outside the United States, or the regulations specifically exempt the acquisition.ⁿ⁴¹

The consistency requirements can be illustrated by the following examples:

Example 1:

A corporation purchases 100 percent of the stock of a target corporation on June 1, 2000, and makes a timely election to treat the purchase as an asset purchase. Within one year, it purchases all of the stock of a second corporation that is a target affiliate of the target corporation. The purchasing corporation is deemed to have made an election with respect to the affiliated corporation even if it does not actually do so.

Example 2:

Assume the same facts as in the previous example except that no election was made after the purchase of the stock of the target corporation. No election can be made with respect to the purchase of the stock of the affiliated corporation.

Example 3:

Assume the same facts as in the prior example except that the second purchase is of the assets of the

affiliated corporation. The purchasing corporation will be deemed to have made an election with respect to the target corporation.

[c] Effect of the Liquidation on Minority Shareholders. The liquidation of a subsidiary under *IRC Section 332* in no way affects the tax consequences of the distribution to minority shareholders. *IRC Section 332* and the applicable basis provision are the concern of the parent corporation alone. Although as a general rule, the holder of a minority interest will recognize his gain or loss under *IRC Section 331* and use fair market value as the basis for the property received by him, he is not precluded in a proper case, from seeking nonrecognition on the ground that the liquidation was also a reorganization, eg, a merger of subsidiary into parent with the parent issuing its stock to the holders of the minority interest.ⁿ⁴²

[d] Liquidation of a Foreign Subsidiary. The general nonrecognition rule of *IRC Section 332* does not apply when the liquidating subsidiary is a foreign corporation and the parent is a domestic corporation. In such case, the parent includes in its gross income as a deemed dividend the all earnings and profits amount for the taxable year in which the distribution occurs.ⁿ⁴³ The all earnings and profits amount is the net positive earnings and profits that would be attributed to a United States shareholder's controlled foreign corporation stock if the stock were sold in a transaction subject to *IRC Section 1248*, except that the all earnings and profits amount does not include amounts attributable to the holding period of non-United States persons, but does include earnings attributable to the United States shareholder's stock whether or not the shareholder was a 10-percent owner of the foreign corporation.ⁿ⁴⁴ The all earnings and profits amount is increased by any gain recognized by the foreign subsidiary, as when there are distributions to minority shareholders.ⁿ⁴⁵

A United States person who is not a 10-percent shareholder of the foreign corporation must recognize gain, but not loss, with respect to the stock of the foreign corporation.ⁿ⁴⁶ However, the shareholder may elect to include in income as a deemed dividend the all earnings and profits amount with respect to its stock in the foreign corporation.ⁿ⁴⁷ A *de minimis* exception eliminates gain recognition if the value of the United States person's stock is less than \$50,000.

[e] Liquidation of Foreign Owned Holding Company. Pursuant to *IRC Section 332(d)(1)*, a complete liquidation of an applicable foreign holding company is not treated as a liquidation of a subsidiary or any other type of liquidation.ⁿ⁴⁸ Instead, the distribution is treated as one to which *IRC Section 301* applies. This means that, if the liquidated company has earnings and profits, the distribution will be treated as a dividend.

An applicable holding company is any domestic corporation (i) that is a common parent of an affiliated group, (ii) the stock of which is directly owned by the distributee foreign corporation, (iii) substantially all of the assets of which consist of stock in other members of the affiliated group, and (iv) that has not been in existence at all times during the five years immediately preceding the date of the liquidation.ⁿ⁴⁹

[f] Record-Keeping and Filing Requirements. The income tax return filed by a parent corporation for each year in which it receives a distribution in liquidation of its subsidiary must contain a complete statement of the facts pertinent to nonrecognition treatment, including:

- (1) a certified copy of the plan of liquidation and of the resolutions adopting the plan;
- (2) a statement under oath showing in detail all transactions incident to the plan;
- (3) a list of all properties received, together with the basis of the property to the liquidating corporation and the fair market value of the property on the date of distribution;
- (4) a statement of any indebtedness of the subsidiary to the parent on the date of adoption of the plan and on the date of first liquidating distribution, and, if the debt was acquired at less than face value, the cost to the parent corporation; and

(5) a statement as to the ownership of all classes of stock of the subsidiary beginning as of the date of adoption of the plan and ending with the distribution in liquidation. As to each class, the number of shares, percentage owned, voting power, cost or other basis, and dates on which acquired must be detailed.ⁿ⁵⁰

The recipient corporation is required also to keep permanent records concerning the information that must be filed with its tax returns.ⁿ⁵¹

FOOTNOTES:

(n1)Footnote 1. *IRC § 331(a)*. *IRC § 2032A* sets forth certain rules for valuing special use property for estate tax purposes. *IRC § 1040* limits the gain to the estate of the distribution of that property to "qualified heirs." Neither of those provisions limits the amount of gain realized on the liquidation of a corporation treated as special use property under *IRC § 2032A*. *Ltr Rul 9146001* .

(n2)Footnote 2. *Treas Reg § 1.332-2(c)*. The retention of major assets by the corporation will preclude a finding that a complete liquidation has occurred. See, eg, *Hageman v Commr*, 446 F2d 20 (5th Cir 1971) .

The Service will not ordinarily rule on the tax effect of a liquidation preceded or followed by the transfer of all or a part of the business assets to another corporation (1) that is the alter ego of the liquidating corporation, and (2) which, directly or indirectly, is owned more than 20 % in value by persons holding directly or indirectly more than 20% in value of the liquidating corporation's stock. *Rev Proc 2010-3*, 2010-1 IRB 110, 116 (§ 4.01(22)).

The courts have recognized that there can be a *de facto* liquidation if (1) there is a manifest intention to liquidate, (2) there is a continuing purpose to terminate corporate affairs, and (3) the activities of the corporation and its shareholders are directed toward that objective. See, eg, *Rendina v Commr*, TC Memo 1996-392 ; *Estate of Maguire v Commr*, 50 TC 130 (1968) .

(n3)Footnote 3. *Id.* A merger of a subsidiary into its parent was followed by the transfer of a nominal amount of the subsidiary's cash to a newly formed corporation organized in the same state and with the same name as the old corporation. The transfer was made solely to protect the corporate name. Held, the substance and effect of the transaction was the same as if the old subsidiary had liquidated and retained its legal existence. *Rev Rul 84-2*, 1984-1 CB 92 .

(n4)Footnote 4. See, eg, *Kennemer v Commr*, 96 F2d 177 (5th Cir 1938) ; *TT Word Supply Co v Commr*, 41 BTA 965 (1940) , acq 1940-2 CB 8 . See also *Poro v Commr*, 39 TC 641 (1963) , acq 1963-2 CB 5 , where the question as to whether a liquidation had occurred had an effect on transferee liability.

(n5)Footnote 5. *IRC § 346(a)*. The Service will not ordinarily issue rulings as to the tax effect of a liquidation by a series of distributions when they are to be made over a period in excess of three years from the date of adoption of the plan of liquidation. *Rev Proc 2010-3*, 2010-1 IRB 110, 116 (§ 4.01(25)).

(n6)Footnote 6. *Treas Reg § 1.331-1(b)*.

(n7)Footnote 7. *Treas Reg § 1.331-1(e)*; *Cooledge v Commr*, 40 BTA 110 (1939) ; *Rev Rul 68-348*, 1968-2 CB 141 , amplified by *Rev Rul 85-48*, 1985-1 CB 126 ; contra, *Palmer v US*, 1 AFTR2d 863 (D Conn 1958) .

(n8)Footnote 8. *Rev Rul 79-10*, 1979-1 CB 140 .

(n9)Footnote 9. *Rev Rul 79-10*, 1979-1 CB 140 .

(n10)Footnote 10. *Quinn v Commr*, 35 BTA 412 (1937) , acq 1937-1 CB 21 ; *Rev Rul 68-348*, 1968-2 CB 141 .

(n11)Footnote 11. *Rev Rul 68-348, 1968-2 CB 141* .

(n12)Footnote 12. *Dresser v US, 55 F2d 499 (Ct Cl 1932)* , *cert denied 287 US 635* ; *Rev Rul 68-348, 1968-2 CB 141* ; but see *Commr v Winthrop, 98 F2d 74 (2d Cir 1938)* allowing the loss in the year in which the corporation made its last substantial distribution, the amount of the final distribution being then determinable with reasonable accuracy; and *Rev Rul 69-334, 1969-1 CB 98* , allowing the loss in the year shareholders surrendered their stock in exchange for property and participation certificates entitling each shareholder to a proportionate interest in the final distribution. The final distribution was minimal and consisted of the cash of the corporation which had amounted to less than one percent of the assets prior to liquidation.

(n13)Footnote 13. A cash basis taxpayer is in constructive receipt of income on the date the liquidating distribution becomes payable, not the date he surrenders his shares. *Rev Rul 80-177, 1980-2 CB 109* .

(n14)Footnote 14. *283 US 404 (1931)* ; see § 1.04[2][a], *supra*. Cases in which the liquidation was held "open" include *Commr v Carter, 170 F2d 911 (2d Cir 1948)* (brokerage contracts for payment of commissions on future deliveries); *Westover v Smith, 173 F2d 90 (9th Cir 1949)* (contract for future royalty payments); *Dorsey v Commr, 49 TC 606 (1968)* (right to receive percentage based on receipts from sales or rentals); *Shea Co v Commr, 53 TC 135 (1969)* , *acq 1970-1 CB xvi* (contested claims). The subject asset was found to have ascertainable value in *Waring v Commr, 412 F2d 800 (3d Cir 1969)* (license agreement); *Grill v US, 303 F2d 922 (Ct Cl 1962)* (percentage interest in film receipts); *Campagna v US, 290 F2d 682 (2d Cir 1961)* (second mortgage); *Marsack's Estate v Commr, 288 F2d 533 (7th Cir 1961)* (license agreement); *Boudreau v Commr, 134 F2d 360 (5th Cir 1943)* (right to oil payments); *Stratton v Commr, TC Memo 1969-195* . (note secured by second mortgage); *Est of Goldstein v Commr, 33 TC 1032 (1960)* , *acq 1960-2 CB 5* (right to insurance renewal commissions). The Commissioner will argue that the value of an asset is ascertainable except in rare and extraordinary circumstances. *Rev Rul 58-402, 1958-2 CB 15* .

The proper year of inclusion may be at issue even when the transaction is closed. See, eg, *Byrne v Commr, 54 TC 1632 (1970)* , *aff'd per curiam 449 F2d 759 (8th Cir 1971)* , holding that the shareholder's gain was realized when the corporation delivered securities to a broker for reissuance to the shareholder and not when the securities were in fact reissued. In *Rushing v Commr, 441 F2d 593 (5th Cir 1971)* , the issue was whether the taxpayer had constructively received the entire distribution in the year of liquidation notwithstanding his installment sale of the stock to independent trustees after adoption of the plan of liquidation but before distribution; the court found for the taxpayer.

The value of the right to receive future royalty payments was held not to be ascertainable in *Cloward Instrument Corp v Commr, TC Memo 1986-345* .

(n15)Footnote 15. *Hudspeth v US, 471 F2d 275 (8th Cir 1972)* ; *Allen v Commr, 66 TC 340 (1976)* ; *Kinsey v Commr, 58 TC 259 (1972)* , *aff'd 477 F2d 1058 (2d Cir 1973)* . If the gift is to a charity, the donor is entitled to a charitable deduction.

(n16)Footnote 16. *Jones v US, 37 AFTR2d 76-885 (6th Cir 1976)* ; *Dayton Hydraulic Co v US, 39 AFTR2d P 77-379 (SD Ohio 1976)* , *aff'd per curiam 592 F2d 937 (6th Cir 1979)* , *cert denied 444 US 831* .

(n17)Footnote 17. Prior to its decision in *Jones v US, 37 AFTR2d 76-885 (6th Cir 1976)* , the Sixth Circuit held for taxpayers whenever it was hypothetically possible that the liquidation would be abandoned. *Jacobs v US, 390 F2d 877 (6th Cir 1968)* . *Jacobs* was cited with approval in *Charleston Natl Bank v US, 323 F Supp 530 (SD WVa 1971)* .

(n18)Footnote 18. The basis of stock subject to restrictions was its restricted value, not the exchange price at the time distributed. *Miller v Commr, TC Memo 1975-356* .

(n19)Footnote 1. *IRC § 332(a)*. The provision applies whether or not the recipient corporation continues the business of the liquidated corporation. *Rev Rul 70-105, 1970-1 CB 70* (business continued as branch of parent); *Rev Rul*

70-357, 1970-2 CB 79 (business discontinued, assets used by parent in its business). The Tax Court has questioned whether IRC § 332 would be applicable if both parent and subsidiary were liquidated. *International Inv Corp v Commr*, 11 TC 678 (1948), *affd per curiam* 175 F2d 772 (3d Cir 1949).

A parent corporation that was indebted to its wholly owned subsidiary received the note evidencing the debt as part of the distribution in complete liquidation of the subsidiary. The note was property for purposes of IRC § 332(a), entitling the transaction to nonrecognition treatment. *Rev Rul 74-54*, 1974-1 CB 76.

Rev Proc 90-52, 1990-2 CB 626, reprinted in Appendix D, *infra*, sets forth the information that must be included in a request for ruling under IRC § 332.

(n20)Footnote 2. IRC § 332 thus requires that the recipient corporation receive a distribution that represents at least partial payment for the stock which it owns in the liquidating corporation. If the latter corporation is so insolvent that it cannot distribute any property to its shareholders, the tax consequences of the loss are governed by *IRC Section 165(g)*. *Treas Reg § 1.332-2(b)*; *Continental Grain Co v Commr*, *TC Memo 1988-577*. See also *HK Porter Co, Inc v Commr*, 87 TC 689 (1986) (IRC § 332 inapplicable; parent allowed to recognize loss on the liquidation of its subsidiary where distribution was not of sufficient magnitude to cover the liquidation preference on the subsidiary's preferred stock, so that nothing was distributed with the respect to the parent's common stock). The receipt of cash alone will bring the liquidation within IRC § 332(a). *Rev Rul 69-379*, 1969-2 CB 48; *Tri-Lakes SS Co v Commr*, 146 F2d 970 (6th Cir 1945).

(n21)Footnote 2.1. See § 6.02[2][b][i], *infra*.

(n22)Footnote 2.2. See *IRC § 381(a)(1)*.

(n23)Footnote 3. *IRC §§ 332(b)(1), 1504(a)(2)*.

(n24)Footnote 4. *IRC § 332(b)(1)*; *Treas Reg § 1.332-2(a)*.

(n25)Footnote 5. *Treas Reg § 1.332-2(a)*.

(n26)Footnote 6. The predecessor of IRC § 332 (IRC of 1939, § 112(b)(6)(A)) was inapplicable if the recipient corporation at any time on or after adoption of the plan of liquidation and until receipt of property owned more stock of any class than it owned at the time of receipt of the property. A disposition of stock to achieve this situation was upheld in *Commr v Day & Zimmerman, Inc*, 151 F2d 517 (3d Cir 1945); *Granite Trust Co v US*, 238 F2d 670 (1st Cir 1956); and *Avco Mfg Corp v Commr*, 25 TC 975 (1956), *acq on other issues 1957-2 CB 3*, *nonacq on this issue 1958-1 CB 7*.

The Tenth Circuit in *Associated Wholesale Grocers, Inc v US*, 927 F2d 1517 (10th Cir 1991), used the interdependence test of the step transaction doctrine to find that a corporation had not lost 80 percent control of a subsidiary, and, thus, IRC § 332 applied.

(n27)Footnote 7. 1970-1 CB 70.

(n28)Footnote 8. *Id* at 71.

(n29)Footnote 9. *Rev Rul 75-521*, 1975-2 CB 120, *distinguishing Rev Rul 70-106*; *George L Riggs, Inc v Commr*, 64 TC 474 (1975), *acq 1976-2 CB 2*.

(n30)Footnote 10. The plan of liquidation must be adopted by each of the parties to the liquidation.

Under the check-the-box rules of *Treas Reg § 301.7701-3*, an election by a corporation to be classified as a partnership or as a disregarded entity is deemed to be a liquidation of the corporation. *Treas Reg § 301.7701-3(g)(1)(ii)*,

(iii). For purposes of satisfying the requirement of adoption of a plan of liquidation under *IRC* § 332, unless a formal plan of liquidation that contemplates the election is adopted, the making of the election is considered to be the adoption of the plan of liquidation immediately before the deemed liquidation. *Treas Reg* § 301.7701-3(g)(2)(ii).

(n31)Footnote 11. *Rev Rul* 76-317, 1976-2 CB 98 .

(n32)Footnote 12. *IRC* § 332(b)(2). The year of adoption of the plan and the year of distribution need not be the same. *Rev Rul* 71-326, 1971-2 CB 177 .

(n33)Footnote 13. *IRC* § 332(b)(3). *IRC* § 332 was held applicable where the resolutions merely provided that the corporation be "immediately dissolved." Distribution was in fact made within three years. The court denied the taxpayer's contention that the absence of a formal plan required recognition of its loss. *Burnside Veneer Co v Commr*, 167 F2d 214 (6th Cir 1948) ; see also *Service Co v Commr*, 165 F2d 75 (8th Cir 1948) .

(n34)Footnote 14. *IRC* § 332(b)(3).

(n35)Footnote 15. *IRC* § 332(b); *Treas Reg* § 1.332-4(a)(2), (3).

(n36)Footnote 16. *Treas Reg* § 1.332-2(c).

(n37)Footnote 17. *Rev Rul* 76-525, 1976-2 CB 98 ; but see *Cherry Burrell Corp v US*, 367 F2d 669 (8th Cir 1966) (cash retained beyond three-year period for purpose of meeting unsettled claims; nonrecognition treatment granted).

(n38)Footnote 18. *Treas Reg* § 1.332-2(c).

(n39)Footnote 19. *Treas Reg* § 1.332-2(c).

(n40)Footnote 20. *IRC* § 332(c). The provision is effective for distributions after May 21, 1998.

See §§ 12.03[1][c] and 13.03[1][c] for a discussion of the dividends paid deduction of a RIC and a REIT, respectively.

(n41)Footnote 21. The election is made on Form 8023. *Treas Reg* § 1.338-1(d); *Treas Reg* § 1.338-2(d).

(n42)Footnote 22. *IRC* §§ 338(a), (d), (g), (h), 1504(a)(2). *Rev Rul* 90-95, 1990-2 CB 67 , sets forth two situations in which a reverse subsidiary cash merger is treated as a qualified stock purchase of a target under *IRC* § 338. In the first case, a subsidiary is organized solely for the purpose of acquiring the stock of the target via a merger of the subsidiary into the target. In the second, the target is liquidated into the parent immediately following the merger of the subsidiary into the target. *Treas Reg* § 1.338-3(d) incorporates the approach of *Rev Rul* 90-95 into the regulations.

Rev Rul 90-95 was distinguished in *Rev Rul* 2001-46, 2001-2 CB 321 , where, pursuant to an integrated plan, a newly formed, wholly-owned subsidiary of an acquiring corporation merged into a target corporation, and then the target corporation merged into the acquiring corporation. The Service treated the transaction as a single statutory merger of the target corporation into the acquiring corporation. *Treas Reg* § 1.338(h)(10)-1(c)(2) permits taxpayers to make elections under *IRC* § 338(h)(10) where the acquisition of stock of the target corporation by the purchaser, viewed independently, constitutes a qualified stock purchase and, after the stock acquisition, the target merges or liquidates into the purchaser (or another member of the affiliated group that includes the purchaser), whether or not, under relevant provisions of law, including the step transaction doctrine, the acquisition of stock and the merger or liquidation qualify as a reorganization described in *IRC* § 368(a). If the election is made in such a case, for all federal tax purposes, the acquisition of the stock is treated as a qualified stock purchase and not as a reorganization described in *IRC* § 368(a).

A transfer of target assets to the purchasing corporation (or another member of the affiliated group of the purchasing

corporation) after a qualified stock purchase can be treated as a reorganization if the election is not made. The continuity of interest requirement is deemed to have been met. *Treas Reg § 1.338-2(c)(3)(ii)*.

(n43)Footnote 23. *IRC § 338(h)(3)(A)*.

(n44)Footnote 24. *IRC § 338(h)(3)(A)*.

(n45)Footnote 25. *IRC § 338(h)(3)(C)*. The carryover basis exception to the definition of purchase does not apply to an acquisition from a related corporation if the acquiring corporation made a qualified stock purchase of the stock of the related corporation and made an election with respect to such stock.

(n46)Footnote 26. The 12-month acquisition period is deemed to begin on the date on which the acquiring corporation is first considered as owning the acquired corporation's stock under *IRC § 318* (other than the option attribution rule of *IRC § 318(a)(4)*), and, if such stock may be considered owned by the acquiring corporation on more than one day, the stock is deemed acquired on the earliest date to the extent thereof.

(n47)Footnote 27. *Treas Reg § 1.338-3(b)(5)(ii)*.

(n48)Footnote 28. *Treas Reg § 1.338-3(b)(5)(iii)*. A redemption from a related corporation is taken into account as a reduction in the target's outstanding stock to the extent that the redeemed stock would have been considered as purchased by the purchasing corporation under *IRC § 338(h)(2)(C)* during the 12-month acquisition period if the redeemed stock had been acquired by the purchasing corporation from the related corporation on the day of the redemption.

(n49)Footnote 29. *IRC § 338(a)*; *Treas Reg § 1.338-1(b)(1)*. However, the regulations provide a list of exceptions to the general rule that "new target" is to be treated as a new corporation, including one providing that "new target" should be considered a continuation of "old target" for purposes of applying Code provisions relating to its employee benefit plans. *Treas Reg § 1.338-1(b)(2)(i)*. The IRS reserves the right to add other exceptions to the list, *Treas Reg § 1.338-1(b)(2)(viii)*, and recently did so in *Notice 2010-1, 2010-2 IRB 251* (new target and old target treated as the same corporation for purposes of applying *IRC § 807(e)(4)(A)*, which establishes specific reserve requirements for a "qualified foreign contract" issued by a foreign life insurance branch of a domestic insurance company if the issuing company was required by the foreign country (as of the time it began operations in the country) to operate in that country through a branch.

(n50)Footnote 30. Minority shareholders in the target corporation are not to be treated as having exchanged their stock for stock in the target corporation. If a valid election is made and the target corporation completely redeems the stock of a minority shareholder, the distribution is governed by *IRC § 336* as if it were in complete liquidation. *IRC § 338(c)(2)*.

(n51)Footnote 31. *IRC § 338(b)(1), (6)*.

Congress has left it to the Treasury to prescribe regulations setting forth the proper adjustments for liabilities of the target corporation and other relevant items and for determining the method of allocating the aggregate basis among the various assets of the target corporation. *IRC § 338(b)(2), (5)*. See the text at N 34, *infra*.

(n52)Footnote 32. *IRC § 338(b)(3)*. For example, if 10 percent of the value of the target corporation's stock is attributable to the purchasing corporation's nonrecently purchased stock, the multiplier would be 10/90.

(n53)Footnote 33. *IRC § 338(b)(4)*.

(n54)Footnote 34. *Treas Reg § 1.338-6*. A similar rule has been enacted for certain asset purchases. *IRC § 1060*.

(n55)Footnote 35. Class II assets do not include stock of affiliates of the acquired corporation, whether or not of a class that is actively traded, other than certain actively traded preferred stock described in *IRC § 1504(a)(4)*.

(n56)Footnote 35.1. *Rev Proc 2003-51, 2003-2 CB 121* , describes methods that may be used to determine the fair market value of inventory items for purposes of the purchase price allocation.

(n57)Footnote 36. *IRC § 338(f),(h)(4)*. The consistency period can be extended to include any period during which the Commissioner determines that there was in effect a plan to make a qualified stock purchase plus one or more other qualified stock purchases or asset acquisitions with respect to the target corporation or a target affiliate. *IRC § 338(h)(4)(B)*.

(n58)Footnote 37. Generally the term "target affiliate" does not include a foreign corporation, a DISC, or certain domestic corporations doing business in Puerto Rico or the Virgin Islands. *IRC § 338(h)(6)(B)*.

The definition of affiliated group found in *IRC § 1504* applies here.

(n59)Footnote 38. *IRC § 338(f)*. To prevent avoidance of the consistency requirements the Commissioner is given authority to treat stock acquisitions pursuant to a plan and satisfying the 80-percent requirement as qualified stock purchases even though they are not otherwise so defined. *IRC § 338(e)(3)*.

(n60)Footnote 39. *Treas Reg § 1.338-4(h)(2)* provides for nonrecognition of gain or loss on the deemed stock sale, if there is no *IRC § 338(h)(10)* election in effect and either (1) the target directly owns 80 percent, by vote and value, of the stock of the target affiliate, or (2) the target directly owns stock in the target affiliate and both are members of a consolidated group filing a final consolidated return.

(n61)Footnote 40. *IRC § 338(e)(1)*. *Rev Proc 89-40, 1989-2 CB 453* , sets forth procedures under which a corporate taxpayer can request that the Service impose a deemed election under *IRC § 338(e)(1)* with respect to an asset acquisition that includes a qualified stock purchase of a target corporation.

(n62)Footnote 41. *IRC § 338(e)(2)*.

(n63)Footnote 42. See *Treas Reg § 1.332-2(e)*. A minority shareholder's attempt to gain nonrecognition treatment failed when the continuity of interest test required in reorganizations was not met. The parent corporation's stockholdings could not be counted as contributing to continuity of interest when such ownership was purchased as the first step in a plan to acquire the assets of the subsidiary with a stepped-up basis. *Kass v Commr, 60 TC 218 (1973)* , *aff'd in an unpublished opinion* (3d Cir 1974).

(n64)Footnote 43. *Treas Reg § 1.367(b)-3(b)*. The provision applies to a US shareholder of the foreign subsidiary or a foreign corporation with respect to which there are one or more US shareholders. A "US shareholder" is any shareholder described in *IRC § 951(b)* (without regard to whether the foreign corporation is a controlled foreign corporation) and also any shareholder described in *IRC § 953(c)(1)(A)* (but only if the foreign corporation is a controlled foreign corporation subject to the rules of *IRC § 953(c)*).

The deemed dividend is treated as a dividend for purposes of the Code and is considered as paid out of earnings and profits with respect to which the amount of the deemed dividend was determined. *Treas Reg § 1.367(b)-2(e)*.

The rules contained in *Treas Reg § 1.367(b)-3* also apply to an asset acquisition described in *IRC § 368(a)(1)*.

(n65)Footnote 44. *Treas Reg § 1.367(b)-2(d)*. See § 20.04[4] for a discussion of *IRC § 1248*.

(n66)Footnote 45. *Treas Reg § 1.367-(b)(3)(ii)*, Ex 3.

(n67)Footnote 46. *Treas Reg* § 1.367(b)-3(c).

(n68)Footnote 47. The election may be made only if (1) the foreign corporation has provided the shareholder information to substantiate the shareholder's all earnings and profits amount with respect to the stock in the foreign corporation, and (2) the shareholder complies with the notice requirement described in *Treas Reg* § 1.367(b)-1(c).

(n69)Footnote 48. The distribution is treated as a liquidation to which *IRC* § 331 applies if the distributee foreign corporation is a controlled foreign corporation. *IRC* § 332(d)(3).

(n70)Footnote 49. *IRC* § 332(d)(2)(A). For this purpose, the term "affiliated group" has the meaning given to the term by *IRC* § 1504(a) (without regard to *IRC* § 1504(b)(2) and (4)). *IRC* § 332(d)(2)(B).

(n71)Footnote 50. *Treas Reg* § 1.332-6(b).

(n72)Footnote 51. *Treas Reg* § 1.332-6(a).



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Taxation of Securities Transactions

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CHAPTER 6 Liquidating Distributions

1-6 Taxation of Securities Transactions § 6.03

§ 6.03 Complete Liquidations--Effect on the Liquidating Corporation

[1] Gain or Loss Resulting From the Distribution.

Until passage of the Tax Reform Act of 1986, *IRC Section 336* stated that no gain or loss would be recognized to a corporation on the distribution of property in complete liquidation. Exceptions to the general rule arose when the corporation distributed an installment obligation, LIFO inventory, or property subject to depreciation recapture. Gain or loss recognition was also required if there was a transfer of appreciated or depreciated property in discharge of the transferor's debt to the distributee, except in liquidations governed by *IRC Section 332*.

The 1986 Act reversed the general rule to provide that, unless otherwise provided, gain or loss will be recognized to a liquidating corporation on a distribution of property in complete liquidation "as if [the] property were sold

to the distributee at its fair market value."¹ If any property distributed in the liquidation is subject to a liability or the shareholder assumes a liability of the liquidating corporation, the fair market value of the property is treated as not less than the amount of the liability.²

The general rule does not apply, and the distributing corporation will not be called upon to recognize gain or loss, if the distribution falls within the reorganization provisions of the Code and there is nonrecognition of gain or loss to the recipient of the property.³ In addition, *IRC Section 336* contains two provisions designed to limit the extent of loss recognition at the corporate level. The first bars loss recognition if there is a distribution to a related party (as defined in *IRC Section 267*)⁴ and either (a) the distribution is not pro rata, or (b) the distributed property is property that was acquired by the liquidating corporation in a transaction to which *IRC Section 351* applied, or as a contribution to capital, during the five-year period ending on the date of distribution.⁵ The second provides that if a principal purpose of the contribution of property to a corporation in advance of its liquidation is to recognize a loss upon the sale or distribution of the property and thereby eliminate or limit corporate level gain, the basis for determining loss of any property acquired in any *IRC Section 351* transaction, or as a contribution to capital, will be reduced (but not below zero) by the excess of the basis of the property on the date of contribution over its fair market value on that date.⁶ For purposes of the second rule, it is presumed that any *IRC Section 351* transaction or contribution to capital within the two-year period prior to adoption of the plan of liquidation (or thereafter) has such a principal purpose.⁷

No gain or loss is recognized to a liquidating subsidiary on the distribution to its parent in a liquidation to which *IRC*

Section 332 applies.ⁿ⁸ Gain is recognized by the corporation, but loss is not, on distributions to minority shareholders in such a liquidation.ⁿ⁹ If the liquidating subsidiary is indebted to its parent, any transfer of property to the parent in satisfaction of the indebtedness in connection with the liquidation is treated as part of the liquidating distribution.ⁿ¹⁰

If a complete liquidation under *IRC Section 332* involves a domestic subsidiary and a foreign corporation, the liquidating subsidiary must recognize gain or loss to the extent of the net gain.ⁿ¹¹ If the subsidiary distributes a partnership interest (whether domestic or foreign), the corporation is treated as having distributed a proportionate share of partnership property.ⁿ¹² If the distribution involves a publicly traded partnership that is treated as a corporation for United States income tax purposes, the distribution is treated in the same manner as a distribution of stock.

There are three exceptions to the recognition rule. The first applies if the property was used by the domestic subsidiary, and will continue to be used by the foreign parent for ten years following the liquidation, in a trade or business in the United States, and both corporations file a ten-year recognition agreement.ⁿ¹³ The second is applicable to a distribution of a United States real property interest (other than stock in a former United States real property holding corporation that is treated as a United States real property interest for five years under *IRC Section 897(c)(1)(A)(ii)*).ⁿ¹⁴ The third applies when there is a distribution of the stock of an 80-percent domestic subsidiary.ⁿ¹⁵

If both the liquidating corporation and distributee corporation in a liquidation governed by *IRC Section 332* are foreign corporations, no gain or loss is recognized to the liquidating corporation, with two exceptions.ⁿ¹⁶ The first is the distribution of property (other than a United States real property interest) used by the liquidating corporation in a United States trade or business at the time of the liquidation, if the foreign parent agrees to use the property in a United States trade or business for ten years and the parties sign a ten-year gain recognition agreement.ⁿ¹⁷ The second arises when the property was previously used in the subsidiary's United States trade or business and is distributed within ten years after it ceased being so used.ⁿ¹⁸

The Code provides for the issuance of regulations under which a corporation, that owns stock that possesses at least 80 percent of the voting power and has at least 80 percent of the value of all stock of another corporation and sells, exchanges, or distributes the stock, can elect to treat the transaction as a disposition of all of the other corporation's assets and not recognize gain or loss on the disposition of the stock.ⁿ¹⁹

Gain or loss will be recognized to the liquidating corporation on a distribution in an *IRC Section 332* liquidation if the parent is a tax-exempt organization (other than a farmer's cooperative), unless, immediately after the distribution, the organization uses the property in an unrelated trade or business.ⁿ²⁰ If gain or loss is recognized on the liquidating distribution, it is also recognized if the subsidiary transfers property to the tax-exempt parent in satisfaction of a debt to it.

A taxable corporation that transfers all or substantially all of its assets to one or more tax-exempt entities is required to recognize gain or loss as if the assets transferred were sold at their fair market value (Asset Sale Rule).ⁿ²¹ The Asset Sale Rule does not apply if the transferred assets are used by the tax-exempt entity in an activity the income of which is subject to the unrelated business tax under *IRC Section 511(a)*; gain on those assets will be included in unrelated business taxable income when the tax-exempt entity disposes of the assets or ceases to use the assets in an activity the income from which is subject to tax under *IRC Section 511(a)*.ⁿ²²

A taxable corporation that changes its status to a tax-exempt entity generally is treated as having transferred all of its assets to a tax-exempt entity immediately before the change becomes effective in a transaction governed by the Asset Sale Rule (Change in Status Rule).ⁿ²³ The Change in Status Rule does not apply (subject to an anti-abuse rule) if the corporation was formerly tax-exempt and the change in status is within three years of the later of (a) the corporation first filing a return as a taxable corporation, or (b) a final determination that the corporation had become a taxable corporation.ⁿ²⁴

A further gain recognition situation is dictated by *IRC Section 897(d)(1)*, and arises whenever a foreign corporation distributes a United States real property interest.ⁿ²⁵ The amount of such recognition is the excess of the value of interest as of the time of distribution over its adjusted basis. However, no gain need be recognized if the basis of the distributed property in the hands of the distributee is the same as its adjusted basis before distribution increased by the amount of any gain recognized by the distributing corporation.

[2] Timing Problems--Income and Deductions.

[a] Income Considerations. Can a corporation escape a tax on income properly attributable to it by liquidating before the income is includable by the corporation under its method of accounting? For example, suppose that one of the assets distributed in liquidation is a contract right to receive income in the future. The value of the right will form a part of the shareholder's amount realized and enter the computation of gain or loss to be taxed at capital gain rates. The value of the contract will also constitute the shareholder's basis in the right to future income, so that until that basis is recovered, all amounts received under the contract will be received tax-free. And if the value of the contract cannot be ascertained with reasonable certainty, the liquidation will remain "open" under the *Carter* doctrine,ⁿ¹ with the result that any amount received under the contract will be deemed to have been received as part of the liquidation and therefore taxed as capital gain (assuming the liquidating distribution exceeds the shareholder's basis for the surrendered stock). Unless the income can in some way be attributed to the distributing corporation, the liquidation will effectively transmute ordinary income into capital gain.

A principal means of forcing attribution of income to the corporation is through application of the assignment of income doctrine. There should be little argument over invoking the doctrine whenever the corporation has a fixed right to future income on the date of liquidation, i.e., when it has done everything necessary to perfect its right to future income. The classic example is the cash basis corporation that has fully performed services for another and is merely awaiting payment of its charges. An assignment of the account receivable must be considered an anticipatory assignment of income.ⁿ²

Where the right to future income is contingent and unearned as of the date of liquidation, the corporation is taxed on the income collected by the shareholders only if it is still in existence at the time of receipt. The genesis of the principle is a statement by the Supreme Court in *United States v. Joliet & Chicago R.R.*ⁿ³ The anticipatory arrangement in that case was a "lease in perpetuity" under which the lessee guaranteed payment of a specified yearly dividend to the shareholders of the corporation. In applying the assignment of income doctrine, the Court stated:

"The fact that the corporation may remain in existence only to maintain a stock transfer book is immaterial. The umbilical cord between it and its shareholders has not been cut."ⁿ⁴

The effect of the "in existence" criterion may be seen by contrasting *United States v. Horschel*,ⁿ⁵ where accrued interest income on notes distributed as part of the liquidation and collected after the corporation had been dissolved was not taxable to the corporation, and *Wood Harmon Corp. v. United States*,ⁿ⁶ where the proceeds of a condemnation award became the corporation's income because it had not terminated its existence prior to receipt of the award; there was a balance in the bank account maintained by the corporation for the purpose of paying liabilities.

At what point is a corporation no longer in existence? According to the regulations, termination of existence occurs when the corporation "ceases business and dissolves, retaining no assets, whether or not under State law it may thereafter be treated as continuing as a corporation for certain limited purposes connected with winding up its affairs, such as for the purpose of suing and being sued."ⁿ⁷ Thus, if the corporation retains funds to pay creditors,ⁿ⁸ or if it is engaged in collecting the proceeds from the sale of business,ⁿ⁹ or if it is actively pressing valuable claims,ⁿ¹⁰ it remains in existence. In sum, as long as a corporation is in the process of liquidating its assets, its existence is not at an end, and this will be so even though an order of dissolution may have been issued.ⁿ¹¹

The "in existence" cases are predicated on a prior finding that the transfer in liquidation constituted an anticipatory assignment of income, that is, that the transfer was of income earned by or properly payable to the liquidating corporation. If the future income is completely dependent on post-liquidation events, the assignment of income doctrine is inapplicable, and the income ultimately realized will be taxed only to the recipient. For example, in *United Mercantile Agencies v. Commissioner*,ⁿ¹² the corporation, a collection agency, distributed uncollected account files to its stockholder. The amounts due could be converted into income only if future attempts at collection proved successful. Since, at the time of liquidation, there was no assurance that any portion of the accounts ever would be reduced to income without further action on the part of the shareholder, the Tax Court refused to tax the corporation on the amounts collected by him.

Income attributed to a liquidated corporation under the assignment of income doctrine is includable in its gross income in the year of receipt, not the year of assignment.ⁿ¹³ A second approach employed by the Commissioner to attribute after-acquired income to the corporation, but to do so in the year of liquidation, calls for application of *IRC Section 446(b)* and the use of a method of accounting which clearly reflects income.ⁿ¹⁴ The leading illustration of the use of *IRC Section 446(b)* in liquidation cases is provided by *Jud Plumbing & Heating, Inc. v. Commissioner*,ⁿ¹⁵ where a corporation that reported income by use of the completed-contract method of accounting (under which no income is reported until the contract is finally completed and accepted) was forced to switch to the percentage-of-completion method in order to clearly reflect the income earned on several long-term construction contracts which remained uncompleted at the time of liquidation.

Application of *IRC Section 446(b)* is not limited to a change from completed-contract method to percentage-of-completion method. For example, in *Commissioner v. Kuckenberg*,ⁿ¹⁶ a two-fold switch was effected--from cash basis to accrual method for some income, and from cash basis to percentage-of-completion method to clearly reflect other income.

Should *IRC Section 446(b)* be applicable if the assignment of income doctrine is available to attribute the income to the corporation? The difference in result can be quite significant. Under the clear reflection of income approach, the income will be includable by the corporation in the year of liquidation; under the assignment of income theory, it is reported as collected. In one case,ⁿ¹⁷ the Tax Court did reject the Commissioner's determination of a deficiency based on *IRC Section 446(b)*, on the ground that the corporation's continued existence permitted the income to be taxed to the corporation on assignment of income principles. The decision is a sound one, for the cash basis method of accounting utilized by the liquidating corporation would clearly reflect the income collected while it remained in existence. Use of *IRC Section 446(b)* in anticipatory assignment of income cases should, therefore, be restricted to situations in which the corporation has terminated its existence prior to receipt of the potential income.ⁿ¹⁸

[b] Deduction Considerations. Suppose that the liquidating corporation is in a business in which expenses are incurred some time prior to receipt of income. If the corporation could liquidate in mid-stream (between the time expenses are incurred and income is realized), deduct the expenses on its final return, and not be required to include the later receipts in income, it would most likely suffer a net operating loss that could be carried back to reduce the income of the three preceding taxable years.ⁿ¹⁹

The Commissioner has enjoyed only limited success in the few attempts he has made to prevent this result. In *Diamond A Cattle Co. v. Commissioner*,ⁿ²⁰ a net operating loss of more than \$300,000 incurred during seven and one-half months of operations was allowed over the Commissioner's contention that the operating loss carryback provisions never contemplated relief to taxpayers in the particular situation presented, while in *Commissioner v. South Lake Farms, Inc.*,ⁿ²¹ the Ninth Circuit refused to apply *IRC Section 446(b)* to require the inclusion of income produced by a post-liquidation harvest in the return for the last taxable period of the liquidated corporation. The Government's difficulty in *South Lake Farms* stemmed from its inability to point to any method of accounting which would require inclusion by the old corporation.

The Ninth Circuit also denied the Commissioner the ability to resort to the tax benefit rule to produce income for the liquidating corporation in *South Lake Farms*. The court's theory in this regard rested on the absence of a recovery of a previously deducted amount since the corporation received nothing on the liquidation. This interpretation of recovery was discredited in *Bliss Dairy, Inc. v. United States*,ⁿ²² where the Supreme Court found that a distribution of expensed assets was inconsistent with the earlier deduction of the cost as a business expense.ⁿ²³

However, in *Central Cuba Sugar Co. v. Commissioner*,ⁿ²⁴ the Service's reallocation of expenses between transferor and transferee under the authority of the predecessor of *IRC Section 482* was held proper. Although *IRC Section 482* would appear to be the Commissioner's most potent weapon, since it permits him to allocate or apportion income and deductions between businesses under common control where necessary to prevent evasion of taxes or to clearly reflect income, resort to it in the liquidation area has been infrequent. Whether the greater use of *IRC Section 482* in general signals increasing application to liquidations in particular remains a question for the future.

[3] The Court Holding and Cumberland Public Service Cases.

Suppose that, prior to the enactment of the Tax Reform Act of 1986, *X Corp.* sold its sole asset at a gain and then liquidated. The corporation would have paid a tax on its profit from the sale while its shareholders would have been taxed on the gain realized on the liquidation. On the other hand, if the corporation were first liquidated and the asset then sold at fair market value, only one tax would have been paid--on the liquidation gain. The corporation would have been exempted from the recognition of gain; the shareholders would have realized no gain on the sale since their basis in the distributed asset would have equaled the amount realized. Thus, the better tax result was produced by a post-liquidation shareholder sale.

But suppose that the sale was negotiated by the corporation, with liquidation occurring immediately before closing. Could the sale now be considered as a sale by the shareholders or did it have to be imputed to the corporation? The answer, provided by the famous case of *Commissioner v. Court Holding Co.*,ⁿ¹ was that

"[T]he transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title."ⁿ²

In *Court Holding*, negotiations for sale were had and an oral agreement reached while the corporation held legal title to the property. On the date the parties met to reduce the agreement to writing, the purchaser was advised by the corporation's attorney that the sale could not be completed because it would impose a large tax liability on the corporation. Liquidation followed a day later and was followed in turn by a written agreement embodying substantially the same terms previously agreed upon, but with the shareholders named as sellers. Title passed to the purchaser three days after contract. The sale, in form by the shareholders, was disregarded, and the sale, in substance by the corporation, given effect.

Five years later, *United States v. Cumberland Public Service Co.*ⁿ³ presented the Supreme Court with a slightly different fact situation. In that case, the shareholders first offered to sell their stock, but were turned down by the prospective purchaser who wanted to purchase assets. The corporation rejected the purchaser's offer because it would have been saddled with a heavy capital gains tax. The shareholders then offered to sell the desired assets to the purchaser after acquiring them by liquidating the corporation. This offer was accepted and the steps necessary to consummate the transaction ensued. The Supreme Court, in affirming a Court of Claims decision in favor of the taxpayer, relied upon the latter court's finding that the sale in question had been made by the stockholders rather than the corporation. This was sufficient to permit the Court to distinguish *Court Holding* on its facts.

The difficulty in deciding when a transaction was made by the shareholders in their individual capacity, rather than as the alter ego of the corporation, prompted Congress to enact what was *IRC Section 337* prior to the Tax Reform Act of

1986 and eliminate the need to determine whether corporation or shareholder was the seller in fact. Repeal of the general rule as to nonrecognition of gain or loss to the liquidating corporation obviated the need for *IRC Section 337*, and it was removed from the Code by the Tax Reform Act of 1986. The repeal raises the specter of the possible application of *Court Holding* in *IRC Section 332* liquidations followed by a sale of the distributed property by the parent corporation.ⁿ⁴

FOOTNOTES:

(n1)Footnote 1. *IRC § 336(a)*. The Service will promulgate regulations to prevent the avoidance of corporate-level taxation with respect to the net built-in gain of C corporation assets that become assets of a regulated investment company or real estate investment trust in a carryover basis transaction. *IRS Notice 88-19, 1988-1 CB 486*, as modified by *IRS Notice 88-96, 1988-2 CB 420*. These regulations will permit the deferral of immediate built-in gain recognition by having the transferee elect to be subject to rules similar to those set forth in *IRC § 1374*. This permission can extend to a corporation that does not transfer any assets, but elects to be treated as a regulated investment company or real estate investment trust. *Ltr Rul 8915041*. Carryforwards from C corporation years can be used to offset the net recognized built-in gains. *Ltr Rul 199920036*.

IRC § 336(a) applies with full force to a liquidation of a corporation treated as special use property for estate tax purposes under *IRC § 2032A*. *Ltr Rul 9146001*.

(n2)Footnote 2. *IRC § 336(b)*. See Crane, "Toward a Theory of the Corporate Tax Base: The Effect of a Corporate Distribution of Encumbered Property to Shareholders," *44 Tax L Rev 113 (1988)*.

(n3)Footnote 3. *IRC § 336(c)*.

(n4)Footnote 4. See § 2.07[4].

(n5)Footnote 5. *IRC § 336(d)(1)*. The Code contemplates the issuance of regulations to provide for recapture of the loss in lieu of disallowance where the plan of liquidation is adopted after the filing of the return for the year in which the loss occurred. *IRC § 336(d)(2)(C)*.

(n6)Footnote 6. *IRC § 336(d)(2)(A), (B)*.

(n7)Footnote 7. Congress intends that the Treasury Department will issue regulations generally providing that the presumed prohibited purpose for contributions of property two years in advance of adoption of a plan of liquidation will be disregarded unless there is no clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises. S Rep No 99-841, 99th Cong, 2d Sess 201 (1986).

(n8)Footnote 8. *IRC § 337(a)*. The determination of whether any corporation is an 80-percent shareholder of the distributing corporation is made without regard to any consolidated return regulation. *IRC § 337(c)*. *Rev Proc 86-16, 1986-1 CB 546*, reprinted as Appendix H, *infra*, contains a checklist of information to be included in a request for ruling under *IRC §§ 331 and 337*.

(n9)Footnote 9. *IRC § 336(d)(3)*.

(n10)Footnote 10. *IRC § 337(b)(1)*.

(n11)Footnote 11. *IRC § 367(e)(2); Treas Reg § 1.367(e)-2(b)(1)(i)*.

IRC § 367(e)(2) does not violate a treaty nondiscrimination provision based on capital ownership similar to Article 24(5) of the US Model Income Tax Convention. *IRS Notice 87-66, 1987-2 CB 168*.

(n12)Footnote 12. *Treas Reg § 1.367(e)-2(b)(1)(iii)*. The foreign corporation's basis in the distributed partnership

interest is equal to the domestic subsidiary's basis in the interest increased by any gain and reduced by any loss recognized by the domestic subsidiary on the liquidation.

(n13)Footnote 13. *Treas Reg § 1.367(e)-2(b)(2)(i)*.

(n14)Footnote 14. *Treas Reg § 1.367(e)-2(b)(2)(ii)*.

(n15)Footnote 15. *Treas Reg § 1.367(e)-2(b)(2)(iii)*.

(n16)Footnote 16. *Treas Reg § 1.367(e)-2(c)(1)*.

(n17)Footnote 17. *Treas Reg § 1.367(e)-2(c)(2)(i)*.

(n18)Footnote 18. *Treas Reg § 1.367(e)-2(c)(2)(ii)*.

(n19)Footnote 19. *IRC § 336(e)*. On August 25, 2008, the IRS issued Proposed Treasury Regulations which provide the requirements for and the consequences of treating a stock sale, exchange, or distribution that would not otherwise be eligible for an *IRC Section 338* election as a deemed asset sale. *Prop Treas Reg §§ 1.336-1 through 1.336-5*.

(n20)Footnote 20. *IRC § 337(b)(2)*.

(n21)Footnote 21. *Treas Reg § 1.337(d)-4(a)(1)*. Loss recognition may be limited by *IRC § 267*, or under circumstances in which an acquisition or distribution is made as part of a plan the principal purpose of which is to recognize a loss by the taxable corporation on the transfer of assets to the tax exempt entity. *Treas Reg § 1.337(d)-4(d)*.

(n22)Footnote 22. *Treas Reg § 1.337(d)-4(b)(1)*.

(n23)Footnote 23. *Treas Reg § 1.337(d)-4(a)(2)*.

(n24)Footnote 24. *Treas Reg § 1.337(d)-4(a)(3)*.

(n25)Footnote 25. See Ch 20.

(n26)Footnote 1. *Commr v Carter*, 170 F2d 911 (2d Cir 1948) ; see § 6.02[1][b], *supra*.

(n27)Footnote 2. *Williamson v US*, 292 F2d 524 (Ct Cl 1961) ; cf *Rev Rul 255*, 1953-2 CB 10 . See generally Biblin, "Assignments of Income in Connection With Incorporating and Liquidating Corporations," 1969 *So Calif Tax Inst* 383, 397; Lyon & Eustice, "Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case," 17 *Tax L Rev* 295 (1962); Farer, "Corporate Liquidations: Transmuting Ordinary Income Into Capital Gains," 75 *Harv L Rev* 527 (1962).

(n28)Footnote 3. 315 US 44 (1942) .

(n29)Footnote 4. 315 US at 48-49 .

(n30)Footnote 5. 205 F2d 646 (9th Cir 1953) ; see also *Telephone Directory Advertising Co v US*, 142 F Supp 884 (Ct Cl 1956) .

(n31)Footnote 6. 311 F2d 918 (2d Cir 1963) .

(n32)Footnote 7. *Treas Reg § 1.6012-2(a)(2)*.

(n33)Footnote 8. *J Ungar, Inc v Commr*, 244 F2d 90 (2d Cir 1957) ; *Wood Harmon Corp v US*, N 6, *supra*.

(n34)Footnote 9. *Cf O'Sullivan Rubber Co v Commr*, 120 F2d 845 (2d Cir 1941) (corporation in existence for purpose of applying personal holding company tax).

(n35)Footnote 10. *Treas Reg § 1.6012-2(a)(2)*; *Messer v Commr*, 52 TC 440 (1969) , *aff'd* 438 F2d 774 (3rd Cir 1971) ; but *cf Cold Metal Process Co v Commr*, 247 F2d 864 (6th Cir 1957) (court found that corporation had no valuable claims for which to bring suit in its own right).

(n36)Footnote 11. *US v Loo*, 248 F2d 765 (9th Cir 1957) , *cert denied* 356 US 928 ; *Hersloff v US*, 310 F2d 947 (Ct Cl 1962) , *cert denied* 373 US 923 ; *Yeckes v Commr*, TC Memo 1966-178 .

(n37)Footnote 12. 34 TC 808 (1960) , *acq* 1961-2 CB 5 .

(n38)Footnote 13. *Sol C Siegel Prods Inc v Commr*, 46 TC 15 (1966) , *acq* 1967-2 CB 3 ; see also *Helvering v Eubank*, 311 US 122 (1940) ; *Harrison v Schaffner*, 312 US 579 (1941) ; *Rev Rul 58-275*, 1958-1 CB 22 . This in part is the explanation for the "in existence" principle.

(n39)Footnote 14. Courts have often failed to distinguish between assignment of income and clear reflection principles, citing precedents under one approach as authority for the other. See, eg, *Williamson v US*, see § 6.03[1], N 7, *supra*; *Floyd v Scofield*, 193 F2d 594 (5th Cir 1952) ; *Standard Paving Co v Commr*, 190 F2d 330 (10th Cir) , *cert denied* 342 US 860 .

The Tax Court held that the failure of a liquidating cash basis corporation to include in income accrued but unpaid interest on demand notes distributed to its shareholders did not clearly reflect income. The court did not consider the absence of demand for payment of any importance since the notes evidenced loans made to one of the shareholders. *Cloward Instrument Corp v Commr*, TC Memo 1986-345 .

(n40)Footnote 15. 153 F2d 681 (5th Cir 1946) .

(n41)Footnote 16. 309 F2d 202 (9th Cir 1962) , *cert denied* 373 US 909 ; see also *Idaho First Natl Bank v US*, 265 F2d 6 (9th Cir 1959) ; *Carter v Commr*, 9 TC 364 (1947) , *aff'd* 170 F2d 911 (2d Cir 1948) .

(n42)Footnote 17. *Sol C Siegel Prods, Inc v Commr*, N 13, *supra*.

(n43)Footnote 18. *Cf Floyd v Scofield*, 193 F2d 594 (5th Cir 1952) ; *Carter v Commr*, 9 TC 364 (1947) , *aff'd* 170 F2d 911 (2d Cir 1948) .

(n44)Footnote 19. *IRC § 172(b)(1)(A)(i)*.

(n45)Footnote 20. 233 F2d 739 (10th Cir 1956) .

(n46)Footnote 21. 324 F2d 837 (9th Cir 1963) .

(n47)Footnote 22. 460 US 370 (1983) . The Tax Court and Service had expressed a similar view. *Tennessee Carolina Transp, Inc v Commr*, 65 TC 440 (1975) , *aff'd* 582 F2d 378 (6th Cir 1978) , *cert denied* 440 US 909 ; *Rev Rul 77-67*, 1977-1 CB 33 ; *Rev Rul 74-396*, 1974-2 CB 106 .

(n48)Footnote 23. The Ninth Circuit refused to extend *Bliss Dairy* to require a farming corporation to recognize as income the amount it deducted as cultivation expenses used to produce unharvested crops that were distributed to the shareholders on the liquidation. *Bliss Dairy* was distinguished on the ground that all expensed items were consumed prior to the liquidation; none were distributed to shareholders in an unused or unconsumed form. *Rojas v Commr*, 901 F2d 810 (9th Cir 1990) .

(n49)Footnote 24. 198 F2d 214 (2d Cir) , *cert denied* 344 US 874 .

(n50)Footnote 1. 324 US 331 (1945) .

(n51)Footnote 2. 324 US at 334 .

(n52)Footnote 3. 338 US 451 (1950) .

(n53)Footnote 4. The Service attempted to use *Court Holding* to treat the taxpayer as the seller of assets in *Martin Ice Cream Co v Commr*, 110 TC 189 (1998) . The Tax Court found that the terms of the sale were quite different from those originally negotiated by the corporation.



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Taxation of Securities Transactions

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CHAPTER 6 Liquidating Distributions

1-6 Taxation of Securities Transactions § 6.04

§ 6.04 Partial Liquidations--Effect on the Shareholder

[1] General Rule.

Amounts distributed to noncorporate shareholders¹ in partial liquidation of a corporation are given the same treatment as redemptions falling under *IRC Section 302(a)*; namely, they are considered as part or full payment in exchange for the stock.² All that is necessary to give the shareholder capital gain or loss on the liquidation is that the stock constitute a capital asset in his hands.

[2] Distributions Qualifying as Partial Liquidations.

IRC Section 302(e)(1) provides that a distribution will be in partial liquidation of a corporation if it is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the next succeeding taxable year.¹ Of critical importance here is the statutory direction that dividend equivalence be tested at the corporate level rather than at the shareholder level.²

[a] Corporate Contraction Doctrine. It will be recalled that under the 1939 Code redemptions and partial liquidations were governed by the same provision and tested for dividend equivalence under the same criteria. In differentiating the manner of determining dividend equivalence for the two kinds of transactions, the framers of the 1954 Code sought to characterize distributions as partial liquidations "by what happens solely at the corporate level by reason of the assets distributed ...".³ In so doing, Congress intended to codify the then existing concept of corporate contraction.⁴ The example of corporate contraction mentioned in the Senate Report is taken from *Imler v. Commissioner*,⁵ a case holding that a distribution of insurance proceeds, received on account of the destruction of the upper floors of a building by fire, was not taxable as a dividend since the distributing corporation discontinued the business operations formerly carried on in the destroyed portion of the building, thereby effecting a bona fide contraction of business activities and a consequent reduction in capital used in the business. The Senate Report goes on to state that "voluntary bona fide contraction of the corporate business may of course also qualify to the same extent as under existing law."⁶

What was the extent to which a voluntary contraction qualified as a partial liquidation under pre-1954 law? One fact pattern involved the distribution of a reserve for expansion after the planned expansion had been abandoned and the funds accumulated for that purpose were no longer needed. For example, in *Commissioner v. Champion*,⁷ a corporation increased its capital structure in anticipation of new plant construction to be undertaken for the purpose of

enhancing profits through an increase in production and a decrease in competitive freight costs. Government regulation of freight costs, coupled with technological innovation which caused a reduction in the demand for the corporation's product (and a consequent decrease in the price for the product), led the corporation to curtail its plan for expansion and to redeem a portion of its shares. The distribution was not treated as a dividend, for in the opinion of the Sixth Circuit:

"There [was] a reasonable inference that shrinkage in its business brought the company face to face with the realization that its capital was in excess of its needs and to that extent unprofitable, and that the increase in capitalization had been a mistake. Under such circumstances, good business judgment might naturally suggest a redemption proportionate to the decline in business. Redemption under such conditions is not essentially equivalent to the distribution of a taxable income ... "n8

Champion must be contrasted with *McGuire v. Commissioner*,ⁿ⁹ where distribution of the reserve for expansion was held to be essentially equivalent to a dividend because the reduction in capital was not accompanied by a commensurate reduction in business activities. The fact that profits had been permitted to accumulate for a definite purpose, subsequently abandoned, could not change the dividend character of the distribution.ⁿ¹⁰

The Senate Report casts some doubt on the present validity of cases such as *Champion* for it states that "a distribution of a reserve for expansion is not a partial liquidation."ⁿ¹¹ However, it may well be that the Senate Finance Committee did not intend to overrule *Champion*, but rather to reaffirm the easily distinguished decision in *McGuire*.

Under the 1939 Code, a reduction in working capital needs could lead to a legitimate corporate contraction, provided there was a matching reduction in corporate activity.ⁿ¹² Under present law, the same rule obtains. In the language of the Service:

"[T]he amount which may be properly distributed as a partial liquidation includes not only the net proceeds derived from the sale of operating assets, or the assets themselves, [the required reduction in business activity] but also includes that portion of the working capital (including cash) reasonably attributable to the business activity terminated."ⁿ¹³

Determination of the amount of working capital attributable to the operation of the terminated business activity is a factual matter based upon many considerations, of which the amount of working capital actually used in the business activity prior to its cessation is most important.ⁿ¹⁴ However, an abnormal increase in working capital just prior to distribution will be disregarded and viewed as an attempt to siphon off corporate earnings as part of the liquidation.ⁿ¹⁵ Similarly, the amount of cash or liquid assets in the corporation prior to distribution cannot be used as the sole measuring rod of working capital, for this might lead to a retention of liquid assets in excess of business needs.ⁿ¹⁶

Additionally, a valid corporate contraction has been occasioned by a distribution of funds made available when the corporation liquidated one of its operating departments.ⁿ¹⁷ However, mere diminution in the size of the corporation's business is insufficient; there must also be a corresponding reduction in the amount of working capital employed in the business. A good illustration of this point is provided by *Estate of Charles D. Chandler v. Commissioner*,ⁿ¹⁸ where the corporation sold a department store which it had been operating, opened a ladies' clothing store equal in size to that department in the old store, and then made a pro rata distribution in redemption of one-half of its outstanding shares. The Tax Court viewed the distribution as nothing more than a vehicle for shifting the corporation's accumulation of excess cash and other liquid assets from its hands to those of its shareholders, something which could have been accomplished by the declaration of a true dividend. Fatal to the taxpayer's contention that the sale of the department store and opening of a smaller business resulted in a corporate contraction was the fact that the amount of capital actually committed to the business did not change accordingly.ⁿ¹⁹

The corporate contraction concept is not limited to cases involving a decline in business needs. For example, in *Commissioner v. Sullivan*,ⁿ²⁰ a majority of the Fifth Circuit found a distribution in kind of oil leases, drilling

equipment, notes receivable, and a gas payment to be in partial liquidation of the corporation, where the transfer was motivated by the corporation's reluctance to assume the risk of developing the oil leases, an activity the corporation had no authority to engage in under its charter. The dissent agreed that a business purpose prompted distribution of the oil leases and drilling equipment, but felt that the notes and gas payment were included solely to benefit the stockholders. The conclusion to be drawn from both opinions in *Sullivan* is that a distribution of operating assets in furtherance of a valid business purpose will more easily pass muster as a corporate contraction than a distribution of cash or other liquid assets.

[b] Termination of an Active Trade or Business. A distribution will automatically qualify as a partial liquidation provided (1) the distribution is either attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business that the corporation actively conducted throughout the five-year period immediately before the distribution and that it did not acquire within such five-year period in a transaction in which gain or loss was recognized in whole or in part; and (2) immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business that it actively conducted throughout the five-year period ending on the date of distribution and that it did not acquire within such period in a transaction in which gain or loss was recognized in whole or in part.ⁿ²¹

A distribution qualifying as a partial liquidation can consist of the assets used in the trade or business during the five-year period preceding distribution, the proceeds from the sale of such assets, the normal quantity of inventory used in the trade or business, or the proceeds from the bulk sale of such inventory. While the composition of the distribution can vary, it appears that the extent of the distribution cannot. The requirement of the Code that the distribution be "attributable to the corporation's ceasing to conduct, or consists of the assets of, a qualified trade or business" has been taken to mean that all of the assets used in the conduct of the terminated trade or business, or all of the proceeds from their sale, must be distributed, and that the distribution must take place as soon as possible after the cessation of business or sale of assets.ⁿ²²

The definition of active trade or business contemplated by the partial liquidation provisions is the same as the one that obtains for divisive reorganizations governed by *IRC Section 355*. The regulations under the latter provision state that a trade or business consists of a specific existing group of activities carried on for the purpose of earning income or profit, and that the activities included in such group must take in every operation which forms a part of, or a step in, the process of earning income or profit from such group.ⁿ²³ Excluded from the definition are the holding of property for investment purposes, and the ownership and operation of land or buildings used substantially by the owner in a trade or business.ⁿ²⁴

An important feature of the repeal of the special provision governing partial liquidations and the requirement that such distributions come under the redemption provisions of the Code is the authorization of regulations to ensure that the change will not be circumvented through the use of *IRC Section 355, 351* or any other provision of the Code or regulations, including those governing consolidated returns.ⁿ²⁵ Congress contemplates that, thereby, a corporation may be treated as a continuing entity and any distribution by it taxed accordingly even though the transaction is in form a corporate liquidation.ⁿ²⁶ One example considered by Congress was the transfer of assets to a new subsidiary followed by a tax-free spinoff of the new stock and then by a distribution of the distributing corporation's remaining assets. Although the distribution of the assets appears to be a liquidation, it is suggested that the subsidiary could be treated as a continuation of the distributor and the distribution of the assets to the shareholders characterized as other than a complete liquidation.ⁿ²⁷

Although some commentators have discerned a tendency to assume the contrary, it appears that a distribution which fails to satisfy the active trade or business test can still qualify as a partial liquidation under the general corporate contraction provision.ⁿ²⁸ The Service position accords with this view.ⁿ²⁹ Thus, in *Revenue Ruling 56-513*,ⁿ³⁰ a delay in distributing the proceeds of the sale of assets used in the discontinued trade or business prevented the distribution from qualifying under the trade or business rule, but did not prevent it from being treated as a partial liquidation under

the general definition.

FOOTNOTES:

(n1)Footnote 1. In determining whether stock is held by a noncorporate shareholder, stock held by a partnership, estate, or trust is treated as if held proportionately by its partners or beneficiaries. *IRC § 302(e)(5)*.

(n2)Footnote 2. *IRC § 302(a), (b)(4)*.

(n3)Footnote 1. The plan must call for partial liquidation. See *Charlie Sturgill Motor Co v Commr, TC Memo 1973-281*, where the distribution was taxed as a dividend because the corporation adopted only a plan of complete liquidation.

A pro rata distribution in partial liquidation of the corporation qualifies as a redemption under *IRC § 302(b)(4)*, even though the shareholders do not surrender any of their stock. *Rev Rul 90-13, 1990-1 CB 65*. Until the Service resolves the issue, it will not issue rulings regarding deemed surrenders in partial liquidations when (i) the corporation has outstanding more than one class of stock and there are priorities as to dividend or liquidating distributions, or any other differences in stock rights, or (ii) either under the terms of the stock or as established contractually, there are outstanding any rights affecting the corporation's stock, such as warrants, options, convertible securities, shareholder agreements or rights of first refusal. *Rev Proc 98-3, 1998-1 IRB 100*.

(n4)Footnote 2. *IRC § 302(e)(1)(A)*.

(n5)Footnote 3. S Rep No 1622, 83d Cong, 2d Sess 49 (1954).

(n6)Footnote 4. S Rep No 1622, 83d Cong, 2d Sess 262 (1954). See generally Chommie, "Section 346(a)(2): The Contraction Theory," *11 Tax L Rev 407 (1956)*.

(n7)Footnote 5. *11 TC 836 (1948)*, *acq 1949-1 CB 2*.

(n8)Footnote 6. S Rep No 1622, 83d Cong, 2d Sess 49 (1954).

The notion of "contraction" contemplates some reduction in business volume or operations. *Charlie Sturgill Motor Co v Commr, TC Memo 1973-281*; see also *Rev Rul 78-402, 1978-2 CB 138*, and *Rev Rul 76-526, 1976-2 CB 101*.

The Service will not rule as to the amount of working capital attributable to a business or portion of a business terminated that can be distributed in partial liquidation, and will not ordinarily rule whether a distribution will qualify as a partial liquidation unless it results in a 20 percent or greater reduction in gross income, net fair market value of assets, and employees. *Rev Proc 2007-3, 2007-1 IRB 108*. Partial liquidations that qualify as complete terminations under *IRC § 302(e)(2)* are not subject to this provision.

(n9)Footnote 7. *78 F2d 513 (6th Cir 1935)*; *accord, Upham v Commr, 4 TC 1120 (1945)*, *acq 1945 CB 7*; *Sagner v Commr, 1953 Tax Ct Memo LEXIS 48*.

(n10)Footnote 8. *Commr v Champion, 78 F2d 513, 514 (6th Cir 1935)*.

(n11)Footnote 9. *84 F2d 431 (7th Cir 1936)*, *cert denied 299 US 591*.

(n12)Footnote 10. The lack of change at the corporate level was matched by a corresponding lack of change at the shareholder level; a father and son owned all of the stock of the corporation except for a single share. A similar result was reached in *Rev Rul 78-55, 1978-1 CB 88*.

(n13)Footnote 11. S Rep No 1622, 83d Cong, 2d Sess, 262 (1954).

(n14)Footnote 12. *Commr v Quackenbos*, 78 F2d 156 (2d Cir 1935) ; *O'Brion v Commr*, 1951 Tax Ct Memo LEXIS 26 ; *Jones v Commr*, BTA Memo 1942-555; *contra*, *Dunton v Clauson*, 67 F Supp 839 (SD Me 1946) ; *Towers v Commr*, 24 TC 199 (1955) , *affd* 247 F2d 233 (2d Cir 1957) , *cert denied* 355 US 914 ; see also *Rev Rul* 67-16, 1967-1 CB 77 (distribution of condemnation proceeds not a contraction; no decline in business activity).

(n15)Footnote 13. *Rev Rul* 60-232, 1960-2 CB 117 , *modifying* *Rev Rul* 55-373, 1955-1 CB 363 . A distribution of working capital attributable to activities that had produced 95 percent of a corporation's gross income prior to termination was held to be a genuine contraction in *Rev Rul* 75-3, 1975-1 CB 108 .

(n16)Footnote 14. *Rev Rul* 60-232, 1960-2 CB 117 .

(n17)Footnote 15. *Rev Rul* 60-232, 1960-2 CB 117 . *Rev Rul* 76-289, 1976-2 CB 100 .

(n18)Footnote 16. *Rev Rul* 60-232, 1960-2 CB 117 ; see also *Rev Rul* 60-322, 1960-2 CB 118 .

(n19)Footnote 17. *Commr v Babson*, 70 F2d 304 (7th Cir 1934) , *cert denied* 293 US 571 ; *Weinman v Commr*, TC Memo 1956-229 ; *Heber Scowcroft Inv Co v Commr*, 1945 Tax Ct Memo LEXIS 140 (1945) ; *Rev Rul* 74-296, 1974-1 CB 80 . The liquidation of property which produced a minor percentage of the corporation's income might not qualify. *Cf* *Rev Rul* 57-333, 1957-2 CB 239 .

A sale of a subsidiary's stock to an unrelated party followed by a distribution of the proceeds of the sale by the parent is not a partial liquidation. *Rev Rul* 79-184, 1979-1 CB 143 . However, a distribution by a parent of the proceeds of a sale of the assets of a subsidiary is a partial liquidation of the parent corporation, if the subsidiary is completely liquidated under *IRC* § 332. *Rev Rul* 75-223, 1975-1 CB 109 .

(n20)Footnote 18. 22 TC 1158 (1954) , *affd per curiam* 228 F2d 909 (6th Cir 1955) . See also *Pliner v Commr*, TC Memo 1961-218 .

(n21)Footnote 19. The Tax Court may have reached the wrong result by focusing on book values as shown on the corporation's financial statements rather than on the portion of the amount realized on the sale which was actually reinvested in the new venture.

(n22)Footnote 20. 210 F2d 607 (5th Cir 1954) ; *accord*, *Lockhart v Commr*, 8 TC 436 (1947) .

(n23)Footnote 21. *IRC* § 302(e)(3), (4). The failure to operate the business for at least five years is not cured by a delay in distributing the proceeds of sale. *Rev Rul* 71-473, 1971-2 CB 179 .

See generally Greene, "Disposing of Part of a Business: Planning Under the Statutory Rules," 15 *Tul Tax Inst* 158 (1965); Caplan, "The Five-Year Active Business Rule in Separations and Partial Liquidations," 1961 *So Calif Tax Inst* 211.

(n24)Footnote 22. *Kenton Meadows Co v Commr*, TC Memo 1984-379 , *affd* 766 F2d 142 (4th Cir 1985) , *cert denied* 474 US 1082 ; *Gordon v Commr*, 424 F2d 378 (2d Cir 1970) , *affg* 51 TC 1032 (1969) . The Tax Court decision in *Gordon* came after a reversal and remand by the Supreme Court. 391 US 83 (1968) , *revd* 382 F2d 499 (2d Cir 1967) ; *Rev Rul* 58-565, 1958-2 CB 140 .

A temporary investment of funds following the sale of part of the taxpayer's business does not prevent the distribution from qualifying as a partial liquidation. *Rev Rul* 71-250, 1971-1 CB 112 . However, any profit earned on the investment and distributed to the shareholders will be subject to tax under *IRC* § 301, while any losses sustained will reduce the amount treated as distributed in partial liquidation. *Rev Rul* 76-279, 1976-2 CB 99 .

(n25)Footnote 23. *Treas Reg* § 1.355-3(b)(2)(i).

(n26)Footnote 24. *Treas Reg § 1.355-3(b)(2)(iv)*. Since the holding of stock for investment does not qualify as an active trade or business, a distribution of stock of a controlled subsidiary that ceases to do business cannot qualify as a partial liquidation of the parent. *Morgenstern v Commr*, 56 TC 44 (1971) .

(n27)Footnote 25. *IRC § 346(b)*.

(n28)Footnote 26. S Rep No 97-494, 97th Cong, 2d Sess 188 (1982).

(n29)Footnote 27. S Rep No 97-494, 97th Cong, 2d Sess 188 (1982).

(n30)Footnote 28. The distribution must still meet the distribution time requirements of *IRC § 302(e)(1)*. *Rev Rul 77-468*, 1977-2 CB 109 .

(n31)Footnote 29. It has been said that a contrary approach would make the general rule meaningless; Rabkin & Johnson, 3A *Federal Income, Gift and Estate Taxation* § 24.10[4].

(n32)Footnote 30. 1956-2 CB 191 ; see also *Rev Rul 57-333*, 1957-2 CB 239 , where the Service first considered whether the distribution could fit the trade or business test and then looked to see if a corporate contraction had occurred.



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CHAPTER 6 Liquidating Distributions

1-6 Taxation of Securities Transactions § 6.05

§ 6.05 Partial Liquidations--Effect on the Liquidating Corporation

A distribution in partial liquidation has the same effect on the distributing corporation as any distribution in redemption of stock. Gain will be recognized if the corporation distributes appreciated property to the shareholder.ⁿ¹ Earnings and profits will be reduced in an amount equal to the ratable share of the earnings and profits attributable to the shares redeemed as part of the partial liquidation.ⁿ²

FOOTNOTES:

(n1)Footnote 1. *IRC § 311(b)(1)*, described more fully in Ch 5.

(n2)Footnote 2. *IRC § 312(n)(7)*. A discussion of the provision can be found in Ch 5.



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CHAPTER 7 Stock Bail-Outs

1-7 Taxation of Securities Transactions 7.syn

§ 7.syn Synopsis to Chapter 7: Stock Bail-Outs

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CHAPTER 7 Stock Bail-Outs

1-7 Taxation of Securities Transactions § 7.01

§ 7.01 Introduction

We have seen that the extraction of earnings and profits from a going corporation cannot be achieved without dividend consequences unless the shareholder's proportionate interest is sufficiently reduced by a redemption which qualifies as an exchange under *IRC Section 302(a)*.ⁿ¹ But if the corporation is sufficiently liquid, a possible solution is a tax-free stock dividend of preferred stock, followed by a sale of the preferred to a third party, and then by the complete redemption of the preferred by the corporation.

The device just described met with court approval in *Chamberlin v. Commissioner*,ⁿ² where the Sixth Circuit held that the rapid succession of prearranged events did not change the character of a nontaxable stock dividend or prevent the shareholders from achieving the same economic result as a dividend, but at preferential capital gain rates. *Chamberlin* was decided in 1953; in 1954, Congress took action to prevent preferred stock "bail-outs" by enacting *IRC Section 306*, which taints the stock received as a dividend and changes the character of the gain realized on its disposition.

FOOTNOTES:

(n1)Footnote 1. This assumes that the distribution does not meet the definition of partial liquidation where the distribution can be pro rata.

(n2)Footnote 2. *207 F2d 462 (6th Cir 1953)* , *cert denied 347 US 918 (1954)* ; but cf *Est of Rosenberg v Commr*, *36 TC 716 (1961)* .



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CHAPTER 7 Stock Bail-Outs

1-7 Taxation of Securities Transactions § 7.02

§ 7.02 Combating Stock Bail-Outs--Section 306 Stock

[1] Section 306 Stock Defined

The legislative attack on preferred stock bail-outs starts with a new concept--Section 306 stock. The scope of the concept is not limited to preferred stock received as a stock dividend; it also includes stock received in a reorganization and stock having a transferred or substituted basis. Since the statute is aimed at preventing the bail-out of profits at preferred rates, stock will not be Section 306 stock if distributed at a time when the corporation has neither current nor accumulated earnings and profits.ⁿ¹ But if there is even \$1 of earnings and profits, the taint of *IRC Section 306* attaches to all of the distributed stock.

[a] Stock Received as a Dividend. Stock received as a dividend after June 22, 1954 will be Section 306 stock if (1) any part of the distribution is excluded from gross income by *IRC Section 305(a)*, and (2) the stock is not common stock issued with respect to common stock.ⁿ² For common stock to be Section 306 stock, it must be distributed as a dividend with respect to stock which is not common stock and must not be includable in gross income when received. For example, if common stock is distributed as a dividend on preferred stock, and the shareholder receiving the stock has the right to take the dividend in stock or in cash, the dividend will be taxable under *IRC Section 305(b)(1)* and the stock will not be Section 306 stock.

There is no statutory or regulatory definition of common stock beyond that common stock which is convertible into preferred stock or property will not be considered common stock.ⁿ³ In fact, the only further clues to the meaning of the term "common stock" are some rulings, one holding that redeemable nonvoting common stock was not common stock for purposes of *IRC Section 306(c)(1)(B)*;ⁿ⁴ a second distinguishing the first, finding that stock was common stock even though no shareholder could sell the stock without first offering it to the corporation at book value;ⁿ⁵ another holding a redesignated class of common stock to be other than common stock because it was preferred as to the payment of dividends;ⁿ⁶ a fourth stating that nonvoting stock was common stock because its disposition, while not giving rise to a loss of voting control, would cause the shareholder to lose an interest in the unrestricted equitable growth of the corporation;ⁿ⁷ and, lastly and perhaps most important, one that provides that stock restricted as to dividends or to share beyond par value on liquidation is not common stock.ⁿ⁸ Perhaps the most important feature of rulings holding that stock with certain preferences is still common stock is the ability of the stock in question to share without limitation in the growth of the corporation.ⁿ⁹

[b] Stock Received Pursuant to a Reorganization. A second category of Section 306 stock is comprised of stock,

other than common stock, received pursuant to a reorganization or corporate separation which is either wholly or partially nontaxable, provided the effect of the transaction is substantially the same as the receipt of a stock dividend or the stock is received in exchange for Section 306 stock.ⁿ¹⁰ The critical determination is whether the transaction has the effect of a stock dividend, a determination which the Regulations make by looking to see if cash received in lieu of such stock would have been treated as a dividend under *IRC Section 356(a)(2)*, or as a distribution governed by *IRC Section 301*.ⁿ¹¹

The foregoing may be amplified by considering a number of cases in which the Internal Revenue Service has been asked to rule whether stock received in a reorganization is Section 306 stock. In Revenue Ruling 59-84,ⁿ¹² a corporation issued one share of new common stock or one share of new nonvoting, nonparticipating, cumulative preferred stock for each share of existing common stock. In the exchange, some of the shareholders of the corporation received only common or preferred while others received both. By definition, the shareholders who received only common stock did not receive Section 306 stock. The one shareholder who received only preferred shares was held not to have received Section 306 stock since, after the exchange, he owned no common stock, no voting stock, and no participating stock. However, each of the shareholders who received both common and preferred ended with a common stock ownership greater in percentage than his ownership interest prior to the exchange. This led the Service to find that, as to such shareholders, the transaction had substantially the same effect as the receipt of a stock dividend, causing the preferred stock received by them to be classified as Section 306 stock.

The criteria applied in determining whether the transaction has the effect of a stock dividend are strikingly similar to those employed in testing a redemption for dividend equivalence.ⁿ¹³ The shareholder who received only preferred stock in exchange for his common suffered a meaningful reduction in his interest in the corporation. Indeed, he had received cash instead of stock, his redemption would have been substantially disproportionate. The shareholders receiving both common and preferred found themselves in much the same position as the shareholder who receives property in a pro rata redemption and is saddled with the receipt of a dividend. To further illustrate the point, one need only compare *Revenue Ruling 70-199*ⁿ¹⁴ with *Revenue Ruling 60-1*.ⁿ¹⁵ In the former, the shareholder's ownership of all of the outstanding shares of one class of stock gave him the power to elect a majority of the directors of the corporation. This power was unaffected by a recapitalization involving other shares of the corporation, causing the Service to conclude that the stock issued pursuant to the reorganization was Section 306 stock. In the latter ruling, a merger of two publicly held corporations brought an exchange of preferred stock in the merged corporation for similar stock in the surviving corporation. Prior to the transaction, the preferred stock in the old corporation had been widely held; the largest individual holder owned only one and one-half percent of the outstanding issue and owned no common stock. In addition, there was no pattern of ownership between common and preferred; the holders of 75 percent of the preferred owned no other stock in the corporation, while the persons who held both common and preferred had less than 25 percent of the voting power before the merger and less than 20 percent after the merger. These circumstances, coupled with the fact that the new preferred stock was issued to meet the needs of the corporation and not for the convenience of the shareholders, resulted in a finding that the effect of the transaction was not substantially the same as the receipt of a stock dividend.

When preferred stock that is not Section 306 stock is exchanged in an acquisitive reorganization for preferred stock of equal value and with terms not substantially different, the new stock will not be Section 306 stock within the meaning of *IRC Section 306(c)(1)(B)*.ⁿ¹⁶

Preferred stock that is convertible into common stock may not be Section 306 stock. The Service has announced that it will usually rule to that effect if the convertible preferred is received in a reorganization by shareholders who will own no common stock after the reorganization, and the preferred stock will be widely held or it is represented that there will not be any conversion of the stock pursuant to a concerted plan which will result in both common and preferred being held by an exchanging shareholder.ⁿ¹⁷ However, even if preferred stock issued with respect to common stock is found to be Section 306 stock, common stock of the same corporation acquired in an exchange of the Section 306 stock will not carry any taint.ⁿ¹⁸

[c] Stock Having a Substituted Basis. *IRC Section 306(c)(1)(C)* adds to the definition of Section 306 stock any stock held by a person whose basis for the stock is determined by reference to the basis of Section 306 stock, either in his hands or in the hands of another. For example, if a person transfers Section 306 stock to a newly formed corporation in exchange for all of the stock of such corporation, the stock received by the transferor will be classified as Section 306 stockⁿ¹⁹ even if it is common stock.ⁿ²⁰ Furthermore, the transferred Section 306 stock will remain tainted since the basis of the stock in the hands of the transferee corporation is determined by reference to the basis of the stock in the hands of the transferor.ⁿ²¹

Under this subsection, Section 306 stock acquired by gift remains Section 306 stock. However, if the value of the gift is includable in the decedent's gross estate because the transfer was made in contemplation of death, and the donee still holds the stock on the date of the donor's death, the taint is removed since the basis of the stock in the donee's hands is determined by reference to its fair market value on the date of death or alternate valuation date.ⁿ²²

[d] Stock Acquired in a Section 351 Exchange. The Tax Equity and Fiscal Responsibility Act of 1982 enlarged the definition of Section 306 stock to include any stock other than common stock acquired in an exchange that normally would be tax free under *IRC Section 351*, if the receipt of money in lieu of the stock would have been treated as a dividend to any extent.ⁿ²³ This provision closes the door to potential tax avoidance by making rules similar to the related corporation redemption rules of *IRC Section 304(b)(2)*ⁿ²⁴ applicable for purposes of determining the amount of the potential dividend and of determining the application of *IRC Section 306* to any subsequent disposition of the stock.

[e] Preventing Avoidance of Section 306. We have already seen that common stock that is convertible into stock other than common stock is excluded from consideration as common stock for purposes of *IRC Section 306*. If this were not so, earnings and profits could be bailed-out by combining a distribution of convertible common stock, with an exercise of the conversion privilege and a sale of the preferred stock acquired on the exchange.

Another potential opportunity to avoid the consequences of *IRC Section 306* is foreclosed by *IRC Section 306(d)*, which treats stock rights as stock. Thus, if the corporation has earnings and profits at the time it distributes rights to acquire stock which would have been Section 306 stock if it were distributed, and if the rights are excluded from the recipient's gross income by *IRC Section 305(a)*, the rights will be considered Section 306 stock, as will any stock acquired by the exercise of those rights.ⁿ²⁵

Avoidance that could result from a substantial change in the terms and conditions of any stock is prevented by making such stock Section 306 stock if there are earnings and profits either at the time of distribution or at the time of the change.ⁿ²⁶ In other words, stock that could not be categorized as Section 306 stock when originally distributed, because of the absence of earnings and profits, may be so classified at a later date if the terms and conditions of the stock are substantially changed and the corporation then has earnings and profits.

[2] The Effect of a Disposition of Section 306 Stock

[a] Where the Disposition Is a Redemption

[i] General Rule. If the disposition of Section 306 stock takes the form of a redemption which does not completely terminate the shareholder's interest in the corporation, the amount realized will be treated as a distribution to which *IRC Section 301* applies.ⁿ¹ The amount that will be taxed as a dividend depends upon the extent of the corporation's earnings and profits at the time of the redemption; the amount of earnings and profits at the time the Section 306 stock is distributed is immaterial, except insofar as the existence of some earnings and profits at the time of the stock distribution is needed to make the stock Section 306 stock.ⁿ²

[ii] Exception--A Complete Redemption or Partial Liquidation. Dividend consequences will not attach if the redemption is a complete redemption to which *IRC Section 302(b)(3)* applies or a partial liquidation falling under *IRC Section 302(b)(4)*.ⁿ³ The constructive ownership rules of *IRC Section 318(a)* must be applied when determining

whether the redemption completely terminates the shareholder's stock interest in the corporation. However, family attribution can be waived if the conditions of *IRC Section 302(c)(2)* are met.ⁿ⁴

[b] Where the Disposition Is Other Than a Redemption

[i] General Rule. If the disposition is not a redemption, the gain realized will be treated as ordinary income to the extent of the shareholder's ratable share of the corporation's earnings and profits at the time the Section 306 stock was distributed.ⁿ⁵ The excess of the amount realized over the portion treated as ordinary income is first applied against and in reduction of the shareholder's basis for the stock, with any further balance treated as gain from the sale of the stock.ⁿ⁶ If the amount realized is greater than the shareholder's ratable share of earnings and profits, but less than the shareholder's basis for his Section 306 stock, the shareholder realizes a loss that he is not allowed to recognize.ⁿ⁷ Instead, the unrecovered basis is added back to the basis of the stock with respect to which the Section 306 stock was issued.ⁿ⁸

Example:

At a time when a corporation had earnings and profits of \$5,000, it distributed 100 shares of preferred stock worth \$5,000 to its sole shareholder. The common stock with respect to which the distribution was made had a basis of \$10,000 and was worth \$15,000 on the date of distribution. Pursuant to *IRC Section 307*,ⁿ⁹ \$2,500 of the shareholder's basis for the common stock must be allocated to the preferred stock; his basis for the common would then become \$7,500. A sale of the preferred stock for \$8,000 would cause the shareholder to realize ordinary income of \$5,000 (his ratable share of earnings and profits at the time of the original stock distribution) and gain attributable to the sale of the stock of \$500 (\$8,000 less the sum of (1) the portion of the amount realized treated as ordinary income, \$5,000, and (2) the adjusted basis of the preferred stock, \$2,500). If the selling price had been \$7,000, the ordinary income portion would still be \$5,000, leaving a balance of \$2,000 to be applied against the \$2,500 basis of the preferred stock. The realized loss of \$500 would not be allowed as a deduction, but that sum would be added to the basis of the shareholder's common stock.

How should a transaction involving Section 306 stock be taxed if, at the time of receipt of the stock, the taxpayer owned some preferred stock and the disposition is of less than his total holding of the preferred? This was the question presented in *Fireover v. United States*,ⁿ¹⁰ where the taxpayer received 535 preferred shares as a dividend on common stock. This raised to 600 the number of preferred shares owned by the taxpayer; the other 65 had been acquired at the same time as the common. The taxpayer then disposed of 451 of the preferred shares. The district court applied the first-in, first-out rule of stock identificationⁿ¹¹ and held that sixty-five of the shares were those owned before the stock dividend. The Third Circuit disagreed on the ground that the tacking rules of *IRC Section 1223(5)* caused the preferred received as a dividend to have the same holding period as the common with respect to which it was issued. Thus, all of the preferred had the same holding period so that of the 451 shares, only 48.86 (65/600ths of 451) were not Section 306 stock.

[ii] Exception--Complete Termination of a Shareholder's Entire Stock Interest. A disposition that is not a redemption will avoid the general rule of *IRC Section 306(a)(1)* if it terminates the shareholder's entire stock interest in the corporation.ⁿ¹² A disposition will not completely terminate a shareholder's interest, if, afterwards, stock owned by another is attributed to the shareholder by operation of the constructive ownership rules of *IRC Section 318(a)*.ⁿ¹³ Moreover, the exception will be inapplicable if the transferee is a person whose stock ownership would be attributable to the shareholder under *IRC Section 318(a)*.ⁿ¹⁴

[iii] Exception--Complete Liquidations. The usual rules governing gain or loss will be applicable if the shareholder redeems Section 306 stock in a distribution which qualifies as a complete liquidation.ⁿ¹⁵ This exception, as well as those relating to complete redemptions, partial liquidations, and complete terminations of a shareholder's interest, is grounded on the assumption that the transaction is not generally considered to be a means by which shareholders can remove corporate earnings at preferential rates.ⁿ¹⁶

[iv] Exception--Nonrecognition Transaction. *IRC Section 306(b)(3)* makes *IRC Section 306(a)* inapplicable to the extent that some other provision of the Code grants nonrecognition to gain or loss realized on the disposition of the Section 306 stock. However, since any stock received by the stockholder in a tax-free exchange will assume a substituted basis and therefore be Section 306 stock, the exception serves merely to defer operation of the general rule. Furthermore, any "boot" received in an otherwise tax-free transaction will not be protected by *IRC Section 306(b)(3)*, but will be subject to *IRC Section 306(a)* treatment.ⁿ¹⁷

[v] Exception--Nonavoidance Transactions. The final exception applies whenever the Service is satisfied that the transaction is "not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax."ⁿ¹⁸ Two sets of transactions are granted immunity from *IRC Section 306(a)*. The first is where the distribution and disposition or redemption do not have a tax avoidance purpose,ⁿ¹⁹ while the second covers the situation in which the shareholder has made a prior or simultaneous disposition (or redemption) of the stock with respect to which the Section 306 stock was issued.ⁿ²⁰

FOOTNOTES:

(n1)Footnote 1. *IRC § 306(c)(2)*. If there is a substantial change in the terms and conditions of stock which would have been *IRC § 306* stock but for the absence of earnings and profits at the time of distribution, the rule of *IRC § 306(c)(2)* will be disregarded if there are earnings and profits at the time of such change. *IRC § 306(g)(3)*.

(n2)Footnote 2. *IRC § 306(c)(1)(A)*; *Treas Reg § 1.306-3(i)*. A distribution of common on common is excluded even if the distributed stock is treasury stock rather than newly issued stock. *Rev Rul 55-746, 1955-2 CB 224* .

The broadened application of *IRC § 305(b)*, relating to taxable stock dividends (see § 4.06[2][a][i]-[iv], *supra*) will lessen the scope of *IRC § 306*.

(n3)Footnote 3. *IRC § 306(e)(2)*; *Treas Reg § 1.306-3(f) (1955)*.

(n4)Footnote 4. *Rev Rul 57-132, 1957-1 CB 115* .

(n5)Footnote 5. *Rev Rul 76-386, 1976-2 CB 95* .

(n6)Footnote 6. *Rev Rul 66-332, 1966-2 CB 108* ; but see *Rev Rul 81-91, 1981-1 CB 123* , modifying *Rev Rul 66-332* .

(n7)Footnote 7. *Rev Rul 76-387, 1976-2 CB 96* .

(n8)Footnote 8. *Rev Rul 79-163, 1979-1 CB 131* .

(n9)Footnote 9. *Rev Rul 81-91* , N 5, *supra*; *Rev Rul 75-222, 1975-1 CB 105* .

(n10)Footnote 10. *IRC § 306(c)(1)(B)*. See generally Trimble, "The Treatment of Preferred Stock Distributions in Reorganizations Under Section 306 of the Internal Revenue Code of 1954," 19 *Tax L Rev* 345 (1964). Stock received in a reorganization subject to the 1939 Code will not be Section 306 stock. *IRC § 306(h)*.

(n11)Footnote 11. *Treas Reg § 1.306-3(d)*. This test was applied to find the presence of Section 306 stock in *Rev Rul 77-335, 1977-2 CB 95* , *Rev Rul 75-236 1975-1 CB 106* , and *Fireoved v US, 318 F Supp 133 (ED Pa 1970) affd in part, revd in part on other grounds 462 F2d 1281 (3d Cir 1972)* .

The attribution rules of *IRC § 318* are applicable in determining whether the effect of the transaction is substantially the same as the receipt of a stock dividend. *IRC § 306(c)(4)*.

(n12)Footnote 12. *1959-1 CB 71* .

(n13)Footnote 13. See § 5.02[2][a], *supra*. The use of a test akin to that employed in an IRC § 302 redemption marks a departure from the strict cash substitution test found in the Regulations. See Metzger, "The Impact of Section 306 Upon Convertible Preferred Stock Issued in a Corporate Reorganization," 116 U Pa L Rev 755 (1968).

(n14)Footnote 14. 1970-1 CB 68 .

(n15)Footnote 15. 1960-1 CB 143 .

(n16)Footnote 16. Rev Rul 88-100, 1988-48 IRB 5 ; Rev Rul 82-118, 1982-1 CB 56 ; Rev Rul 79-287, 1979-2 CB 130 .

(n17)Footnote 17. Rev Proc 77-37, 1977-2 CB 568 . An excellent treatment of the subject of the effect of IRC § 306 on the use of convertible preferred stock is contained in Metzger, N 13, *supra*.

(n18)Footnote 18. IRC § 306(e)(1). The exchange need not be pursuant to a conversion privilege contained in the instrument.

(n19)Footnote 19. Rev Rul 77-108, 1977-1 CB 56 . This assumes that the transaction meets the conditions of IRC § 351 so that the transferor's basis for the acquired stock is controlled by IRC § 358(a). See § 3.03, *supra*.

(n20)Footnote 20. Treas Reg § 1.306-3(e).

(n21)Footnote 21. IRC § 362(a)(1).

(n22)Footnote 22. IRC § 1014(a), (b)(9); Treas Reg § 1.306-3(e).

(n23)Footnote 23. IRC § 306(c)(3). The attribution rules of IRC § 318 apply in determining the extent of common control, with the corporation-shareholder provisions applied using 5 percent as the stock ownership prerequisite. IRC § 306(c)(4).

(n24)Footnote 24. See § 5.04[1], *supra*.

(n25)Footnote 25. Treas Reg § 1.306-3(b).

(n26)Footnote 26. IRC § 306(g)(3).

(n27)Footnote 1. IRC § 306(a)(2).

(n28)Footnote 2. Treas Reg § 1.306-1(c).

(n29)Footnote 3. IRC § 306(b)(1)(B). Complete redemptions are discussed in § 5.02 [2][c], *supra*.

(n30)Footnote 4. Treas Reg § 1.306-2(a)(2).

(n31)Footnote 5. IRC § 306(a)(1)(A). The amount treated as ordinary income is considered to be a dividend received from the corporation for purposes of IRC § 1(h)(11), the maximum rate of tax on dividends. IRC § 306(a)(1)(D). See § 2.06[2][a][i] for a discussion of IRC § 1(h)(11).

Although the statute is couched in terms of earnings and profits at the time of distribution, the appropriate measure should be accumulated earnings and profits and current earnings and profits for the year of distribution. See B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* 10-10 (5th ed. 1987).

If there has been a substantial change in the terms and conditions of the stock, the ratable portion of earnings and

profits will be the portion determined as of the date of the change, if that figure is higher than the one determined as of the date of distribution. *IRC § 306(g)(3)*.

It should be noted that the realization of ordinary income at the shareholder level is not offset by a reduction of earnings and profits at the corporate level.

(n32)Footnote 6. *IRC § 306(a)(1)(B)*. The gain will be capital gain if the stock is a capital asset in the hands of the taxpayer.

(n33)Footnote 7. *IRC § 306(a)(1)(C)*.

(n34)Footnote 8. *Treas Reg § 1.306-1(b)*, Exs. (2) and (3).

(n35)Footnote 9. See *§ 4.06[2][b]*, *supra*.

(n36)Footnote 10. See *§ 7.02[1]*, N 11, *supra*,

(n37)Footnote 11. See *§ 1.05 [7][a]*, *supra*.

(n38)Footnote 12. *IRC § 306(b)(1)(A)*.

(n39)Footnote 13. *IRC § 306(b)(1)(A)*.

(n40)Footnote 14. *IRC § 306(b)(1)(A)*.

(n41)Footnote 15. *IRC § 306(b)(2)*.

(n42)Footnote 16. S Rep No 1622, 83d Cong, 2d Sess 243 (1954).

(n43)Footnote 17. *Treas Reg § 1.306-3(d)*; *Rev Rul 76-14, 1976-1 CB 97* ; but see *Rev Rul 76-15, 1976-1 CB 98* .

The issuance of cash to minority shareholders in lieu of fractional shares of Section 306 stock in a recapitalization does not serve a tax avoidance purpose and will be treated as a redemption under *IRC § 302(a)*. *Rev Rul 81-81, 1981-1 CB 122* .

(n44)Footnote 18. *IRC § 306(b)(4)*.

(n45)Footnote 19. The Service will not ordinarily issue a ruling as to whether a distribution or disposition or redemption of Section 306 stock is in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes. *Rev Proc 2010-3, 2010-1 IRB 110, 116* (§ 4.01(23)).

(n46)Footnote 20. The fact that the Section 306 stock is widely held is in itself not a ground for relief under *IRC § 306(b)(4)*. *Rev Rul 89-63, 1989-1 CB 90* . The ruling will not be applied adversely to taxpayers who treated transactions in accordance with contrary conclusions found in *Rev Rul 57-212, 1957-1 CB 114*, *Rev Rul 57-103, 1957-1 CB 113* , and *Rev Rul 56-116, 1956-1 CB 164* , in the case of stock either issued before May 1, 1989, or issued thereafter pursuant to the terms of a plan of reorganization that was adopted before, and remained in effect until, that date.

A gift of Section 306 stock to a charitable organization did not produce income for the donee in *Rev Rul 57-328, 1957-2 CB 229* . The utility of a charitable gift of Section 306 stock has been diminished by the enactment of *IRC § 170(e)(1)*. See Ch 1, and *Pescosolido v Commr, 91 TC 52 (1988)* , *affd 883 F2d 187 (1st Cir 1989)* , and *Ltr Rul 8930001* .

All of the underlying common stock must be sold if such sale is the sole factor relied on to show the absence of a plan

of tax avoidance. *Rev Rul 75-247, 1975-1 CB 104* .

Rev Rul 80-33, 1980-1 CB 69 , is illustrative of the burden placed on a taxpayer to show that the distribution of preferred stock was not in pursuance of a tax avoidance purpose.



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CHAPTER 8 Reorganizations and Other Exchanges

1-8 Taxation of Securities Transactions 8.syn

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CHAPTER 8 Reorganizations and Other Exchanges

1-8 Taxation of Securities Transactions § 8.01

§ 8.01 Introduction

The discussion in earlier chapters indicated that gain or loss realized on the disposition of property will ordinarily be recognized in the year of transfer, but that there are instances in which the Internal Revenue Code permits the taxpayer to forego recognition of gain or loss on the ground that the transaction involves changes in the form of the taxpayer's investment, but not in its substance. The exceptions to the general rule are founded on the theory that the imposition of tax or allowance of loss should be postponed until the substance of the investment also undergoes change.

The reorganization provisions of the Code are in keeping with this approach. Nonrecognition is granted to a specified group of exchanges "which effect only a readjustment of continuing interest in property under modified corporate forms."ⁿ¹ But as in all tax-free exchange cases, it is not enough that a transaction meets the literal definition of reorganization; it must also satisfy the purposes and assumptions which underlie the exception to the general rule requiring recognition.ⁿ²

The initial discussion in this chapter will focus on the impact of the choice of a particular instrument on the reorganization status of the exchange. Following that, consideration will be given to the effect of a reorganization exchange on the holder of stock or securities in the reorganized corporation. The final portion of the chapter will be devoted to the tax consequences which attach to exchanges of stock or securities made other than as part of a reorganization.ⁿ³

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.368-1(b)*.

(n2)Footnote 2. *Id*; *Treas Reg § 1.1002-1(b)*. See, eg, *Bazley v Commr*, 331 US 737 (1947), where the Supreme Court refused to give reorganization (recapitalization) status to an exchange of all of a corporation's 1,000 shares of \$100 par value common stock for 5,000 shares of no-par value stock (the stock had a stated value of \$300,000) and \$400,000 of debentures, payable in ten years but callable at any time; the transaction did not partake of the elements which underlie the Congressional exemption, but was merely a device to distribute earnings.

(n3)Footnote 3. Recapitalizations, which can be reorganizations under *IRC § 368(a)(1)(E)*, will be discussed in connection with the treatment of "other exchanges." See § 8.07[1], *infra*. For a discussion of matters not covered here, see 1 Fox & Fox, *Corporate Acquisitions and Mergers* Ch 4.

See § 8.07[6], *infra*, for the treatment of reorganizations involving two or more undiversified investment companies.



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CHAPTER 8 Reorganizations and Other Exchanges

1-8 Taxation of Securities Transactions § 8.02

§ 8.02 The Continuity of Interest and Continuity of Business Enterprise Requirements

[1] Purpose of the Requirements.

A transaction will not qualify as a reorganization unless the holders of stock or securities in the old corporation continue to retain an interest in the new enterprise.ⁿ¹ The requirement, which had its origins in judicial opinion, is intended to ensure that an exchange is truly a reorganization--a readjustment of interests under modified corporate form--and not a disguised sale.

The continuity of business enterprise requirement is a creature of the regulations.ⁿ² It is intended to serve the same policy as continuity of interest.

[2] Judicial Development of the Continuity of Interest Requirement.

The continuity of interest requirement first found expression in *Cortland Specialty Co. v. Commissioner*,ⁿ¹ where the Second Circuit held a transfer of substantially all the assets of one corporation in exchange for cash and short-term notes of another to be the equivalent of a sale and not a reorganization, even though the transaction literally fit the definition of reorganization then obtaining. In the court's opinion, a primary requisite of reorganization was that there be "some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption,"ⁿ² and that this could not be found in notes payable in so short a time that they resembled cash.

One year later, the Supreme Court, in deciding *Pinellas Ice & Cold Storage Co. v. Commissioner*,ⁿ³ approved the result reached in *Cortland Specialty*, and laid to rest any possibility that short-term notes could give the holders thereof the necessary continuance of interest in the properties transferred by stating:

"[W]e think that to be within the exemption the seller must acquire an interest in the affairs of the purchasing corporation more definite than that incident to ownership of its short-term purchase-money notes."ⁿ⁴

Left unanswered by *Cortland Specialty* and *Pinellas* was whether long-term obligations could furnish the requisite continuity of interest.ⁿ⁵ The definitive answer to that question came in *LeTulle v. Scofield*,ⁿ⁶ where more than 90 percent of the consideration received by the transferor consisted of secured bonds, payable serially over a period beginning little more than one year and ending more than 12 years after the exchange. The Supreme Court reached the

conclusion that

"[T]he term of the obligations is not material. Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think that it cannot be said the transferor retains any proprietary interest in the enterprise. ... [W]e do not think that the fact ... that the bonds were secured solely by the assets transferred and that, upon default, the bondholder would retake only the property sold, changes his status from that of a creditor to one having a proprietary stake. ... "n7

By denying that a holder of debt securities could retain a proprietary interest in the transferee corporation, *LeTulle v. Scofield* made it clear that stock was the only form of consideration that could provide continuity of interest. Although one might conclude that the result in *LeTulle v. Scofield* establishes that continuity of interest is synonymous with participation in management, such is not the case; the required interest is present even when the taxpayer receives nothing other than nonvoting preferred stock redeemable at stated intervals.ⁿ⁸ Indeed, continuity of interest has been deemed to exist in instances in which no stock was received, but the taxpayer's proprietary interest was present in some other form, eg, depositor in mutual savings bank, policyholder in mutual life insurance company.ⁿ⁹ However, in *Paulsen v. Commissioner*,ⁿ¹⁰ the Supreme Court denied tax-free treatment on the merger of a stock savings and loan association into a mutual savings and loan association, where the shareholders of the target corporation had the choice of receiving passbook accounts or time certificates of deposit for their guaranty shares.ⁿ¹¹ Although depositors and borrowers of the acquiring corporation had the power to vote on matters that required shareholder approval, a majority of the Court concluded that the debt characteristics of the interests in the mutual savings and loan association greatly outweighed the equity characteristics, and, thus, that there was no continuity of interest.

The continuity of interest requirement looks not only to see whether stock is received, but also how much stock is received.ⁿ¹² This quantitative side of the requirement is satisfied only if the retained equity interest represents a substantial part of the value of the property transferred; the extent of transferor's percentage ownership interest in the transferee corporation is unimportant. For example, in *Helvering v. Minnesota Tea Co.*,ⁿ¹³ a transfer of assets for an equity interest worth approximately \$540,000 and cash of approximately \$425,000, was considered a reorganization, even though the equity interest amounted to only 7 percent of the total outstanding equity in the transferee corporation; the stock interest received represented a material part (56 percent) of the value of the transferred assets. This should be contrasted with *Southwest Natural Gas Co. v. Commissioner*,ⁿ¹⁴ where the retention of an equity interest representing 1 percent of the value of the property transferred was held to be inadequate, notwithstanding that, following the exchange, the shareholders of the old corporation owned 16 percent of the outstanding stock of the transferee corporation.

There is no magic formula for determining the amount of stock necessary to satisfy the quantitative element of the continuity of interest requirement. However, the Service currently takes the position that shareholders of the old corporation preserve a substantial part of the value of their proprietary interest if, pursuant to a contract to effect the proposed reorganization that provides a fixed consideration for their equity interest, they acquire in the aggregate stock in the transferee corporation equal in value to at least 40 percent of the total value of all consideration received for the outstanding stock of the old corporation, determined as of the last business day before the first date such contract becomes a binding contract.ⁿ¹⁵ How much lower than 40 percent one can go and still satisfy the requirement is unclear, but one should be aware of the fact that as the amount of nonstock consideration increases, so does the likelihood of litigation.ⁿ¹⁶

It was thought at one time that the continuity of interest requirement could not be met if stock issued in a reorganization of an insolvent corporation went to the creditors of the insolvent corporation and not to its stockholders.ⁿ¹⁷ However, in *Helvering v. Alabama Asphaltic Limestone Co.*,ⁿ¹⁸ the Supreme Court held that since the creditors of an insolvent corporation succeed to the proprietary interests of its shareholders, stock received by such creditors can satisfy the continuity of interest requirement. The regulations follow this mandate and provide rules for determining whether the continuity of interest requirement is met when creditors of the target receive stock in the reorganization transaction.ⁿ¹⁹

The creditor continuity of interest (creditor COI) regulations apply whether or not the target corporation is a party to a title 11 or similar case (i.e., whether the reorganization is a G reorganization or a reorganization of another kind),ⁿ²⁰ but if the reorganization occurs outside a title 11 case, the target must be insolvent (i.e., its liabilities must exceed the fair market value of its assets).ⁿ²¹

The creditor COI regulations determine whether the continuity of interest requirement is satisfied by comparing the value of stock of the acquiring corporation (or stock of a corporation in control of the acquiring corporation)ⁿ²² received by the creditors and stockholders of the target for their proprietary interests with the total consideration (including cash and property other than stock) received for their proprietary interests. The regulations make it significantly easier to meet the continuity of interest test by excluding from the comparison nonstock consideration received by senior creditors, which is deemed received in exchange for the senior creditors' interests *qua* creditors rather than in exchange for their proprietary interests in the target.ⁿ²³ The amount of consideration deemed received by senior creditors in exchange for their proprietary interests equals the value of their claims multiplied by a fraction, the numerator of which is the value of stock in the acquiring corporation received by all senior creditors and the denominator of which is the value of all consideration (including such stock plus any money and the value of any other property) received by all senior creditors.ⁿ²⁴ All consideration (if any) received by junior creditors and shareholders, including nonstock consideration, is deemed received in exchange for their proprietary interests.ⁿ²⁵ "The effect of this rule is that there [will be] 100 percent continuity of interest if each senior claim is satisfied with the same ratio of stock to nonstock consideration and no junior claim is satisfied with nonstock consideration."ⁿ²⁶

Example:

T Corp is insolvent, with assets valued at \$150x and liabilities of 200x. T Corp transfers all of its assets to A Corp in exchange for \$95x in cash and A Corp stock with a value of \$55x. A senior class of creditors with claims valued at \$50x receives \$40x in cash and \$10x of A Corp stock. A junior class of creditors with claims valued at \$100x receives \$55x in cash and \$45x in A Corp stock. (The shareholders of T Corp receive nothing.) Under the creditor COI regulations, 20 percent or \$10x of the total consideration received by the senior class of creditors is deemed received in exchange for their proprietary interests in T Corp ($\$50x \text{ (value of claims)} \times (\$10x \text{ (value of A Corp stock)} / \$50x \text{ (value of all consideration received)}) = \$10x$). (The remaining 80% or \$40x is deemed paid to the senior creditors in exchange for the value of their debt claims.) Therefore, in total T Corp's creditors received stock worth \$55x (\$45x to the junior class and \$10x to the senior class) for their proprietary interests in T Corp out of a total consideration of \$110x paid by the acquiring corporation in cash and stock for the creditors' proprietary interests in the corporation. Since a substantial part (50 percent) of the proprietary interests in T Corp is preserved, the continuity of interest requirement is satisfied.ⁿ²⁷

Suppose that a taxpayer sells acquired stock within a short period of time after the exchange. None of the Supreme Court cases establishing the continuity of interest requirement addressed the issue of whether sales of stock in the issuing or acquiring corporation by former shareholders of the acquired or target corporation violated the continuity of interest requirement. A number of lower court cases focused on the question of whether, on the date of the potential reorganization, the shareholders intended to sell the newly acquired stock. Looking at facts that were nearly identical, some courts found that continuity of interest did not exist, while others held the requirement to be satisfied.ⁿ²⁸

Final regulations issued in 1998 permit former target corporation shareholders to sell stock received in a potential reorganization to third parties without causing the reorganization to fail to satisfy the continuity of interest requirement. The regulations provide that the requirement is satisfied if, in substance, a substantial part of the value of the proprietary

interest in the target corporation is preserved in the exchange.ⁿ²⁹ A proprietary interest in the target corporation is preserved if, in the transaction, it is exchanged for a proprietary interest in the issuing corporation, it is exchanged by the issuing corporation for a direct interest in the target enterprise, or it otherwise continues as a proprietary interest in the target corporation.ⁿ³⁰ A proprietary interest in the target corporation is not preserved if, in connection with the transaction, it is acquired by the issuing corporation for consideration other than stock in the issuing corporation, or stock in the issuing corporation furnished in exchange for a proprietary interest in the target corporation is redeemed.

A proprietary interest is not preserved if, in connection with a potential reorganization, a person related to the issuing corporation acquires, with consideration other than a proprietary interest in the issuing corporation, stock of the target corporation, or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the transaction, except to the extent those persons who were the direct or indirect owners of the target corporation prior to the transaction maintain a direct or indirect proprietary interest in the issuing corporation.ⁿ³¹

In determining whether a proprietary interest in the target corporation is preserved, the consideration to be exchanged for proprietary interests in that corporation pursuant to a contract to effect the potential reorganization is to be valued on the last business day before the first date the contract is a binding contract, if the contract provides for a fixed consideration.ⁿ³² If the term of a binding contract that relates to the amount or type of consideration the shareholders of the target corporation will receive in the potential reorganization is modified before the closing date of the potential reorganization, the date of the modification will be treated as the first date there is a binding contract.ⁿ³³

A contract provides for a fixed consideration if it provides the number of shares of each class of stock of the issuing corporation, the amount of money, and the other property (identified by value or by specific description), if any, to be exchanged for all of the proprietary interests and for each proprietary interest in the target corporation.ⁿ³⁴ A contract that does not meet the general rule for a contract with a fixed consideration, but with respect to which a target corporation shareholder has an election to receive stock, or stock and money or other property, for target corporation stock is treated as providing for fixed consideration if the determination of the number of shares of issuing corporation stock to be provided to the target corporation shareholder is determined using the value of the issuing corporation stock on the last business day before the first date there is a binding contract.ⁿ³⁵

A contract that provides for contingent adjustments to the consideration will be treated as providing for fixed consideration if it would satisfy the rules for fixed consideration without the contingent adjustment provision.ⁿ³⁶ A contract will not be treated as providing for fixed consideration if the contract provides for contingent adjustments to the consideration that prevent (to any extent) the target corporation shareholders from being subject to the economic benefits and burdens of ownership of the issuing corporation stock after the last business day before the first date the contract is a binding contract.ⁿ³⁷

The following will not prevent a contract from being treated as a contract for a fixed consideration: (1) placing part of the consideration to be exchanged for proprietary interests in the target corporation in escrow to secure target's performance of customary pre-closing covenants or customary target representations or warranties;ⁿ³⁸ (2) the presence of a customary anti-dilution clause;ⁿ³⁹ (3) the possibility that some shareholders may exercise dissenters' rights and receive consideration other than that provided in the binding contract;ⁿ⁴⁰ and (4) the fact that money may be paid in lieu of issuing fractional shares.ⁿ⁴¹

For purposes of the continuity of interest requirement regulations, two corporations are related persons if either of the corporations are members of the same affiliated group under *IRC Section 1504* (without regard to the exceptions in *IRC Section 1504(b)*), or a purchase of stock by one corporation by another corporation would be treated as a redemption of the stock of the first corporation under *IRC Section 304(a)(2)* (acquisition by a subsidiary of its parent's stock).ⁿ⁴² Each partner of a partnership will be treated as owning or acquiring any stock owned or acquired by the partnership, and as having furnished its share of any consideration furnished by the partnership to acquire the stock in accordance with that partner's interest in the partnership.ⁿ⁴³

[3] Statutory Development of the Continuity of Interest Requirement.

Two of the transactions defined as reorganizations by *IRC section 368(a)(1)* automatically give the taxpayer a proprietary interest in the transferee corporation. The type "B" reorganization--the acquisition of a controlling voting stock interest--cannot be effected unless the entire consideration for the transfer is voting stock.ⁿ¹

The transaction involving the acquisition of more than 80 percent of the outstanding shares of Hartford Fire Insurance Company stock by ITT in exchange for ITT voting stock presented a unique question to the courts. The problem in the transaction was that ITT purchased some Hartford shares shortly before the transaction.ⁿ² The Tax Court held that the acquisition qualified as a "B" reorganization.ⁿ³ In so doing, the court distinguished those cases in which the 80-percent requirement could not be met without taking the cash purchases into account and those in which there was a single acquisition for stock and impermissible consideration.

The Third Circuit reversed, rejecting, *inter alia*, the taxpayers' argument that the voting stock and control requirements are interrelated so that an acquisition of control of the target corporation qualifies as a "B" reorganization.ⁿ⁴ After petitions for certiorari were filed, the Service announced that it had reached a settlement with ITT under which the corporation agreed to pay \$18.5 million to the government in exchange for its promise not to pursue tax claims against former Hartford shareholders who had treated the stock-for-stock exchange as nontaxable.ⁿ⁵

The type "C" reorganization, the acquisition of another corporation's assets, also requires the bulk of the consideration to be in the form of voting stock, but here the statute permits the acquiring corporation to assume liabilities of the transferor corporation,ⁿ⁶ and even to give the transferor a limited amount of non-stock consideration.ⁿ⁷

The solely for voting requirement is not violated if, as part of the plan of reorganization but separate from the exchange of stock, the acquiring corporation contributes cash to the acquired corporation so it can discharge a bona fide debt of the corporation that was guaranteed by an exchanging shareholder.ⁿ⁸ It is also not violated if the acquiring corporation assumes valid reorganization expenses of the acquired corporation or its shareholders.ⁿ⁹

By insuring continuity of interest in the case of "B" and "C" reorganizations, the judicially developed concept of continuity is important only if the transaction is an "A" reorganization (a statutory merger or consolidation), "D" reorganization (a transfer of assets to a corporation controlled by the transferor or its shareholders), an "F" reorganization (a mere change in identity, form, or place of organization),ⁿ¹⁰ or a "G" reorganization (a transfer of assets in a bankruptcy proceeding).ⁿ¹¹

[4] The Problem of Remote Continuity of Interest.

[a] Judicial Development. Suppose that one corporation transfers assets to another and receives in exchange therefor the stock of a corporation that controls the transferee. Under case law developed before 1954,ⁿ¹ the receipt of stock of a corporation other than the acquiring corporation would not give the transferor the necessary proprietary interest in the transferee corporation. Remote continuity is now permitted by statute, but it should be noted that the effective dates of the provisions allowing the use of the stock of a corporation other than the transferee are different for "A," "B," "C", and "G" reorganizations.

[b] Statutory Relief.

[i] Type "A" Reorganization. A merger will qualify as an "A" reorganization if the shareholders of the merged corporation receive stock in either the acquiring corporation or a corporation that is in control of the acquiring corporation.ⁿ² The use of the stock of one corporation precludes the use of the stock of the other; split consideration is not permitted.ⁿ³

One further prerequisite to the use of the stock of the controlling corporation in an "A" reorganization requires that a

merger of the old corporation into the controlling corporation also have qualified as an "A" reorganization.ⁿ⁴ Thus, since a merger will be an "A" reorganization only if "effected pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia,"ⁿ⁵ it would appear that the Code prohibits the use of the parent corporation's stock if it is a foreign corporation, or if the triangular merger cannot be achieved under state law. However, the Regulations provide that

"The ... test of whether the transaction would have qualified under section 368(a)(1)(A) if the merger had been into the controlling corporation means that the general requirements of a reorganization under section 368(a)(1)(A) (such as a business purpose, continuity of business enterprise, and continuity of interest) must be met in addition to the special requirements of section 368(a)(2)(D). Under the test, it is not relevant whether the merger into the controlling corporation could have been effected pursuant to State or Federal corporation law."ⁿ⁶

Under Section 368(a)(2)(E), the stock of a parent corporation can also be used when the merger is of a subsidiary into an unrelated corporation that survives the merger, if:

- (1) after the merger, the surviving corporation holds substantially all of its properties (other than the voting stock of the parent corporation received on the merger) and substantially all of the subsidiary's property; and
- (2) the shareholders of the surviving corporation receive voting stock of the parent in exchange for the parent's acquisition of 80 percent control of the survivor.ⁿ⁷

Consideration other than voting stock can be used to acquire stock of the surviving corporation in excess of the amount necessary to give the parent control of the surviving corporation.

[ii] Type "B" and "C" Reorganizations. The consideration given by the acquiring corporation in a "B" or "C" reorganization can likewise consist of the stock of the acquiring corporation or of the stock of a corporation that is in control of the acquiring corporation.ⁿ⁸ Split consideration (the use of stock in both corporations in the same transaction) is never permitted in a "B" reorganization, and the Regulations set forth an identical rule for "C" reorganizations.ⁿ⁹ Nevertheless, there is no valid reason for a complete prohibition against the use of the stock of both the acquiring corporation and the controlling corporation in a "C" reorganization. Nonstock consideration is allowed in a "C" reorganization to the extent of 20 percent of the value of the property owned by the transferor corporation. Since the Code does not specify the form which such consideration must take, presumably it could consist of the stock of another corporation. If this is so, then the Regulations would be limited in application to instances in which neither the stock of the acquiring corporation nor the stock of the controlling corporation has a value equal to at least 80 percent of the value of the property of the transferor corporation.

[iii] Type "G" Reorganization. The use of stock of a corporation controlling the acquiring corporation in a "G" reorganization (a transfer by a corporation of all or part of its assets in a case under title 11 of the United States Code or a receivership, foreclosure, or similar proceeding in a federal or state court)ⁿ¹⁰ is sanctioned by *IRC Section 368(a)(2)(D)*. As in the case of a statutory merger, stock of the acquiring corporation cannot be used in the transaction.

A "G" reorganization also can take the form of a "reverse merger" of the insolvent corporation. The requirements in such case are that no former shareholder of the surviving corporation receives any consideration for his stock and that former creditors of the surviving corporation exchange their claims for voting stock of the controlling corporation having a value equal to at least 80 percent of the value of the debt of the surviving corporation.ⁿ¹¹

[c] Regulatory Relief.

The step transaction doctrine permits the IRS to attempt to collapse a multi-step transaction into fewer steps in order to

recharacterize the tax treatment of the transaction. Since corporate reorganizations involve businesses with ongoing business activity, it is, in theory, possible for any post-reorganization transfer to be lumped back in with the original reorganization in order for the IRS to challenge the tax-free qualification of the reorganization. *Treasury Regulation Section 1.368-2(k)*ⁿ¹² creates safe harbors for certain transfers of assets or stock following a reorganization. The failure of a transfer to meet this safe harbor will not cause the transfer to disqualify the original reorganization, however it does mean that the transfer may still be scrutinized under the step transaction rule. Essentially this regulation permits stock and assets acquired in a reorganization to be further transferred within a qualified group as defined in *Treasury Regulation Section 1.368-1(d)(4)(ii)*, provided that the corporation does not, with the transfer, cease to be a member of the qualified group, or terminate its existence for federal income tax purposes.

[5] Scope of the Continuity of Business Enterprise Requirement.

The continuity of business enterprise requirement will be satisfied if the issuing corporation continues the target corporation's historic business.ⁿ¹ The fact that the acquiring corporation is in the same line of business as the acquired corporation tends to establish the requisite continuity, but alone, is insufficient.ⁿ²

A corporation's historic business is the business it has conducted most recently.ⁿ³ However, a business entered into as part of a plan of reorganization does not qualify as such.ⁿ⁴ If the acquired corporation has more than one line of business, continuity of business enterprise requires only that the acquiring corporation continue a significant line of business.ⁿ⁵

Continuity of business enterprise will also result from the use by the issuing corporation of a significant portion of the target corporation's historic assets in a business.ⁿ⁶ A corporation's historic business assets are those used in its historic business, and may include stock and securities, and intangible assets such as goodwill and trademarks whether or not they have a tax basis.ⁿ⁷ Generally, the determination of the portion of a corporation's assets considered significant is based on the relative importance of the assets to the operation of the business.ⁿ⁸ However, all of the facts and circumstances, such as the net fair market value of those assets, will be considered.

The following rules apply in determining whether the continuity of business requirement is satisfied:

- (1) The issuing corporation is treated as holding all of the businesses held by all of the members of a qualified group.ⁿ⁹ For this purpose, a qualified group consists of one or more chains of corporations connected through stock ownership with the issuing corporation, but only if (a) the issuing corporation owns directly at least 80 percent of the voting stock and at least 80 percent of the total number of shares of all other classes of stock of one other corporation, and (b) at least 80 percent of the voting stock and at least 80 percent of all other classes of stock in each of the other corporations (except the issuing corporation) is owned directly or indirectly by one or more of the other corporations.ⁿ¹⁰
- (2) Each partner of a partnership will be treated as owning the target corporation's business assets used in a business of the partnership in accordance with that partner's interest in the partnership.ⁿ¹¹
- (3) The issuing corporation will be treated as conducting a business of a partnership if members of a qualified group, in the aggregate, own an interest in the partnership representing a significant interest in the partnership, or one or more members of the qualified group have active and substantial management functions as a partner with respect to that partnership business.ⁿ¹²
- (4) If a significant historic target corporation business is conducted in a partnership, the fact that the issuing corporation is conducting that business as described in the preceding paragraph tends to establish the requisite continuity, but is not sufficient by itself.ⁿ¹³

Revenue Ruling 87-76,¹⁴ sheds further light on the Service's position with respect to the nature of a corporation's historic business. The acquired corporation in the ruling was engaged in the investment business, and, from its inception, maintained one-third of its investment portfolio in growth stocks, one-third in income stocks, and one-third in corporate bonds. The corporation was acquired in a "C" reorganization by an investment company whose portfolio consisted of high-grade municipal bonds. Pursuant to the plan of reorganization, the acquired corporation was required to sell its entire portfolio of stocks and bonds prior to the reorganization, and to invest the proceeds in municipal bonds. Although both corporations were in the investment business, the Service took the position that the acquired corporation's historic business of investing in stocks and bonds was not the same line of business as investing in municipal bonds. Moreover, since the investment in municipal bonds was made in contemplation of the reorganization, the investment could not be considered the acquired corporation's historic business.

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.368-1(b)*.

(n2)Footnote 2. *Treas Reg § 1.368-1(d)*.

(n3)Footnote 1. *60 F2d 937 (2d Cir 1932)*, cert denied *288 US 599*.

(n4)Footnote 2. *60 F2d at 940*.

(n5)Footnote 3. *287 US 462 (1933)*.

(n6)Footnote 4. *Id at 470 (1933)*.

(n7)Footnote 5. The Second Circuit did suggest that the result might have been different had the securities given the creditor some assured participation in the properties of the transferee corporation.

(n8)Footnote 6. *308 US 415 (1940)*.

(n9)Footnote 7. *Id at 420-421*.

(n10)Footnote 8. *John A Nelson Co v Helvering*, *296 US 374 (1935)*. Shareholders, who placed stock in a voting trust but continued to receive the dividends thereon, were considered the owners in determining whether the continuity of interest test had been met. *Rev Rul 75-95, 1975-1 CB 114*.

(n11)Footnote 9. *Rev Rul 78-286, 1978-2 CB 145*; *Rev Rul 74-277, 1974-1 CB 88*; *Rev Rul 71-233, 1971-1 CB 113*.

(n12)Footnote 10. *469 US 131 (1985)*. The decision resolved a conflict in the circuits. Compare *West Side Fed Sav & Loan Assn v US*, *494 F2d 404 (6th Cir 1974)* and *Home Sav & Loan Assn v US*, *514 F2d 1199 (9th Cir 1975)*, cert denied *423 US 1015*.

(n13)Footnote 11. A situation similar to *Paulsen* was presented in *Estate of Silverman v Commr*, *98 TC 54 (1992)*. Although the transaction could not qualify as a tax-free reorganization, the taxpayer was able to treat six-year certificates of deposit issued by the acquiring bank as evidence of indebtedness of the acquirer and, thus, could defer gain until payment under the installment sale rules.

(n14)Footnote 12. A transfer from one wholly owned subsidiary to another qualified as a reorganization even though no stock was received either by the transferor or by the parent corporation. Since the parent already owned all of the stock of the acquiring corporation, the issuance of additional shares would have been a meaningless gesture. *Rev Rul 75-383, 1975-2 CB 127*. A similar result was reached in *Rev Rul 70-240, 1970-1 CB 81*, where the same individual was the sole shareholder of both parties to the reorganization.

(n15)Footnote 13. 296 US 378 (1935) .

(n16)Footnote 14. 189 F2d 332 (5th Cir 1951) , cert denied 342 US 860 .

(n17)Footnote 15. See *Temp Treas Reg § 1.368-1(e)(2)*, discussed below at fns 31-39 and accompanying text, and the Examples at *TempTreas Reg § 1.368-1(e)(2)(v)*. The 40 percent minimum, which replaces a 50 percent standard followed by the Service for many years, see, eg, *Rev Rul 66-224, 1966-2 CB 114* , has been followed in recent IRS private rulings. See, eg, *PLR 200930025*, (April 22, 2009) . Although *Temp Treas Reg § 1.368-1(e)(2)* expired on March 19, 2010, the Internal Revenue Service has announced that, until final regulations are issued on the subject, taxpayers may continue to rely on the provisions of the Temporary Regulations so long as all relevant parties adopt positions consistent with those provisions. See Notice 2010-25, 2010-14 IRB 527 ; fn 40, *infra*.

(n18)Footnote 16. In *John A Nelson Co v Helvering*, 296 US 374 (1935) , the value of the stock received equaled about 38 percent of the value of the assets transferred to the acquiring corporation.

(n19)Footnote 17. *Comm'r v Palm Springs Holding Corp*, 119 F2d 846 (9th Cir 1941) ; *Helvering v New President Corporation*, 122 F2d 92 (8th Cir 1941) .

(n20)Footnote 18. 315 US 179 (1942) .

(n21)Footnote 19. *Treas Reg § 1.368-1(e)(6)*, added by *TD 9434* , 73 *Fed Reg* 75566 (Dec 12, 2008) .

(n22)Footnote 20. See *Norman Scott, Inc v Commr*, 48 TC 598 (1967) which upheld, as a tax-free type "A" reorganization, a statutory merger involving insolvent corporations.)

(n23)Footnote 21. *Treas Reg § 1.368-1(e)(6)(i)*. The preamble to *TD 9434* , justifies the expansion of the application of the G reorganization rules to reorganizations of insolvent corporations outside of bankruptcy as "consistent with Congress' intent to facilitate the rehabilitation of troubled corporations." *TD 9434* , 73 *Fed Reg* at 75566. When Congress, in the Bankruptcy Tax Act of 1980 (Pub L 96-589), added G reorganizations to the list of transactions that qualify as a "reorganization," it made clear that such reorganizations were expected to meet the same continuity of interest requirement that applies to other reorganizations. See S Rep No 96-1035, 96th Cong, 2d Sess 10 (1980); HR Rep No 833, 96th Cong 2d Sess 8 (1980).

(n24)Footnote 22. See *IRC § 368(a)(2)(D)*.

(n25)Footnote 23. Senior creditors means the most senior class of creditors that receives stock in exchange for its claims, as well as any other class of creditors of equal seniority.

(n26)Footnote 24. If some senior creditors receive a higher proportion of their consideration in the form of cash or other property than others in the same class, a portion of the nonstock consideration received by such senior creditors will be taken into account in the continuity of interest test. See *Treas Reg § 1.368-1(e)(8)*, Ex 10 (ii).

(n27)Footnote 25. *Treas Reg § 1.368-1(e)(6)(ii)*.

(n28)Footnote 26. *TD 9434* . If only one class of creditors of the target corporation receives stock in the acquiring corporation pursuant to the terms of the reorganization, their stock is counted for purposes of measuring continuity of interest provided that the stock issued by the acquiring corporation is not de minimis in relation to the total consideration received by the insolvent target corporation, its shareholders, and its creditors. *Treas Reg § 1.368-1(e)(6)(ii)*.

(n29)Footnote 27. *Treas Reg § 1.368-1(e)(8)*, Ex 10. Note that had the nonstock consideration received by the senior creditors not been excluded from the continuity of interest comparison, the portion of the total consideration received by T Corp's creditors represented by A Corp stock would have been less than 37 percent, not enough to meet

the Internal Revenue Service's usual minimum standard for continuity of interest. See Rev Proc 77-37, 1977-2 CB 568 .

(n30)Footnote 28. Compare *McDonald's Restaurants of Illinois v Commr*, 688 F2d 520 (7th Cir 1982) and *Heintz v Commr*, 25 TC 132 (1955) , *nonacq* 1958-2 CB 9 , with *Est of Christian v Commr*, TC Memo 1989-413 , and *Penrod v Commr*, 88 TC 1415 (1987) .

Faber, "Postreorganization Sales and Continuity of Interest," 68 *Tax Notes* 863 (1995).

Satisfaction of the continuity of interest test is not affected by a partnership's distribution of stock received in a reorganization to its partners in accordance with their interests in the partnership. *Rev Rul* 95-69, 1995-2 CB 38 .

An open market repurchase by the acquiring corporation of shares issued in a merger was held to have no effect on continuity of interest in *Rev Rul* 99-58, 1999-2 CB 701 .

(n31)Footnote 29. *Treas Reg* § 1.368-1(e)(1)(i).

(n32)Footnote 30. For purposes of the continuity of interest regulations, any reference to the issuing corporation or the target corporation includes a reference to a successor or predecessor of such corporation, except that the target corporation is not treated as a predecessor of the issuing corporation and the issuing corporation is not treated as a successor of the target corporation. *Treas Reg* § 1.368-1(e)(5).

A proprietary interest in the acquired corporation (other than one held by the acquiring corporation) is not preserved to the extent that consideration received prior to a potential reorganization, either in a redemption of the acquired corporation stock or in a disposition with respect to the acquired corporation stock, is treated as other property or money received in the exchange for purposes of *IRC* § 356, or would be so treated if the shareholder of the acquired corporation also had received stock of the issuing corporation in exchange for stock owned by the shareholder in the acquired corporation. *Treas Reg* § 1.368-1(e)(1)(ii).

(n33)Footnote 31. *Treas Reg* § 1.368-1(e)(3)(i).

(n34)Footnote 32. *Temp Treas Reg* § 1.368-1T(e)(2)(i). A binding contract is an instrument enforceable under applicable law against the parties to the instrument. The presence of a condition outside the control of the parties, such as regulatory agency approval, will not prevent an instrument from being a binding contract. The fact that insubstantial terms remain to be negotiated, or that customary conditions remain to be satisfied, will not prevent an instrument from being a binding contract. *Temp Treas Reg* § 1.368-1T(e)(2)(ii)(A).

Any class of stock, securities, or indebtedness that the issuing corporation issues to the target corporation shareholders pursuant to the potential reorganization and that does not exist before the first date there is a binding contract to effect the potential reorganization is deemed to have been issued before the last business day before the first date there is a binding contract. *Temp Treas Reg* § 1.368-1T(e)(2)(iv).

(n35)Footnote 33. *Temp Treas Reg* § 1.368-1T(e)(2)(ii)(B)(1). A modification of a term that relates to the amount or type of consideration the target shareholders will receive in a transaction that would have resulted in the preservation of a substantial part of the target shareholders' proprietary interests in the target corporation if there had been no modification will not be treated as a modification if (i) the modification has the sole effect of providing for the issuance of additional shares of issuing corporation stock to the target corporation shareholders, (ii) the modification has the sole effect of decreasing the amount of money or other property to be delivered to the target corporation shareholders, or (iii) the modification has the effect of decreasing the amount of money or other property to be delivered to the target corporation shareholders and providing for the issuance of additional shares of issuing corporation stock to the target corporation shareholders. *Temp Treas Reg* § 1.368-1T(e)(2)(ii)(B)(2).

A modification of a term that does not preserve the target corporation shareholders' proprietary interest will not be treated as a modification if (i) the modification has the sole effect of providing for the issuance of fewer shares of issuing corporation stock to the target corporation shareholders, (ii) the modification has the sole effect of increasing the amount of money or other property to be delivered to the target corporation shareholders, or (iii) the modification has the effect of increasing the amount of money to be delivered to the target corporation shareholders and providing for the issuance of fewer shares of issuing corporation stock to the target corporation shareholders. *Temp Treas Reg* § 1.368-1T(e)(2)(ii)(b)(3).

A tender offer that is subject to § 14(d) of the Securities and Exchange Act of 1934 and is not pursuant to a binding contract, is treated as a binding contract made on the date of its announcement, notwithstanding that it may be modified by the offeror. *Temp Treas Reg* § 1.368-1T(e)(2)(ii)(C).

(n36)Footnote 34. *Temp Treas Reg* § 1.368-1T(e)(2)(iii)(A).

(n37)Footnote 35. Id.

(n38)Footnote 36. *Temp Treas Reg* § 1.368-1T(e)(2)(iii)(B)(1).

(n39)Footnote 37. *Temp Treas Reg* § 1.368-1T(e)(2)(iii)(B)(2). For example, a contract will not provide for a fixed consideration if there are contingent adjustments to the consideration if the value of the stock or assets of the issuing corporation increase or decrease after the last business day before the first date there is a binding contract, or if there are contingent adjustment to the number of shares of issuing corporation stock to be provided to target corporation shareholders using a value of issuing corporation shares after the last business day before the first date there is a binding contract.

(n40)Footnote 38. *Temp Treas Reg* § 1.368-1T(e)(2)(iii)(C).

(n41)Footnote 39. *Temp Treas Reg* § 1.368-1T(e)(2)(iii)(D). The absence of an anti-dilution clause will prevent a contract from being treated as providing for fixed consideration if the issuing corporation alters its capital structure between the first date there is a binding contract and the effective date of the potential reorganization in a manner that materially alters the economic arrangement of the parties to the contract.

(n42)Footnote 40. *Temp Treas Reg* § 1.368-1T(e)(2)(iii)(E).

(n43)Footnote 41. *Temp Treas Reg* § 1.368-1T(e)(2)(iii)(F).

Temp Treas Reg § 1.368-1T(e)(2), cited in footnotes 31-40 above, expired on March 19, 2010, three years after issuance, pursuant to *IRC* § 7805(e)(2). However, in *Notice 2010-25*, 2010-14 *IRB* 527, the IRS announced that taxpayers may continue to rely on the rules set forth in *Temp Treas Reg* § 1.368-1T(e)(2) after the expiration of the temporary regulations and prior to the issuance of new regulations, provided that such rules are consistently applied by the target corporation, the issuing corporation, the controlling corporation of the acquiring corporation (if its stock is provided as consideration in the transaction) and any direct or indirect transferee of transferred basis property from any of the foregoing.

(n44)Footnote 42. *Treas Reg* § 1.368-1(e)(4)(i). The following rules apply for purposes of *Treas Reg* § 1.368-1(e)(4):

(1) A corporation will be treated as related to another corporation if such relationship exists immediately before or immediately after the acquisition of the stock involved.

(2) A corporation, other than the target corporation, or a person related to the target corporation, will be treated as related to the issuing corporation if the relationship is created in connection with the potential

reorganization. *Treas Reg* § 1.368-1(e)(4)(ii).

(n45)Footnote 43. *Treas Reg* § 1.368-1(e)(5).

(n46)Footnote 1. *IRC* § 368(a)(1)(B). Preferred stock allowed to vote only if there are arrearages in dividends should not be considered voting stock unless dividends are in arrears at the time of the exchange. Cf *Rev Rul* 66-339, 1966-2 CB 274 . In *Forrest Hotel Corp v Fly*, 112 F Supp 782 (SD Miss 1953) , common stock which was prevented from voting because dividends on preferred were in arrears held to be voting stock, as was the preferred which was permitted to vote because of the existence of such arrearages.

The Supreme Court, giving full content to the phrase "solely for ... voting stock" has held warrants to purchase additional shares not to be voting stock. *Helvering v Southwest Consol Corp*, 315 US 194 (1942) ; see also *Gordon v Commr*, 424 F2d 378 (2d Cir) , *cert denied* 400 US 848 ; *Rev Rul* 70-108, 1970-1 CB 78 . However, the Service has ruled that contingent stock arrangements will not defeat a "B" reorganization as long as the contingent right is not embodied in a negotiable instrument. *Rev Rul* 75-456, 1975-2 CB 128 ; *Rev Rul* 75-237, 1975-1 CB 116 ; *Rev Rul* 67-90, 1967-1 CB 79 ; *Rev Rul* 66-112, 1966-1 CB 68 ; see also *Hamrick v Commr*, 43 TC 21 (1964) , *acq in result Rev Rul* 66-112 (contingent right stock for purposes of *IRC* § 351). The Service will issue favorable rulings on contingent stock transactions provided certain conditions are satisfied. See § 8.03[1], *infra*.

Contingent stock payments may be subject to the imputed interest rules of *IRC* § 483. See Ch 2 for the method of determining the portion of a contingent stock payment representing unstated interest.

Furthermore, the payment of cash in lieu of fractional shares will not disqualify the transaction if the payment is made for the purpose of rounding off fractions and is not a separately bargained-for consideration. *Mills v Commr*, 331 F2d 321 (5th Cir 1964) ; *Rev Rul* 74-36, 1974-1 CB 85 ; *Rev Rul* 66-365, 1966-2 CB 116 . The payment will not give rise to a taxable stock dividend under *IRC* § 305(b)(2). *Treas Reg* § 1.305-3(c). See § 4.06[2][a], *supra*.

(n47)Footnote 2. The Service had issued a private letter ruling advising that the transaction would be a "B" reorganization if ITT unconditionally divested itself of the purchased shares. Later, the Service, alleging misrepresentations in the application for the ruling, revoked it. The Service has taken the position in a published ruling that an unconditional sale of stock to an unrelated third party prior to the exchange offer will permit the transaction to qualify as a "B" reorganization. *Rev Rul* 72-354, 1972-2 CB 216 .

(n48)Footnote 3. *Reeves v Commr*, 71 TC 727 (1979) . The same conclusion was reached in *Pierson v US*, 472 F Supp 957 (D Del 1979) .

(n49)Footnote 4. *Heverly v Commr*, 621 F2d 1227 (3d Cir 1980) . The appeal from the district court in *Pierson v US*, 472 F Supp 957 (D Del 1979) , was consolidated with an appeal from the Tax Court in one of the cases that had been heard with *Reeves v Commr*, 71 TC 727 (1979) . The First Circuit also reversed the Tax Court in *Chapman v Commr*, 618 F2d 856 (1st Cir 1980) .

(n50)Footnote 5. The petitions for certiorari were dismissed. 451 US 1012 .

(n51)Footnote 6. *IRC* § 368(a)(1)(C). The assumption of too many liabilities may so alter the character of the transaction as to place it outside the purposes and assumptions of the reorganization provisions. *Treas Reg* § 1.368-2(d)(1).

For transactions occurring after Dec 31, 1999, prior ownership of stock of the acquired corporation by the acquiring corporation will not by itself prevent the solely for voting stock requirement from being satisfied. *Treas Reg* § 1.368-2(d)(4)(i).

(n52)Footnote 7. *IRC § 368(a)(2)(B)*. The consideration other than voting stock cannot exceed 20 percent of the value of all property owned by the transferor corporation. While the assumption of liabilities will not be deemed "other consideration" if only voting stock is exchanged for property, it will so count if the transferee corporation acquires some of the transferor's property for a consideration other than voting stock.

If the acquiring corporation owned stock of the acquired corporation prior to the transaction, the sum of money or other property distributed to the acquired corporation's shareholders, other than the acquiring corporation and the acquired corporation's creditors, plus the acquired corporation's liabilities assumed by the acquiring corporation, cannot exceed 20 percent of the value of all the acquired corporation's properties. *Treas Reg § 1.368-2(d)(4)(i)*.

(n53)Footnote 8. *Rev Rul 79-89, 1979-1 CB 152* . A different result was reached in *Rev Rul 79-4, 1979-1 CB 150* , where the guaranteed loan was treated as the debt of the shareholder.

(n54)Footnote 9. *Rev Rul 73-54, 1973-1 CB 187* . The payment or assumption of expenses that are not solely and directly related to the reorganization, the transfer of property of the target corporation for stock of the acquiring corporation, or the exchange of equity interests, will constitute additional consideration.

(n55)Footnote 10. Taxpayers have often attempted to characterize transactions of "F" reorganizations in order to make better use of carryovers from the acquired entity. See, eg, *Security Indus Ins Co v US, 702 F2d 1234 (5th Cir 1983)* .

(n56)Footnote 11. The Service once contended that the continuity of interest requirement was applicable to recapitalizations. It no longer does so. *Treas Reg § 1.368-1(b)*.

(n57)Footnote 1. *Groman v Commr, 302 US 82 (1937)* ; see also *Helvering v Bashford, 302 US 454 (1937)* .

Groman was applied to deny reorganization status to the transaction in *Calcote v US 327 F Supp 363 (DNJ 1971)* . In that case, the taxpayers were shareholders in corporation X as well as minority shareholders in corporation Y; corporation X owned 80 percent of the Y stock. In a two-step transaction, the taxpayers exchanged their Y shares for additional X shares and then exchanged their X shares for stock in corporation A. Since both steps formed an integral part of the transaction, they had to be viewed as constituting the acquisition of the stock of one corporation by another in exchange for the stock of the acquiring corporation's parent; this could not be treated as a "B" reorganization in the year involved.

(n58)Footnote 2. *IRC § 368(a)(2)(D)*. See generally Ferguson & Ginsburg, "Triangular Reorganizations," *28 Tax L Rev 159 (1973)*; Freling, "Three-Party Reorganizations," *22 Tul Tax Inst 179 (1973)*.

IRC § 368(a)(2)(D) can apply when the parent corporation merges into one of two subsidiaries created for purposes of the transaction. *Rev Rul 77-428, 1977-2 CB 118* .

One corporation is in control of another if it owns 80 percent of all classes of stock entitled to vote and 80 percent of the total number of shares of all classes of stock of the corporation. *IRC § 368(c)*. This provision has been construed as requiring the ownership of 80 percent of *each* class of stock of the corporation. *Rev Rul 59-259, 1959-2 CB 115* .

The Service has ruled that a state law merger will not qualify as a Type "A" reorganization if the merger does not result in one corporation acquiring the assets of a target corporation and the target corporation ceasing to exist. *Rev Rul 2000-5, 2000-1 CB 436* .

(n59)Footnote 3. *IRC § 368(a)(2)(D)*.

(n60)Footnote 4. *IRC § 368(a)(2)(D)*.

(n61)Footnote 5. *Treas Reg § 1.368-2(b)*.

(n62)Footnote 6. *Treas Reg § 1.368-2(b)(2)*.

(n63)Footnote 7. A merger failed to qualify under *IRC § 368(a)(2)(E)* when only 2 percent of the total consideration received by the shareholders of the surviving corporation consisted of voting stock of the parent corporation. The continuity of interest requirement was not satisfied. *Rev Rul 73-427, 1973-2 CB 301*.

The fact that the shareholders of the target corporation made a firm commitment underwriting of some of the shares of the parent corporation received by them a precondition to the merger, did not prevent a holding that the voting stock was used to acquire control in *Ltr Rul 8702003*.

Flyer, "An Analysis of the New A Reorganization: Its Operation And Planning Potential," *35 J Tax'n 30 (1971)*.

(n64)Footnote 8. *IRC § 368(a)(1)(B), (C)*. *Rev Rul 74-564, 1974-2 CB 124*, and *Rev Rul 74-565, 1974-2 CB 125*, illustrate complicated maneuvers involving mergers that could not qualify as "A" reorganizations, but did constitute "B" reorganizations. In each case, a corporation used voting stock of its parent to gain control of another corporation.

(n65)Footnote 9. *Treas Reg § 1.368-2(d)(1)*.

(n66)Footnote 10. *IRC § 368(a)(1)(G), (3)(A)*. The transfer must be made while the transferor corporation is under the jurisdiction of the court and must be pursuant to a plan of reorganization approved by the court. *IRC § 368(a)(3)(B)*. In addition, the stock or securities received from the acquiring corporation must be distributed in a transaction which qualifies under *IRC § 354, 355 or 356*. *IRC § 368(a)(1)(G)*.

(n67)Footnote 11. *IRC § 368(a)(3)(E)*.

(n68)Footnote 12. *TD 9396, 2008-22 IRB 1026*, effective May 9, 2008.

(n69)Footnote 1. *Treas Reg § 1.368-1(d)(1), (2)(i)*.

(n70)Footnote 2. *Treas Reg § 1.368-1(d)(2)(i)*.

(n71)Footnote 3. *Treas Reg § 1.368-1(d)(2)(iii)*. Investment activity can be a historic business for purposes of the continuity of business enterprise requirement. *Abegg v Commr, 50 TC 145 (1968)*, *aff'd 429 F2d 1209 (2d Cir 1970)*, *cert denied 400 US 1008*.

(n72)Footnote 4. *Treas Reg § 1.368-1(d)(2)(iii)*.

(n73)Footnote 5. *Treas Reg § 1.368-1(d)(2)(ii)*.

(n74)Footnote 6. *Treas Reg § 1.368-1(d)(1), (3)(i)*. The historic business assets of a merged corporation consisted of tax-exempt bonds and a municipal bond fund. These assets were distributed or disposed of within a short period of time following the merger. The Tax Court held that the continuity of business requirement was not met because the surviving corporation did not continue the merged corporation's historic business or use a significant portion of the merged corporation's historic assets in its business. *Honbarrier v Commr, 115 TC 300 (2000)*.

(n75)Footnote 7. *Treas Reg § 1.368-1(d)(3)(ii)*.

(n76)Footnote 8. *Treas Reg § 1.368-1(d)(3)(iii)*.

(n77)Footnote 9. *Treas Reg § 1.368-1(d)(4)(i)*.

(n78)Footnote 10. *Treas Reg § 1.368-1(d)(4)(ii)*. If members of the qualified group own interests in a partnership meeting requirements equivalent to *IRC § 368(c)* (a *§ 368(c)* controlled partnership), any stock owned by the *§ 368(c)* controlled partnership will be treated as members of the qualified group. Solely for purposes of determining whether a lower-tier partnership is a *§ 368(c)* controlled partnership, any interest in a lower-tier partnership that is owned by a *§ 368(c)* controlled partnership is treated as owned by members of the qualified group. *Treas Reg § 1.368-1(d)(4)(iii)(D)*.

(n79)Footnote 11. *Treas Reg § 1.368-1(d)(4)(iii)(A)*.

(n80)Footnote 12. *Treas Reg § 1.368-1(d)(4)(iii)(B)*.

(n81)Footnote 13. *Treas Reg § 1.368-1(d)(4)(iii)(C)*.

(n82)Footnote 14. *1987-2 CB 84* .



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Taxation of Securities Transactions

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CHAPTER 8 Reorganizations and Other Exchanges

1-8 Taxation of Securities Transactions § 8.03

§ 8.03 Effect of Reorganizations on Shareholders and Holders of Securities

[1] Nonrecognition of Gain or Loss.

[a] General Rule. Under *IRC Section 354(a)(1)*, no gain or loss will be recognized if stock or securities in a corporation which is a party to the reorganization are exchanged solely for stock or securities in such corporation or in another corporation, also a party to the reorganization. The section is applicable solely to exchanges in pursuance of a reorganization as defined in the Code. Thus, if the transaction takes the form of a "B" reorganization, the only exchange sheltered from recognition is the one in which stock of the acquired corporation is surrendered and stock of the acquiring corporation received; a contemporaneous exchange of debentures between the acquiring corporation and security holders of the acquired corporation, since not a part of the definition of a "B" reorganization, will be subject to the general rule regarding recognition of gain or loss.ⁿ¹ Even where the exchange is part of a reorganization, some gain may be recognized if (1) the principal amount of securities received exceeds the principal amount of securities surrendered, (2) securities are received and none are surrendered,ⁿ² or (3) nonqualified preferred stock as defined in *IRC Section 351(g)(2)* is received in exchange for stock other than nonqualified preferred stock (as so defined),ⁿ³ although the only instance in which nonrecognition is wholly unavailable is the one in which only stock is surrendered and only securities are received.ⁿ⁴

The receipt of nonqualified preferred stock in a recapitalization of a family-owned corporation does not result in the recognition of gain.ⁿ⁵ For this purpose, a family-owned corporation is defined as any corporation if at least 50 percent of the stock (by vote and value) is owned by members of the same family for the eight-year period beginning five years before the recapitalization.ⁿ⁶ However, shares held by a family member are not treated as held by a family member to the extent a non-family member had a right, option, or agreement to acquire the shares (directly or indirectly), or with respect to which a family member has reduced risk or loss with respect to the share.ⁿ⁷

Ordinarily, a United States person recognizes gain under *IRC Section 367(a)* on the transfer of property in a reorganization exchange, unless an exception applies. One exception comes about on an exchange of stock or securities of a domestic or foreign corporation pursuant to an asset reorganization, unless the exchange is considered an indirect stock transfer under *Regulations Section 1.367(a)-3(d)*.ⁿ⁸

[b] Definitional Problems.

[i] Party to a Reorganization. One of the conditions of *IRC Section 354(a)* is that the exchange be of stock or

securities in a corporation which is "a party to a reorganization." The term "a party to a reorganization" is defined by the Code as including:

- (1) a corporation resulting from a reorganization;
- (2) both corporations, in the case of a reorganization resulting from the acquisition by one corporation of the stock or properties of another;
- (3) a corporation in control of the acquiring corporation in a "B," "C," or "G" reorganization, provided the controlling corporation's stock is the consideration for the acquisition;
- (4) a corporation controlling the surviving corporation in a statutory merger, provided the stock of the controlling corporation is used in the transaction and the transaction qualifies as an "A" reorganization by virtue of *IRC Section 368(a)(2)(D)* or *368(a)(2)(E)*; and
- (5) a corporation which acquires stock or property in an "A," "B," "C," or "G" reorganization and then transfers such assets or stock to a controlled subsidiary.ⁿ⁹

To illustrate:

Example:

If Corporation *A* is merged into Corporation *B*, both corporations will be parties to the reorganization. If Corporation *A* transfers substantially all of its assets to Corporation *B* in exchange for the voting stock of Corporation *C*, which controls Corporation *B*, all three corporations are parties to the reorganization. But if Corporation *A* transfers all of the stock of Corporation *B* to Corporation *C* in exchange solely for the voting stock of the latter corporation, only Corporation *B* and Corporation *C* would be parties to the reorganization; the fact that Corporation *A* takes part in the transaction does not make it a party to the reorganization.ⁿ¹⁰

If a transaction otherwise qualifies as a Type "B" reorganization or as a reverse triangular merger (see *Section 8.05A*), the target corporation in the Type "B" reorganization or the surviving corporation in the reverse triangular merger remains a party to the reorganization even though its stock or assets are transferred in a transaction described below.ⁿ¹¹ If a transaction otherwise qualifies as a forward triangular merger, a triangular Type "B" reorganization, a triangular Type "C" reorganization, or a reorganization in a bankruptcy proceeding, the acquiring corporation remains a party to the reorganization even though its stock is transferred in such a transaction.ⁿ¹²

A transfer qualifies under the preceding paragraph if it consists of one or more distributions to shareholders (including distributions that involve the assumption of liabilities), (1) the property distributed consists of (a) assets of the acquired corporation, the acquiring corporation, or the surviving corporation, as the case may be, or an interest in an entity received in exchange for such assets in a transfer described in the succeeding sentence; (b) stock of the acquired corporation provided the distributions of stock do not cause the acquired corporation to cease to be a qualified corporation, or (c) a combination thereof; and (2) the aggregate of such distributions does not consist of (a) an amount of assets of the acquired corporation, the acquiring corporation (disregarding assets held before the potential reorganization) or the surviving corporation (disregarding assets of the merged corporation), as the case may be, that would result in a liquidation of the corporation for federal income tax purposes, or (b) all of the stock of the acquired corporation that was acquired in the transaction.ⁿ¹³ A transfer of assets or stock (or a combination thereof) as set forth in the preceding sentence will qualify if the corporation involved does not terminate its corporate existence in connection with the transfers.ⁿ¹⁴

[ii] Stock or Securities. Suppose that as part of a statutory merger which meets the tests for an "A" reorganization,

a taxpayer exchanges stock in the merged corporation for stock and rights to acquire additional stock of the surviving corporation. For many years, the regulations provided that "for the purpose of section 354, stock rights or stock warrants are not included in the term 'stock or securities.'"n15 On the other hand, if the taxpayer received contingent rights to acquire additional stock, he was more likely to succeed in having such rights classified as stock. For example, in *Carlberg v. United States*,n16 the consideration received by shareholders of a merged corporation consisted of stock and "certificates of contingent interest," the latter representing stock which was set aside pending the determination of unresolved but potentially substantial liabilities. The Eighth Circuit found the contingent interest to be evidence of a stock interest and not "other property" as contended by the Government. The court deemed it significant that the "certificates of contingent interest" could produce nothing other than stock. A result similar to *Carlberg* was reached in *Hamrick v. Commissioner*,n17 where the contingent right to additional shares was embodied in a contract and not in a separate, transferable instrument as in *Carlberg*. The Service has acquiesced in the result in *Hamrick* in a ruling which held that a provision for a nonassignable contingent contract right to additional voting stock will not violate the "solely for voting stock requirement" of a "B" reorganization.n18

Regulations, effective March 9, 1998, now provide that, for purposes of *IRC Section 354*, the term "securities" includes rights issued by a party to the reorganization to acquire its stock.n19 However, *IRC Section 354* will not apply to any transaction in which the shareholder receives solely rights to acquire stock in a corporation a party to the reorganization.n20 (It is important to note that the imputed interest provisions of *IRC Section 483* will come into play if any of the shares acquired on the exercise of the rights are issued to the shareholders more than one year after the effective date of the reorganization.)n21

Suppose, however, that the plan of reorganization calls for bondholders to exchange their securities for short-term notes. The problem here is whether the notes constitute securities that may be received without recognition of gain or loss. Early cases, latching on to the statement in *Pinellas Ice & Cold Storage Co. v. Commissioner*,n22 that short-term notes "were not securities within the intendment of the [reorganization provisions]"n23--a statement meant to convey that such notes did not provide the holder with a continuing proprietary interest in the issuer--generally held notes maturing in less than five years after issuance not to be securities.n24 Later cases have abandoned time as a controlling criterion; a one-year note can be a security if an overall evaluation of the instrument leads to the conclusion that it has the characteristics of a security.n25

When a distribution of stock or securities to shareholders is statutorily required to qualify a transaction as a non-divisive "D" reorganization, but because of an identity (or near identity) of ownership of the corporate parties to the reorganization such a distribution would be a "meaningless gesture" that would not change the substance of the transaction, the regulations supply a "deemed" distribution where an actual distribution is lacking.n26 In a typical case contemplated by the regulations, T, a corporation wholly owned by shareholder A, sells all of its assets to S, also wholly owned by A, for \$100x of cash, after which T liquidates.n27 Such a transaction would qualify as a reorganization under *IRC Section 368(a)(1)(D)* if S issued even a single share of stock to T which T distributed to A.n28 However, even if S does not issue its stock in the transaction, and T has no S stock to distribute to A, S will be deemed to have issued a share of its stock to T as consideration for T's assets,n29 and that share will be deemed distributed to T's shareholder A.n30

[c] Receipt of Other Property--"Boot."

[i] Extent of Recognition. Although *IRC Section 354* seemingly grants nonrecognition only when stock or securities are exchanged *solely* for other stock or securities, the receipt of other property ("boot") will not be a complete bar to nonrecognition, provided the exchange would have fit within *IRC Section 354* but for the receipt of the other property.n31 By virtue of *IRC Section 356(a)(1)*, the taxpayer's recognized gain cannot exceed the amount of "boot." Thus, gain will be recognized in full only when the amount of other property received equals or exceeds the realized gain. On the other hand, any loss realized on the exchange will not be recognized no matter how much "boot" the taxpayer receives.n32

For purposes of computing any recognized gain, to the extent the terms of the exchange specify the other property or money that is received in exchange for a particular share of stock or security surrendered or a particular class of stock or securities surrendered, those terms control provided that they are economically reasonable.ⁿ³³ If there is no such specification, a pro rata portion of the other property and money received is treated as received in exchange for each share of stock and security surrendered, based on the fair market value of each surrendered share or security.ⁿ³⁴

Nonqualified preferred stock (as defined in *IRC Section 351(g)(2)*) received in a reorganization will be treated as other property except to the extent that, under *IRC Section 354*, it can be received without the recognition of gain.ⁿ³⁵

IRC § 357(c)(1), discussed in § 3.02[2][a][ii], requires recognition of gain whenever the sum of liabilities assumed by a transferee corporation in a Type "D" reorganization exceeds the total of the adjusted bases of the assets transferred pursuant to the corporation if, following the transfer, the corporation distributes its stock or securities in a tax-free divisive reorganization.ⁿ³⁶

[ii] Character of the Recognized Gain. Since the gain required to be recognized by *IRC Section 356(a)* results from an exchange of property, it would appear that such gain should be capital gain provided the stock or securities exchanged by the taxpayer constituted a capital asset in his hands. However, *IRC Section 356(a)(2)* requires that the taxpayer treat the recognized gain as a dividend to the extent of his ratable share of the corporation's accumulated earnings and profits whenever the exchange "has the effect of the distribution of a dividend."ⁿ³⁷

Because dividend income under *IRC Section 356(a)(2)* is keyed to the amount of gain recognized under *IRC Section 356(a)(1)*, which, in turn, is keyed to the amount of gain realized and the amount of "boot," the taxpayer's dividend income can never exceed the amount of other property received by him on the exchange; it can be less.

Example:

If the taxpayer receives other property of \$2,000 in an exchange in which he realizes \$4,000 of gain, and if at the time of the exchange his ratable share of post-1913 earnings and profits is \$3,000, he will have \$2,000 of dividend income (if *IRC Section 356(a)(2)* is applicable) and \$2,000 of unrecognized gain. If the taxpayer's ratable share of accumulated earnings and profits amounted to \$1,000, he would have dividend income of only \$1,000; the balance of his recognized gain would be capital gain.

When does a reorganization exchange have the effect of a distribution of a dividend? Early regulations gave the impression that dividend consequences automatically ensued whenever the corporation had accumulated earnings and profits.ⁿ³⁸ The position taken by the Regulations stemmed from the opinion in *Commissioner v. Estate of Bedford*.ⁿ³⁹ A case involving the exchange of shares of cumulative preferred stock for shares of new preferred, shares of common, and cash. Since the cash represented payment of dividend arrearages on the surrendered preferred, the distribution took on the characteristic of a dividend, and the case so held. However, because of certain language in the opinion--"that a distribution, pursuant to a reorganization, of earnings and profits has the effect of a distribution of a taxable dividend" within [the predecessor of *IRC Section 356(a)(2)*]"ⁿ⁴⁰--language that went further than was necessary for the decision in *Bedford*, it was commonly assumed that any gain recognized under *IRC Section 356* would be treated as a dividend to the extent of the taxpayer's ratable share of the distributing corporation's earnings and profits. Later cases and rulings have tended to restrict *Bedford* to its facts and to determine the character of the recognized gain by applying the same criteria used in testing a stock redemption for dividend equivalence.ⁿ⁴¹ As the Court of Claims put it:

"If Congress meant merely to say that any boot money at all paid out of earnings should be a taxable dividend, it used a verbose and complicated way of saying it."ⁿ⁴²

Thus, a distribution of cash or other property, made as part of a reorganization exchange, should be classified as a dividend only if the exchange does not produce a meaningful reduction in the shareholder's proportionate interest in the

corporation.ⁿ⁴³ And the corporation in which the meaningful reduction must occur is the acquiring corporation, not the acquired corporation, as the Fifth Circuit had once held.ⁿ⁴⁴ According to the Supreme Court,ⁿ⁴⁵ the proper approach utilizes the step-transaction doctrine and assumes that the transaction begins with a stock-for-stock exchange that is followed by a redemption of a portion of the shares for cash or other property.

[iii] Securities as Other Property. A reorganization exchange involving the receipt of securities will be wholly tax-free only when securities are exchanged for securities in an equal or lesser principal amount or for stock and securities in an equal or lesser principal amount.ⁿ⁴⁶ If the principal amount of the securities received exceeds the principal amount of the securities surrendered, the taxpayer will be in receipt of "boot" to the extent of the fair market value of such excess.ⁿ⁴⁷ If securities are received and none are surrendered, as in the case of an exchange of stock and securities,ⁿ⁴⁸ the fair market value of the entire principal amount of the securities received will be treated as other property.ⁿ⁴⁹ The following examples illustrate the foregoing rules:

Example 1:

A taxpayer exchanges a security in the principal amount of \$10,000 for a security in the principal amount of \$15,000, but with a fair market value of \$12,000. Because the principal amount of the securities received exceeds the principal amount of those surrendered, the taxpayer will be in receipt of "boot" to the extent of the fair market value of the excess principal amount, or \$4,000 ($5,000/15,000 \times \$12,000$). If the taxpayer had received two securities, each in the principal amount of \$7,500, but one having a fair market value of \$7,500 and the other, a fair market value of \$4,500, one-third of the value of each security would be treated as "boot."ⁿ⁵⁰

Example 2:

A taxpayer exchanges stock for stock and a security in the principal amount of \$10,000 with a fair market value of \$9,000. Since no securities were surrendered, the fair market value of the security received, \$9,000, will be treated as other property.

Example 3:

A taxpayer exchanges a security in the principal amount of \$10,000 for stock and a security in the principal amount of \$9,000. No gain or loss will be recognized in this situation; the principal amount of the security received is less than the principal amount of the security surrendered.

A right to acquire stock that is treated as a security for purposes of *IRC Section 354* or *355* has no principal amount.ⁿ⁵¹ Therefore, the right is not other property when received in a transaction to which *IRC Section 356* applies regardless of whether securities are surrendered in the exchange.

Example 4:

A taxpayer exchanges stock for stock and a right to acquire stock. Because the right does not have a principal amount, the taxpayer does not receive an excess principal amount. The same result would obtain if the taxpayer exchanged a right to acquire stock for stock and another right to acquire stock.

Example 5:

A taxpayer exchanges a right to acquire stock for stock and a debt security with a principal amount of \$10,000. The taxpayer receives an excess principal amount of \$10,000 because the stock right surrendered had no principal amount.

[2] Basis and Holding Period.

[a] Nonrecognition Property. Property which can be received tax-free in a reorganization exchange will assume a basis equal to that of the property surrendered, decreased by the amount of "boot" received, and increased by the amount of gain (including the amount of dividend income) recognized on the exchange.ⁿ¹ If more than one kind or

class of nonrecognition property is received in the exchange, the aggregate basis of such property, determined in the manner specified in the preceding sentence, must be allocated among the several classes of stock and securities received in proportion to their respective fair market values.ⁿ² If one share of stock or security is received for more than one share of stock or security, or if a fraction of a share or security is received, the basis of the shares or securities surrendered must be allocated to the shares or securities received in a manner that reflects, to the greatest extent possible, that a share or security received in respect of shares or securities that were acquired on the same day and at the same price.ⁿ³ To the extent it is not possible to allocate basis in this manner, the basis of the shares or securities surrendered must be allocated to the shares or securities received in a manner that minimizes the disparity in the holding periods of the surrendered shares or securities whose basis is allocated to any particular share or security received.ⁿ⁴

To the extent that the terms of the reorganization exchange specify which shares of stock or securities, or other property or money, are received in exchange for a particular share or security or a particular class of stock or securities, those terms will control provided they are economically reasonable.ⁿ⁵ If the terms of the exchange do not contain such a specification, a pro rata portion of the shares of stock and securities of each class received is treated as received in exchange for each share of stock and security surrendered, based on the fair market value of the surrendered stock and securities.ⁿ⁶

If a shareholder or security holder surrenders a share of stock or a security and receives no property, or property (including property that can be received under *IRC Section 354* without the recognition of gain, or other property or money) with a fair market value less than that of the stock or securities surrendered in the transaction, the shareholder or security holder is treated as follows:ⁿ⁷

First, the shareholder or security holder is treated as receiving the stock, securities, other property, or money actually received and an amount of stock of the issuing corporation that has a value equal to the excess of the value of the stock or securities surrendered over the value of the stock, securities, other property, or money actually received in the transaction. If the shareholder owns only one class of stock of the issuing corporation the receipt of which would be consistent with the economic rights associated with each class of stock of the issuing corporation, the stock deemed received by the shareholder will be the stock of that class. If the shareholder owns multiple classes of stock of the issuing corporation the receipt of which would be consistent with the economic rights associated with each class of stock of the issuing corporation, the stock deemed received by the shareholder will be stock of each class owned by the shareholder immediately prior to the transaction. The basis of each share of stock or security deemed received and actually received will be determined under the rules discussed above.

Second, the shareholder or security holder is then treated as surrendering all of its stock and securities to the issuing corporation, including the shares and securities held immediately before the transaction and those shares and securities actually and deemed received in the transaction, in a recapitalization in exchange for the stock and securities the shareholder or security holder actually holds after the transaction. The basis of each share of stock and security deemed received in the recapitalization is determined under the rules discussed above.

If a shareholder or security holder that acquired shares or securities on different dates or at different prices exchanges the shares or securities, and is not able to identify which particular share of stock is received in exchange for a particular share of stock or security, the shareholder or security holder may designate which share of stock or security is received in exchange for a particular share of stock or security, provided the designation is consistent with the terms of the exchange or distribution.ⁿ⁸ The designation must be made on or before the first date on which the basis of a share of stock or a security received (or deemed received) is relevant.ⁿ⁹

The holding period of nonrecognition property received in a reorganization exchange is prescribed by *IRC Section 1223(1)*. If the transferred stock or securities constituted a capital asset in the hands of the taxpayer, their holding period will be added to the holding period of the stock or securities received.

[b] Other Property. The basis of any other property (except money) received by the taxpayer will be its fair market value at the time of receipt.ⁿ¹⁰ The holding period of such property commences with acquisition by the taxpayer.

[3] Record-Keeping and Filing Requirements.

Every taxpayer, other than a corporation that is a party to the reorganization, who participates in a reorganization exchange must file a statement with his income tax return for the year of exchange showing (a) the cost or other basis of the stock or securities transferred in the exchange, (b) the fair market value on the date of the exchange of the stock, securities, and "boot" received, and (c) any liabilities assumed and any liabilities to which the property received is subject.ⁿ¹ A second requirement makes the taxpayer maintain permanent records to substantiate the information contained in the statement.ⁿ²

A corporation is saddled with reporting requirements whenever a person (or group of persons) acquires at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of all classes of stock of the corporation in either a single transaction or series of related transactions.ⁿ³ The provision applies as well to other substantial changes in the capital structure of a corporation. The information required to be furnished is set forth in regulations.ⁿ⁴ No reporting is required if the transaction takes the form of a dissolution of the corporation or a liquidation of the whole or any part of its capital stock and information regarding the transaction must be reported under *IRC Section 6043(a)*,ⁿ⁵ or if the corporation reasonably determines that all of its shareholders who receive cash, stock, or other property pursuant to the acquisition of control or substantial change in capital structure are exempt recipients as defined in the regulations.ⁿ⁶

The regulations state that acquisition of control occurs in a transaction or series of related transactions if (a) before an acquisition of stock of the first corporation (directly or indirectly) by a second corporation, the second corporation does not have control of the first corporation; (b) after the acquisition, the second corporation has control of the first corporation; (c) the fair market value of the stock acquired in the transaction or any related transaction as of the date or dates the stock was acquired is \$100 million or more; (d) the shareholders of the first corporation receive stock or other property pursuant to the acquisition; and (e) the first corporation or any of its shareholders is required to recognize gain if any under *IRC Section 367(a)* and the regulations, as a result of the transaction.ⁿ⁷

A change in capital structure occurs if a corporation in a transaction or series of transactions (i) merges, consolidates, or otherwise combines with another corporation or transfers all or substantially all of its assets to one or more corporations; (ii) transfers all or part of its assets to another corporation in a bankruptcy or similar case and, in pursuance of the plan, distributes stock or securities of that corporation; or (iii) changes its identity, form or place of organization and the corporation or any shareholder is required to recognize gain, if any, under *IRC Section 367(a)* and the regulations, as a result of the transaction.ⁿ⁸ The change is substantial if the amount of any cash and the fair market value of property (including stock) provided to the shareholders of the corporation pursuant to the change in capital structure, as of the date or dates on which the cash or other property is provided, is \$100 million or more.ⁿ⁹

A corporation that fails to file the required return is subject to a penalty unless the failure is due to reasonable cause. The penalty is \$500 a day for each day that the failure continues; the total penalty cannot exceed \$100,000.ⁿ¹⁰

FOOTNOTES:

(n1)Footnote 1. *Rev Rul 98-10, 1998-1 CB 643 ; Rev Rul 70-41, 1970-1 CB 77 . See also Rev Rul 77-271, 1977-2 CB 116 , where the shareholder received additional stock as consideration for entering into an employment agreement with the acquiring corporation; the additional stock was compensation income.*

(n2)Footnote 2. *IRC § 354(a)(2)(A).* The taxpayer should here consider the impact of having an instrument denominated stock found in fact to be a debt instrument. See § 3.06[2], *supra*.

(n3)Footnote 3. *IRC § 354(a)(2)(C)(i)*. See § 3.02[2] for a discussion of nonqualified preferred stock. See also § 8.06[2][b].

(n4)Footnote 4. *Treas Reg § 1.354-1(d)*, Ex. (3). The regulations suggest the applicability of *IRC § 302*.

(n5)Footnote 5. *IRC § 354(a)(2)(C)(ii)(I)*.

(n6)Footnote 6. *IRC §§ 354(a)(2)(C)(ii)(II), 447(d)(2)(C)*. Members of the same family are an individual, the individual's brothers and sisters, the brothers and sisters of the individual's parents and grandparents, the ancestors and lineal descendants of any of the foregoing, and the estate of any of the foregoing, with limited attribution. *IRC § 447(e)*.

(n7)Footnote 7. *IRC §§ 354(a)(2)(C)(i)(II), 355(d)(6)(B)*.

(n8)Footnote 8. *Treas Reg § 1.367(a)-3(a)*.

(n9)Footnote 9. *IRC § 368(b)*. A corporation that changes its name and issues shares in an "F" reorganization is a party to a reorganization, as is a corporation that issues preferred stock to shareholders as part of a recapitalization ("E" reorganization). *Rev Rul 72-206, 1972-1 CB 105*.

(n10)Footnote 10. Other examples can be found in *Treas Reg § 1.368-2(f)*.

(n11)Footnote 11. *Treas Reg § 1.368-2(f)*.

(n12)Footnote 12. *Id.*

(n13)Footnote 13. *Treas Reg § 1.368-2(k)(i)*.

(n14)Footnote 14. *Treas Reg § 1.368-2(k)(ii)*.

(n15)Footnote 15. *Treas Reg § 1.354-1(e) (1970); Gordon v Commr, 424 F2d 378 (2d Cir), cert denied 400 US 848*.

(n16)Footnote 16. *281 F2d 507 (8th Cir 1960)*; contra, *Rev Rul 57-586, 1957-2 CB 249*.

(n17)Footnote 17. *43 TC 21 (1964)*, acq in result *Rev Rul 66-112, 1966-1 CB 68*.

(n18)Footnote 18. *Rev Rul 66-112, 1966-1 CB 68*. *Rev Rul 57-586, 1957-2 CB 249*, was distinguished on the ground that the interest in that ruling was embodied in a negotiable instrument.

The Service will issue favorable rulings on transactions involving contingent rights to acquire additional stock if (1) all of the stock will be issued within five years from the date of the initial transfer, (2) there is a valid business reason for the issuance of the contingent rights, (3) the maximum number of shares that may be issued in the exchange is stated, (4) at least 50 percent of the maximum number of shares of each class that may be issued is issued in the initial distribution, (5) the contingent rights are either nonassignable or not evidenced by a negotiable certificate, (6) the rights can give rise to the receipt of additional stock only, (7) the stock issuance will not be triggered by an event the occurrence or nonoccurrence of which is within the control of the shareholder, (8) the stock issuance will not be triggered by the payment of additional tax or reduction in tax paid as a result of a Service audit of the shareholders or the corporation either with respect to the transaction in which the contingent stock will be issued or when the transaction in which the contingent stock will be issued involves related parties within the meaning of *IRC § 267(c)(4)*, and (9) the mechanism for the calculation of the additional stock to be issued is objective and readily ascertainable.

Rulings will be issued for transactions calling for stock to be placed in escrow if (1) there is a valid business reason for the escrow arrangement; (2) the escrowed stock is legally outstanding under state law and is so shown on the

balance sheet; (3) dividends are paid currently to the exchanging shareholders; (4) voting rights are exercisable by exchanging shareholders; (5) no share is subject to restrictions requiring return of stock to the corporation because of death, termination of employment, etc; (6) the stock is released from escrow within five years of the consummation of the reorganization; (7) at least 50 percent of the initially issued stock is not subject to the escrow; and (8) the conditions specified in (7), (8), and (9) of the preceding paragraph are met. *Rev Proc 77-37, 1977-2 CB 568*, amplified by *Rev Proc 84-42, 1984-1 CB 521*.

Contingent stock payments may be subject to the imputed interest rules of *IRC § 483*. See Ch 2 for the method of determining the portion of a contingent stock payment representing unstated interest.

See generally Tillinghast, "Contingent Stock Pay-Outs in Tax-Free Reorganizations," 22 *Tax Lawyer* 467 (1969).

(n19)Footnote 19. *Treas Reg § 1.354-1(e) (1998)*. A right to acquire stock has no principal amount.

A right to acquire nonqualified preferred stock, received in an exchange for (or in a distribution with respect to) stock, or a right to acquire stock, other than nonqualified preferred stock is not considered either stock or a security. *Temp Treas Reg § 1.356-6T(a)(2)*.

For this purpose the term "rights to acquire stock" has the same meaning as it does under *IRC §§ 305 and 317*, discussed in Chapter 4.

(n20)Footnote 20. *Treas Reg § 1.354-1(d), Ex 4*.

(n21)Footnote 21. *Vorbleski v US, 589 F2d 123 (3d Cir 1978)*; *Katkin v Commr, 570 F2d 139 (6th Cir 1978)*; *Solomon v Commr, 570 F2d 28 (2d Cir 1977)*; *Jeffers v US, 556 F2d 986 (Ct Cl 1977)*; *Rev Rul 72-32, 1972-1 CB 48*. Where the interest is paid in the form of additional stock, the "interest" shares will have a basis equal to fair market value. *Rev Rul 70-300, 1970-1 CB 125*, clarified by *Rev Rul 72-35, 1972-1 CB 139*.

(n22)Footnote 22. *287 US 462 (1933)*.

(n23)Footnote 23. *Id at 468-69*.

(n24)Footnote 24. Eg, *Neville Coke & Chem Co v Commr, 148 F2d 599 (3d Cir)*, *cert denied 326 US 726*; *Commr v Sisto Fin Corp, 139 F2d 253 (2d Cir 1943)*. Additional discussion can be found in § 3.02[2][a], *supra*.

(n25)Footnote 25. *US v Mills, 399 F2d 944 (5th Cir 1968)*.

In *Rev Rul 2004-78, 2004-2 CB 108*, a target corporation issued securities with a 12-year term. The corporation was acquired in a merger two years prior to the maturity date of the instruments. As part of the merger, the security holders of the target corporation exchanged those securities for instruments of the acquiring corporation that contained the same terms (other than interest rate) as the securities of the target corporation. Although instruments with a term of two years generally would not qualify as securities, the Service held that the debt instruments of the acquiring corporation represented a continuation of the security holders' investment in the target corporation in substantially the same form. This meant that the debt instruments of the acquiring corporation exchanged for the securities of the target corporation were securities for purposes of *IRC § 354*.

(n26)Footnote 26. *Treas Reg § 1.368-2(l)*, added by *TD 9475, 74 Fed Reg 67053 (Dec 18, 2009)*. The "meaningless gesture" doctrine was engrafted onto the reorganization provisions by the courts, see *James Armour, Inc v Commr, 43 TC 295, 307 (1964)* and was long followed by the Internal Revenue Service, see *Rev Rul 70-240, 1970-1 CB 81*, before being incorporated into the regulations.

(n27)Footnote 27. The regulations apply to any case in which "the same person or persons own, directly or

indirectly, all of the stock of the transferor and transferee corporations in identical proportions." *Treas Reg* § 1.368-2(l)(2)(i). Thus, the regulations would apply if, in the above example, S and T were owned by individuals A, B, and C, who owned 34 percent, 33 percent and 33 percent, respectively, of each corporation. *Treas Reg* § 1.368-2(l)(3), Ex 4. The attribution principles of *IRC* § 318(a)(2) are followed in determining stock ownership except that attribution to corporations is made without regard to the 50 percent stock ownership limitation in *IRC* § 318(a)(2)(C), and an individual and all members of his family are treated as one individual. *Treas Reg* § 1.368-2(l)(2)(ii). The same person or persons will be treated as owning all of the stock of the transferor and transferee corporations even if there is a *de minimis* variation in shareholder identity or proportionality of ownership. *Treas Reg* § 1.368-2(l)(2)(iii). The regulations under *Treas Reg* § 1.368-2(l) do not apply, however, to transactions qualifying as triangular reorganizations as defined in *Treas Reg* § 1.358-6(b)(2). *Treas Reg* § 1.368-2(l)(2)(iv).

(n28)Footnote 28. Under *IRC* § 368(a)(1)(D), "stock or securities of the corporation to which the assets are transferred ... [must be] distributed in a transaction which qualifies under section 354, 355 or 356." *IRC* § 354(b)(1)(B) provides that *IRC* § 354 will not apply to an exchange in pursuance of a plan of reorganization described in *IRC* § 368(a)(1)(D) unless the transferee corporation acquires substantially all of the assets of the transferor, and the stock, securities, and other properties received by the transferor, as well as any other properties of the transferor, are distributed in pursuance of the plan of reorganization.

(n29)Footnote 29. In cases where no consideration is received from S, the transferee, in exchange for the transferor T's assets, or the value of the consideration paid by S is less than the fair market value of T's transferred assets, the stock that is deemed transferred by S is presumed to have a value equal to the excess of the assets' fair market value over any consideration paid for the assets by S. If S paid fair market value for T's assets, a share of S's stock is nevertheless considered issued for nominal value in addition to the consideration S actually transferred. *Treas Reg* § 1.368-2(l)(2)(i).

(n30)Footnote 30. *Treas Reg* § 1.368-2(l)(2)(i). Where appropriate, the fictional share of stock is deemed distributed through chains of ownership to the extent necessary to reflect the actual ownership of S and T, the transferor and transferee corporations. When the deemed-issued stock has only nominal value (because the consideration actually given up by S equaled the fair market value of T's assets), the shareholder(s) of S and T, after adjusting the basis of such share in accordance with the rules of *IRC* § 358 and the regulations thereunder (see § 8.03[2], *supra*), may designate an actual share of the transferee's stock to which the basis, if any, of the fictional share will attach. See *Treas Reg* § 1.358-2(a)(2)(iii).

(n31)Footnote 31. Following completion of a merger, the market price of the acquiring corporation's stock fell precipitously due to reports that the corporation had failed to disclose material facts about its financial condition. The shareholders of the merged corporation sued the acquiring corporation for securities fraud. As part of the settlement of the litigation, the taxpayer received cash and certain discounts on future purchases. The cash and discounts were treated as if they had been received as part of the merger and, thus, were taxable as "boot." *Tribune Publishing Co v US*, 836 F2d 1176 (9th Cir 1988).

(n32)Footnote 32. *IRC* § 356(c). Since gain or loss must be computed separately for each block of stock or securities transferred as part of the exchange, the taxpayer can find himself with recognized gains and unrecognized losses resulting from the same transaction.

(n33)Footnote 33. *Treas Reg* § 1.356-1(b).

(n34)Footnote 34. *Id.*

(n35)Footnote 35. *IRC* § 356(e); *Treas Reg* § 1.356-6(a). A discussion of nonqualified preferred stock can be found in § 3.02[2]. See also § 8.06[2][b].

(n36)Footnote 36. *IRC* § 357(c)(1)(B).

(n37)Footnote 37. The distribution involved in *Vesper Co v Commr*, 131 F2d 200 (8th Cir 1942) , was held to have the effect of a dividend even though the corporation had only current earnings and profits; the court applied the *IRC* § 316 test.

The Third Circuit and the Tax Court have held that the amount of "boot" dividend is measured by the accumulated earnings and profits of the transferor corporation, not those of the acquiring corporation. *Atlas Tool Co v Commr*, 614 F2d 860 (3d Cir 1980) , *cert denied* 449 US 836 ; *Est of Bell v Commr*, TC Memo 1971-285 . The Fifth Circuit used the earnings and profits of both corporations where there was an identity of stock interests in the two corporations. *Davant v Commr*, 366 F2d 874 (5th Cir 1966) , *cert denied* 386 US 1022 .

A "boot" dividend qualifies as a dividend for the dividends received deduction under *IRC* § 243(a), *Rev Rul* 72-327, 1972-2 CB 197 , and for the deemed-paid foreign tax credit allowed by *IRC* § 902. *Rev Rul* 74-387, 1974-2 CB 207 .

(n38)Footnote 38. *Treas Reg* § 1.356-1(c), Ex (1). The Regulation was revised in 2006 to eliminate that impression. In the interim, the Service had ruled that cash received in lieu of fractional shares would be treated as consideration paid for the redemption of such shares if not a separately bargained-for consideration. *Rev Rul* 74-36, 1974-1 CB 85 ; *Rev Rul* 69-34, 1969-1 CB 105 ; *Rev Rul* 66-365, 1966-2 CB 116 .

(n39)Footnote 39. 325 US 283 (1945) .

(n40)Footnote 40. *Id* at 292 .

(n41)Footnote 41. Eg, *Wright v US*, 482 F2d 600 (8th Cir 1973) ; *Hawkinson v Commr*, 235 F2d 747 (2d Cir 1956) ; *Idaho Power Co v US*, 161 F Supp 807 (Ct Cl 1958) , *cert denied* 358 US 832 ; *Rev Rul* 93-62, 1993-2 CB 118 ; *Rev Rul* 75-515, 1974-2 CB 118 .

(n42)Footnote 42. *Idaho Power Co v US*, 161 F Supp 807, 809 (Ct Cl) , *cert denied* 358 US 832 (1958) .

(n43)Footnote 43. *US v Davis*, 397 US 301 (1970) , discussed in Ch 5.

See TAM 199934001 for an application of the meaningful reduction test to characterize "boot" received in a recapitalization as gain rather than a dividend.

The Commissioner might contend that the distribution of other property was functionally unrelated to the reorganization, causing the distribution to be treated as a dividend to the extent provided by *IRC* § 301. This argument is likely to be pressed in liquidation-reincorporation cases. See, eg, *Davant v Commr*, 366 F2d 874 (5th Cir 1966) , *cert denied* 386 US 1022 , (applying *IRC* § 301); *American Mfg Co v Commr*, 55 TC 204 (1970) (denying *IRC* § 301 treatment).

A special rule affects "boot" received in exchange for Section 306 stock. Under *IRC* § 356(f), an amount equal to the value of the other property received by the taxpayer will be treated as a distribution of property to which *IRC* § 301 applies. See Ch 4.

(n44)Footnote 44. *General Housewares Corp v US*, 615 F2d 1056 (5th Cir 1980) ; *Shimberg v US*, 577 F2d 283 (5th Cir) , *cert denied* 439 US 1115 .

(n45)Footnote 45. *Commr v Clark*, 109 S Ct 1455 (1989) . See Gardner & Stewart, "Boot Distributions in Reorganizations: Has the U.S. Supreme Court's *Clark* Decision Resolved the Controversy?" 17 *J Corp Tax* 41 (1990).

(n46)Footnote 46. *IRC* § 354(a)(1), (2)(A).

Nonrecognition does not extend to stock including nonqualified preferred stock as defined in *IRC* § 351(g)(2),

securities, or other property received that is attributable to interest that has accrued on securities on or after the beginning of the holder's holding period. *IRC* § 354(a)(2)(B). Moreover, the property attributable to such interest is not treated as "boot" under *IRC* § 356, but, rather, as income under *IRC* § 61. (This situation will arise when the reorganization is a "G" reorganization.)

(n47)Footnote 47. *IRC* § 356(d)(1), (2)(B).

(n48)Footnote 48. An exchange of stock solely for securities does not fit within *IRC* § 354 at all. Therefore, the securities cannot be treated as "boot" under *IRC* § 356. The transaction is treated as a redemption of stock and is governed by *IRC* § 302. *Treas Reg* § 1.354-1(d), Ex (3).

(n49)Footnote 49. *IRC* § 356(d)(1), (2)(B).

(n50)Footnote 50. *Treas Reg* § 1.356-3(c), Ex 6.

(n51)Footnote 51. *Treas Reg* § 1.356-3(b), effective Mar 9, 1998. The rule does not extend to a right to acquire nonqualified preferred stock received in exchange for (or in a distribution with respect to) stock, or a right to acquire stock, that is other than nonqualified preferred stock. *Treas Reg* § 1.356-6(a)(2).

(n52)Footnote 1. *IRC* § 358(a)(1). If the property exchanged was purchased at different times or at different prices, the taxpayer may be faced with an identification problem when he comes to sell the property received in the exchange. See § 1.05[7].

(n53)Footnote 2. *IRC* § 358(b); *Treas Reg* § 1.358-2(a)(2). If the taxpayer surrenders more than one class of stock or securities or surrenders both stock and securities, it becomes necessary to determine the stock and securities received with respect to each class of stock or securities surrendered before any allocation can be made. Then a separate basis computation and allocation must be made for each class. *Treas Reg* § 1.358-2(a)(4). Stock or securities in different corporations, or stock or securities in the same corporation which have different rights attributable to them, will be considered different classes of stock or securities. *Treas Reg* § 1.358-2(a)(1).

(n54)Footnote 3. *Treas Reg* § 1.358-2(a)(2)(i).

(n55)Footnote 4. *Id.*

(n56)Footnote 5. *Treas Reg* § 1.358-2(a)(2)(ii).

(n57)Footnote 6. *Id.*

(n58)Footnote 7. *Treas Reg* § 1.358-2(a)(2)(iii). The rules of this section apply as well to a stockless reorganization, a situation that may arise in a reorganization involving commonly controlled acquiring and target corporations where the issuance of additional stock would constitute a meaningful gesture. See *Treas Reg* § 1.358-2(c), Ex. 10.

(n59)Footnote 8. *Treas Reg* § 1.358-2(a)(2)(vii).

(n60)Footnote 9. *Id.*

(n61)Footnote 10. *IRC* § 358(a)(2).

(n62)Footnote 1. *Treas Reg* § 1.368-3(b).

(n63)Footnote 2. *Treas Reg* § 1.368-3(c).

(n64)Footnote 3. *IRC § 6043(c)*.

(n65)Footnote 4. *Treas Reg § 1.6043-4*. The return must be filed on Form 8806 on or before the 45th day following the acquisition of control or substantial change in capital structure of the corporation, or, if earlier, on or before January 5th of the year following the calendar year in which the acquisition of control or substantial change in capital structure occurs. *Treas Reg § 1.6043-4(a)(3)*.

(n66)Footnote 5. *Treas Reg § 1.6043-4(a)(3)*.

(n67)Footnote 6. *Treas Reg § 1.6043-4(a)(4)*. The list of exempt recipients is set forth in *Treas Reg § 1.6043-4(b)(5)*.

(n68)Footnote 7. *Treas Reg § 1.6043-4(c)(1)*. Control for this purpose means the ownership of stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote, or at least 50% of the total value of shares of all classes of stock. *IRC § 304(c)(1)*; *Treas Reg § 1.6043-4(c)(2)*. The attribution rules of *IRC § 318* as modified by *IRC § 958(b)* (discussed in § 20.04[1]) apply.

(n69)Footnote 8. *Treas Reg § 1.6043-4(d)(2)*.

(n70)Footnote 9. *Treas Reg § 1.6043-4(d)(1)*.

(n71)Footnote 10. *IRC § 6652(l)*.



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CHAPTER 8 Reorganizations and Other Exchanges

1-8 Taxation of Securities Transactions § 8.04

§ 8.04

Effect of Reorganizations on the Transferor Corporation

[1] Nonrecognition of Gain or Loss.

Under *IRC Section 361(a)*, no gain or loss is recognized to a corporation that is a party to a reorganization and, pursuant to the plan of reorganization, exchanges property solely for stock or securities in another corporation that is a party to the reorganization. If the exchange is not solely in kind and "boot" is received, the recipient will be forced to recognize gain to the extent that the "boot" is not distributed pursuant to the plan; loss is not recognized in any event.ⁿ¹ A transfer of money or property to creditors in connection with the reorganization is treated as a distribution in pursuance of the plan.ⁿ²

IRC Section 361(c)(1) sets forth a second nonrecognition rule to govern the distribution of "qualified property"--stock in (or the right to acquire stock in), or an obligation of (i) the distributing corporation, or (ii) any other corporation that is a party to the reorganization, if the stock, right, or obligation was received by the distributing corporation in the exchange.ⁿ³ A distribution of appreciated property that is not qualified property leads to the recognition of gain (in the amount of the appreciation) by the distributing corporation.ⁿ⁴ The provisions of *IRC Sections 311, 336, and 337* have no application to a distribution in connection with a reorganization.ⁿ⁵

A transfer of property by a domestic corporation to a foreign corporation is taxable to the transferor. *IRC Section 367(a)(1)* does not permit the foreign corporation to be treated as a corporation for the purpose of determining the extent to which gain must be recognized on the transfer. The exceptions contained in *IRC Sections 367(a)(2) and (3)*, for the transfer of stock or securities of a foreign corporation that is a party to the exchange or reorganization, and the transfer of property for use by the foreign corporation in the active conduct of a trade or business, do not apply unless the transferor corporation is controlled (within the meaning of *IRC Section 368(c)*) by five or fewer domestic corporations.ⁿ⁶

[2] Basis and Holding Period.

The transferor corporation determines its basis for stock and securities in another corporation that is a party to the reorganization received pursuant to the plan of reorganization under the rules prescribed by *IRC Section 358*, namely, the same basis as the transferred property, decreased by the amount of any "boot" received,ⁿ¹ and increased by the amount of any gain recognized on the exchange. Any other property received pursuant to the plan of reorganization will

assume a basis equal to its basis in the hands of the transferor of the property, adjusted by the amount of gain or loss to such transferor on the transfer.ⁿ²

The holding period of nonrecognition property received in exchange for property which was either a capital asset or Section 1231 property will include the period that the transferor held the transferred property.ⁿ³ The holding period of stock or securities received in exchange for noncapital assets or for property which was not Section 1231 property, as well as the holding period of any "boot" received in exchange, will commence with acquisition.

[3] Effect on Earnings and Profits.

IRC Section 312(h)(2), effective for plans of reorganization adopted after July 18, 1984, decrees that proper allocation with respect to the earnings and profits of the acquired corporation in a "C" or "D" reorganization be made between the acquiring corporation and the acquired corporation (or any corporation that had control of the acquired corporation before the reorganization).

[4] Treatment of Expenses Incurred by the Transferor.

An acquisitive reorganization often involves the expenditure of funds by the transferor for such things as investment banking fees. At issue in *INDOPCO, Inc. v. Commissioner*ⁿ¹ was whether expenses incurred in a reorganization could be deducted by the acquired corporation under *IRC Section 162(a)*. The Supreme Court held they could not, but rather had to be capitalized under *IRC Section 263*. In so doing, the Court rejected the taxpayer's argument that capitalization was required only when the payments resulted in the creation of a separate and distinct additional asset. The applicable test for Justice Blackmun was whether the expenditure produced significant benefits to the taxpayer extending beyond the tax year in which they were incurred.

In *Wells Fargo & Co. v. Commissioner*ⁿ² the Eighth Circuit held that a portion of compensation paid to employees of a target corporation was a currently deductible expense.ⁿ³ The employees worked on various aspects of the transaction in which the corporation was acquired in a tax-free reorganization. None of the employees was hired specifically to render services on the transaction; all were hired to conduct the day-to-day business of the corporation. The court distinguished *INDOPCO* on the ground of the relationship of the expense at issue and the long-term benefit to be derived therefrom, finding that there was only an incidental benefit between the compensation (that originates in the employment relationship) and the acquisition (that provides the long-term benefit).

INDOPCO was distinguished in *Santa Fe Pacific Gold Co and Subs v Comm'r*,ⁿ⁴ where the Tax Court allowed the deduction of a \$65 million termination fee paid by the taxpayer to a "white knight" with which the taxpayer had entered into a merger agreement in an attempt to avoid a hostile takeover by a larger company. When the defensive action failed and the taxpayer finally succumbed to a merger with the larger company, it was required by the terms of its earlier merger agreement with the white knight to pay a termination fee. Unlike *INDOPCO*, the taxpayer's expenditure did not contribute to a restructuring of the company which produced benefits lasting beyond the taxable year. To the contrary, it was incurred as the result of taxpayer's unsuccessful attempt to prevent the restructuring, which taxpayer's management regarded as inconsistent with the company's best interests. Consequently, the termination fee was deductible by the taxpayer under either *IRC Section 162*, as an expenditure made to defend its business, or *IRC Section 165*, as a loss from an abandoned transaction (the white knight merger).ⁿ⁵

[5] Filing Requirements.

Every corporation that is a party to the reorganization is required to file with its return for the year in which the reorganization occurs a statement of all facts pertinent to nonrecognition treatment, including: (a) a copy of the plan of reorganization, with a statement, executed under penalties of perjury, showing in full the purposes of the reorganization and in detail all transactions incident to the plan; (b) a statement of the cost or other basis of all property, including

stock and securities, transferred incident to the plan; (c) a statement of the amount and fair market value (as of the date of exchange) of all stock, securities, and other property or money received and of all distributions or other dispositions thereof; and (d) a statement of the amount and nature of any liabilities assumed or to which any of the property received is subject.ⁿ¹

FOOTNOTES:

(n1)Footnote 1. *IRC § 361(b)(1), (2).*

(n2)Footnote 2. *IRC § 361(b)(3), (c)(3).* If a corporation to which assets are transferred in a Type "D" reorganization distributes its stock or securities in a tax-free divisive reorganization, *IRC § 361(b)(3)* applies only to the extent that the sum of money and the fair market value of other property transferred to the creditors does not exceed the adjusted bases of the transferred assets (reduced by the amount of liabilities assumed (within the meaning of *IRC § 357(c)*)).

(n3)Footnote 3. *IRC § 361(c)(2)(B).*

(n4)Footnote 4. *IRC § 361(c)(2)(A).* If property is distributed subject to a liability, or the shareholder assumes a liability of the distributing corporation in connection with the distribution, the fair market value of the distributed property can never be less than the amount of the liability. *IRC § 361(c)(2)(C).*

(n5)Footnote 5. *IRC § 361(c)(4).*

(n6)Footnote 6. *IRC § 367(a)(5).* See also *Prop Treas Reg § 1.367(a)-7*, which provides rules for *IRC § 367(a)(5).*

(n7)Footnote 1. The assumption of the transferor's liabilities by the acquiring corporation will be considered "boot" for basis purposes even though the general rule of *IRC § 357(a)* keeps it from being "boot" for gain recognition purposes. *IRC § 358(d).* A discussion of *IRC § 357* can be found at § 3.02[2][b][ii], *supra* .

(n8)Footnote 2. *IRC § 358(a)(2).*

(n9)Footnote 3. *IRC § 1223(1).*

(n10)Footnote 1. *112 S Ct 1039 (1992)* .

(n11)Footnote 2. *224 F3d 874 (8th Cir 2000)* .

(n12)Footnote 3. The deductible portion of the salaries paid related to the investigatory stage of the transaction. The Service takes the position that these are start-up costs that must be capitalized, but that can be amortized over 60 months if the taxpayer so elects under *IRC § 195. Rev Rul 99-23, 1999-1 CB 998* .

(n13)Footnote 4. *132 TC 240 (2009)* .

(n14)Footnote 5. See also *US v Federated Dept Stores, Inc, 171 Bankr 603 (SD Ohio 1994)* .

(n15)Footnote 1. *Treas Reg § 1.368-3(a).*



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CHAPTER 8 Reorganizations and Other Exchanges

1-8 Taxation of Securities Transactions § 8.05

§ 8.05

Effect of Reorganizations on the Transferee Corporation

[1] Nonrecognition of Gain or Loss.

Under *IRC Section 1032(a)*, no gain or loss is recognized by a corporation that exchanges its own stock, including treasury stock, for money or other property. Although the provision expressly refers to the issuance of the acquiring corporation's stock, the Service has stated that no gain or loss will be recognized by a subsidiary which uses its parent's stock as consideration for the acquisition.ⁿ¹

There is no statutory provision governing the consequence of the issuance of securities for property. However, it is now unquestioned that the corporation recognizes no gain or loss on such a transaction.

An acquiring corporation will be called upon to recognize any gain realized on the distribution of appreciated property as "boot." The earnings and profits of the corporation will be increased by the amount of recognized gain.ⁿ²

The regulations contain special rules for the disposition of stock or stock options in transactions in which a corporation or partnership (the acquiring entity) acquires money or other property in exchange, in whole or in part, for stock of a corporation (the issuing corporation).ⁿ³ These rules apply to transactions not qualifying under any other nonrecognition provision.

Generally, no gain or loss is recognized on the disposition of the issuing corporation's stock by the acquiring entity.ⁿ⁴ The transaction is treated as if, immediately before the acquiring entity disposes of the stock of the issuing corporation, the acquiring entity purchased the issuing corporation's stock from the issuing corporation for fair market value with cash contributed to the acquiring entity by the issuing corporation (or, if necessary, through intermediate corporations or partnerships). If the issuing corporation receives money or other property in payment for its stock, the amount of cash deemed contributed is the difference between the fair market value of the issuing corporation stock and the amount of money or the fair market value of other property received by the issuing corporation as payment.ⁿ⁵

The rules apply only if, pursuant to a plan to acquire money or other property, (1) the acquiring entity acquires stock of the issuing corporation directly or indirectly from the issuing corporation in a transaction in which, otherwise, the basis of the stock of the issuing corporation would be determined, in whole or in part, with respect to the issuing corporation's

basis in its stock under *IRC Section 362(a)* or 723 (provided that, in the case of an indirect acquisition by the acquiring entity, the transfers of stock through intermediate entities occur immediately after one another); (2) the acquiring entity immediately transfers the stock of the issuing corporation to acquire money or other property (from a person other than an entity from which the stock was directly or indirectly acquired); (3) the party receiving the stock of the issuing corporation from the acquiring entity does not receive a substituted basis in the stock of the issuing corporation; and (4) the issuing corporation stock is not exchanged for stock of the issuing corporation.ⁿ⁶

Example 1:

A Corp. owns all of the stock of B Corp. B Corp. enters into an agreement with X to acquire property from X in exchange for 10 shares of A Corp. stock worth \$1,000. A Corp. transfers the 10 shares of its stock to B Corp. in a transaction in which, normally, the basis of the A Corp. stock in the hands of B Corp. would be determined with respect to A Corp.'s basis in the stock under *IRC Section 362(a)*. B Corp. transfers the stock to X to acquire the property.

Because of the rules discussed above, no gain or loss is recognized on the disposition of the A Corp. stock by B Corp. Immediately before the disposition, B Corp. is treated as purchasing the stock from A Corp. for \$1,000 in cash contributed to B Corp. by A Corp. Under *IRC Section 358*, A Corp.'s basis in its B Corp. stock is increased by \$1,000.

The same result would obtain if, instead of transferring stock, A Corp. had transferred an option with a fair market of \$1,000 to purchase its stock.

Example 2:

Assume the same facts as in Example 1, except that B Corp. is a partner in a partnership, and that the partnership enters into the agreement with X. After the transfer of the A Corp. stock to B Corp., the latter transfers the stock to the partnership in a transaction in which, normally, the basis of the A Corp. stock in the hands of the partnership would be determined under *IRC Section 723*. The partnership then immediately transfers the shares to X.

Because of the above rules, no gain or loss is recognized on the disposition of the A Corp. stock by the partnership. Immediately before the partnership's disposition of the stock, it is treated as having purchased the stock from A Corp. for \$1,000 in cash indirectly contributed to the partnership by an intermediate corporation. Under *IRC Section 722*, B Corp.'s basis in its partnership interest is increased by \$1,000. In addition, under *IRC Section 358*, A Corp.'s basis in its B Corp. stock is increased by \$1,000.

[2] Basis and Holding Period.

The basis of property acquired by a corporation in connection with a reorganization will be the same basis that the property had in the hands of the transferor, increased by the amount of gain recognized by the transferor on the exchange.ⁿ¹ Thus, since gain will be recognized by the transferor only in the instance in which it receives "boot," the transferor's basis will never be stepped-up if the reorganization exchange is wholly tax-free to the transferor.ⁿ² The statute is applied literally--gain must be recognized by the transferor; the recognition of gain by a transferor corporation's shareholders on the distribution of "boot" received by the transferor corporation as part of the reorganization will not trigger an adjustment to the transferee's basis.ⁿ³

The substituted basis rule of *IRC Section 362(b)* is made inapplicable if the property acquired by the transferee consists of stock or securities in a corporation which is a party to the reorganization, unless the stock or securities are acquired in exchange for the stock or securities of the transferee or of a corporation which is in control of the transferee. It also will

be inapplicable if there is an importation of net built-in loss as part of the reorganization.ⁿ⁴

The transferee corporation's holding period for the acquired property will include the period during which the property was held by the transferor.ⁿ⁵ This will apply to all of the acquired property, not just to property which was a capital asset or *IRC Section 1231* property in the hands of the transferor.

[3] Filing Requirements.

The regulations do not impose different filing requirements for transferee corporations. The statement required of transferor corporations must be filed by transferees as well.ⁿ¹

FOOTNOTES:

(n1)Footnote 1. *Rev Rul 57-278, 1957-1 CB 124* .

(n2)Footnote 2. *Rev Rul 72-327, 1972-2 CB 197* .

(n3)Footnote 3. *Treas Reg § 1.1032-3(a)*. The rules apply to an option issued by a corporation to buy or sell its own stock in the same manner as they apply to the stock of an issuing corporation. *Treas Reg § 1.1032-3(d)*.

(n4)Footnote 4. *Treas Reg § 1.1032-3(b)(1)*.

(n5)Footnote 5. *Treas Reg § 1.1032-3(b)(2)*.

(n6)Footnote 6. *Treas Reg § 1.1032-3(d)*.

(n7)Footnote 1. *IRC § 362(b)*. In no event can the basis of property be increased above the fair market value of the property, determined without regard to *IRC § 7701(g)* (fair market value of property subject to a nonrecourse liability treated as not less than the amount of the debt). *IRC § 362(d)(1)*. If gain is recognized to the transferor as a result of an assumption of a nonrecourse liability that is also secured by assets that are not transferred to the transferee, and no person is subject to tax on the gain, the basis can be increased only by the ratable portion of the liability determined according to the relative fair market values of all assets subject to the liability. *IRC § 362(d)(2)*.

IRC § 362(b) has been applied in concert with *IRC § 1013* to give the acquiring corporation the transferor's basis for work-in-process inventory acquired in the transaction. *Arwood Corp v Commr, TC Memo 1971-2* .

IRC § 358(e) eliminates the possibility that *IRC § 358* can control the basis of the acquired property when the transferee corporation uses treasury stock rather than newly issued stock as consideration for the acquisition.

(n8)Footnote 2. Because the increase in basis is tied to recognized gain and not the receipt of "boot" by the transferor, there will be no adjustment to basis if the transferor receives "boot" but sustains a loss on the exchange.

(n9)Footnote 3. *Schweitzer & Conrad, Inc v Commr, 41 BTA 533 (1940)* . The transferor corporation will avoid recognition of gain only when the distribution of "boot" received by it is "in pursuance of the plan of reorganization." *IRC § 361(b)(1)(A)*.

(n10)Footnote 4. *IRC § 362(e)(1)*, discussed in § 3.05[2].

(n11)Footnote 5. *IRC § 1223(2)*.

(n12)Footnote 1. See § 8.04[4].



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CHAPTER 8 Reorganizations and Other Exchanges

1-8 Taxation of Securities Transactions § 8.05A

§ 8.05A Triangular Reorganizations

A triangular reorganization is a reorganization involving a parent corporation (*P*), its controlled corporation (*S*), and a third corporation (*T*), in which the stock of *P* is transferred pursuant to the reorganization.ⁿ¹ This section will consider gain and loss and basis issues that arise in the following types of transactions:

- (1) *Forward triangular merger.* A forward triangular merger is a statutory merger of *T* and *S*, with *S* surviving, that qualifies as a reorganization under *IRC Section 368(a)(1)(A)* or *(G)* by reason of the application of *IRC Section 368(a)(2)(D)*.ⁿ²
- (2) *Triangular C reorganization.* A triangular C reorganization is an acquisition by *S* of substantially all of *T*'s assets in exchange for *P* stock in a transaction that qualifies as a reorganization under *IRC Section 368(a)(1)(C)*.ⁿ³
- (3) *Reverse triangular merger.* A reverse triangular merger is a statutory merger of *S* and *T*, with *T* surviving, that qualifies as a reorganization under *IRC Section 368(a)(1)(A)* by reason of the application of *IRC Section 368(a)(2)(E)*.ⁿ⁴
- (4) *Triangular B reorganization.* A triangular B reorganization is an acquisition by *S* of *T* stock in a transaction that qualifies as a reorganization under *IRC Section 368(a)(1)(B)*.ⁿ⁵

[1] Gain or Loss on the Exchange of Parent Corporation Stock in a Triangular Reorganization.

In the case of a forward triangular merger, a triangular C reorganization, or a triangular B reorganization, *P* stock provided by *P* to *S* (or directly to *T* or *T*'s shareholders on behalf of *S*), pursuant to the plan of reorganization, is treated as a disposition by *P* of shares of its own stock for *T*'s assets or stock, as applicable.ⁿ¹ This means that, under *IRC Section 1032(a)*, *P* will recognize neither gain nor loss on the transaction. If the transaction is a reverse triangular merger, nonrecognition for *P* is found in *IRC Section 361*.

S must recognize gain or loss on its exchange of *P* stock as consideration in a forward triangular merger, a triangular C reorganization, or a triangular B reorganization, if *S* did not receive the *P* stock from *P* pursuant to the plan of reorganization.ⁿ² This rule does not apply in the case of a reverse triangular merger; *IRC Section 361* provides

nonrecognition treatment for *S*'s use of *P* stock in that instance.

An indirect transfer occurs if a United States person exchanges stock or securities of a corporation (the acquired corporation) for stock or securities of a foreign corporation that controls the acquiring corporation in a triangular merger or triangular B reorganization.ⁿ³ This will require gain recognition by the United States person under *IRC Section 367(a)*.ⁿ⁴

[2] Basis of Stock Held by a Parent Corporation in a Triangular Reorganization.

Regulations Section 1.358-6 uses an over-the-top method to determine *P*'s basis in the stock of its subsidiary (*S* or *T*, as the case may be) following a triangular reorganization. The following rules apply:

(1) Forward triangular merger--In such a merger, *P*'s basis in its *S* stock is adjusted as if (a) *P* acquired the *T* assets acquired by *S* (and *P* assumed any liabilities that *S* assumed or to which the acquired *T* assets were subject) directly from *T* in a transaction in which *P*'s basis in the *T* assets was determined under *IRC Section 362*, and (b) *P* transferred those *T* assets (and liabilities) to *S* in a transaction in which *P*'s basis in *S* stock was determined under *IRC Section 358*.ⁿ¹

(2) Triangular C reorganization--The basis of *P*'s *S* stock is determined in the same manner as in the case of a forward triangular merger.ⁿ²

(3) Reverse triangular merger--Generally, *P*'s basis in the *T* stock acquired in the reverse triangular merger equals its basis in its *S* stock before the transaction adjusted as if *T* had merged into *S* in a forward triangular merger.ⁿ³ If *P* acquires less than all of the *T* stock in the transaction, the basis adjustment is reduced in proportion to the percentage of *T* stock not acquired.ⁿ⁴ If *P* owns *T* stock before the transaction, *P* can treat that stock as acquired in the transaction or not, without regard to the form of the transaction.ⁿ⁵

If a reorganization qualifies as both a reverse triangular merger and a transfer to a controlled corporation governed by *IRC Section 351*, or both as a reverse triangular merger and a reorganization governed under *IRC Section 368(a)(1)(B)* (exchange of stock for voting stock), *P* can (a) determine the basis in its *T* stock under the general rule applicable to reverse triangular mergers, or (b) determine its basis in the *T* stock as if *P* acquired the *T* stock from the former *T* shareholders in a transaction in which *P*'s basis in the *T* stock was determined under *IRC Section 362(b)*.ⁿ⁶

(4) Triangular B reorganization--In a triangular B reorganization, *P*'s basis in its *S* stock is adjusted as if (i) *P* acquired the *T* stock (actually acquired by *S*) directly from the *T* shareholders in a transaction in which *P*'s basis in the *T* stock was determined under *IRC Section 362(b)*; and (ii) *P* transferred the *T* stock to *S* in a transaction in which *P*'s basis in the stock was determined under *IRC Section 358*.ⁿ⁷

The amount of any adjustment to *P*'s basis in its *S* or *T* stock, described above, is decreased by the fair market value of any consideration (including *P* stock in which gain or loss is recognized) that is exchanged in the reorganization and that is not provided by *P* pursuant to the plan of reorganization.ⁿ⁸ There is no adjustment at all to *P*'s basis if the decrease equals or exceeds the amount of the adjustment prescribed when *P* furnishes all of the consideration.ⁿ⁹

The following examples illustrate the foregoing rules:ⁿ¹⁰

Example 1:

T has assets with an aggregate basis of \$1,200,000 and a fair market value of \$2 million, and no

liabilities. Pursuant to a plan, *P* forms *S* with cash of \$100,000 (that *S* retains), and *T* merges into *S*, with the former *T* shareholders receiving *P* stock worth \$2 million in exchange for their *T* stock. The transaction is a forward triangular merger.

In order to determine *P*'s basis in its *S* stock as a result of the reorganization, *P*'s \$100,000 basis in its *S* stock is adjusted as if *P* acquired the *T* assets directly from *T* in a transaction in which *P*'s basis in the *T* assets was determined under *IRC Section 362(b)*. Under that provision, *P* would have an aggregate basis of \$1,200,000 in the *T* assets. *P* is then treated as if it transferred the *T* assets to *S* in a transaction in which *P*'s basis in the *S* stock was determined under *IRC Section 358*. This requires an increase in the basis of its *S* stock by the \$1,200,000 basis in the *T* assets deemed transferred, giving *P* a \$1,300,000 basis in its *S* stock.

Example 2:

The facts are the same as in Example 1, except that *T*'s assets are subject to \$1 million of liabilities and the *T* shareholders receive \$1 million of *P* stock in exchange for their *T* stock. *P*'s basis in its *S* stock is first increased by the \$1,200,000 basis in the assets deemed transferred and then decreased by the \$1 million of liabilities to which the assets are subject, yielding a net basis adjustment of \$200,000, and a \$300,000 basis for *P* in its *S* stock.

Example 3:

Assume the same facts as in Example 1, except that *T*'s assets are subject to liabilities of \$1,800,000 and the *T* shareholders receive \$200,000 of *P* stock in exchange for their *T* shares. Because the liabilities to which the *T* assets acquired by *S* are subject exceed the aggregate adjusted basis in those assets, *P* has no adjustment in its *S* stock as a result of the reorganization.

Example 4:

T has assets with an aggregate basis of \$1,200,000 and a fair market value of \$2 million, and no liabilities. *P* has a \$2,200,000 basis in its *S* stock. Pursuant to a plan, *S* merges into *T* with *T* surviving. In the merger, the *T* shareholders receive \$1,800,000 of *P* voting stock and \$200,000 in exchange for their *T* stock. The transaction is a reverse triangular merger.

P's basis in the *T* stock acquired in the merger is *P*'s \$2,200,000 basis in its *S* stock before the transaction, adjusted as if *T* had merged into *S* in a forward triangular merger. In such case, *P*'s basis in its *S* stock would have been increased by \$1,200,000, the basis of the *T* assets deemed transferred. This results in *P* having a basis of \$3,400,000 in its *T* stock immediately after the transaction.

Example 5:

Assume the same facts as in Example 4, except that *P* forms *S* pursuant to the plan of reorganization and the *T* shareholders receive \$2 million of *P* voting stock in exchange for their *T* stock in which they have a basis of \$1,700,000. The reorganization qualifies both as a reverse triangular merger and a reorganization under *IRC Section 368(a)(1)(B)* (stock-for-stock exchange).

P can determine its basis as if the transaction was a reverse triangular merger (in which case the basis would be \$1,200,000, *T*'s net asset basis), or as if *P* acquired the *T* stock from the former *T* shareholders in a transaction in which *P*'s basis in the *T* stock was determined under *IRC Section 362(b)* (in which case the basis would be \$1,700,000, the *T* shareholders' aggregate basis in the *T* stock immediately before the reorganization).

Example 6:

The facts are the same as in Example 4, except that a 10 percent shareholder of *T* does not participate in the transaction. The remaining *T* shareholders receive \$200,000 cash from *P* and *P* stock worth \$1,600,000 for their *T* stock. The \$1,200,000 basis adjustment determined in Example 4 must be reduced in proportion to the percentage of *T* stock not acquired in the transaction (10 percent), resulting in a net adjustment of \$1,080,000 and a basis of \$3,280,000 for the *T* stock acquired by *P* in the transaction.

Example 7:

The facts are the same as in Example 4, except that *P* owns 10 percent of the *T* stock, with a basis of \$160,000, before the transaction. All *T* shareholders, other than *P*, surrender their *T* stock for \$200,000 cash and *P* stock worth \$1,600,000. *P* can treat its *T* stock owned before the transaction as acquired in the transaction or not. If *P* treats that *T* stock as acquired in the transaction, *P*'s basis in all of its *T* stock will be adjusted as in Example 4. If *P* treats its *T* stock as not acquired in the transaction, *P* retains its \$160,000 basis in that stock and determines its basis in the *T* shares actually acquired in the same manner as in Example 6.

Example 8:

T has assets with a fair market value of \$2 million and no liabilities. The *T* shareholders have an aggregate basis in their *T* stock of \$1,700,000 immediately before the reorganization. Pursuant to a plan of reorganization, *P* forms *S* with \$100,000 cash and *S* acquires all of the *T* stock in exchange for *P* voting stock worth \$2 million. The transaction is a reorganization to which *IRC Section 368(a)(1)(B)* applies.

P's \$100,000 basis in its *S* stock is adjusted by treating *P* as if it acquired the *T* stock acquired by *S* directly from the *T* shareholders in exchange for the *P* stock in a transaction in which *P*'s basis in the *T* stock was determined under *IRC Section 362(b)*, that is, *P* would have an aggregate basis of \$1,700,000 in the *T* stock acquired by *S* in the reorganization. *P* is then treated as if it transferred the *T* stock to *S* in a transaction in which *P*'s basis in the *S* stock was determined under *IRC Section 358*. This increases *P*'s basis in its *S* stock by the \$1,700,000 basis in the *T* stock deemed transferred, resulting in *P* having a basis of \$1,800,000 in its *S* stock after the transaction.

Example 9:

T has assets with an aggregate basis of \$1,200,000 and fair market value of \$2 million and no liabilities. *S* is an operating company with substantial assets that has been in existence for several years. *P* has a \$2 million basis in its *S* stock. Pursuant to a plan of reorganization, *T* merges into *S* and, in exchange for their *T* stock, the *T* shareholders receive \$1,400,000 of *P* stock provided by *P* pursuant to the plan and \$600,000 cash provided by *S*. The transaction is a forward triangular merger.

P's \$2 million basis in its *S* stock is increased by the \$1,200,000 basis in the *T* assets deemed transferred and then decreased by the \$600,000 of cash provided by *S* in the reorganization. Thus, *P* has a net adjustment of \$600,000 in its *S* stock, giving *P* a \$2,600,000 basis in its *S* stock.

Example 10:

Assume the same facts as in Example 9, except that the consideration furnished by *S* consists of an asset with an adjusted basis of \$400,000 and a fair market value of \$600,000. *P*'s adjusted basis is the same as in Example 9, but *S* recognizes \$200,000 of gain under *IRC Section 1001* on the disposition of the asset in the reorganization. If *S* had furnished an asset with a basis of \$1,200,000 and a fair market value of \$600,000, *S* would recognize a \$600,000 loss under *IRC Section 1001*. *P*'s basis adjustment would remain the same.

Example 11:

Assume the same facts as in Example 9, except that the consideration furnished by *S* consists of *P* stock worth \$600,000 acquired by *S* in an unrelated transaction several years before the reorganization. *S* has an adjusted basis of \$400,000 in the *P* stock. *P*'s basis adjustment is the same as in Example 9; *S* recognized \$200,000 of gain on the disposition of *P* stock under *Regulations Section 1.1032-2(c)*.

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.358-6(b)(1)*.

(n2)Footnote 2. *Treas Reg § 1.358-6(b)(2)(i)*. *P*'s transfer of the acquiring corporation's stock to another subsidiary controlled by *P* as part of the plan of reorganization, following the merger of *T* with and into *S*, will not prevent the transaction from qualifying as a forward triangular merger. *Rev Rul 2001-24, 2001-1 CB 1290*.

(n3)Footnote 3. *Treas Reg § 1.358-6(b)(2)(ii)*.

(n4)Footnote 4. *Treas Reg § 1.358-6(b)(iii)*. A merger qualifies as a tax-free reverse triangular merger even though the surviving corporation sells a portion of its assets to an unrelated party immediately after the merger pursuant to the plan of reorganization. *Rev Rul 2001-25, 2001-1 CB 1291*. In the fact pattern set forth in the ruling, *T* sold 50 percent of its operating assets following the merger, but continued to hold the sale proceeds.

The Service has ruled that the control-for-voting-stock requirement of a reverse triangular merger was satisfied when *P* received 51 percent of *T*'s stock in a tender offer and *S* then merged into *T* with the remaining *T* shareholders receiving cash and *P* stock for their *T* shares. *Rev Rul 2001-26, 2001-1 CB 1297*.

An acquiring corporation formed a subsidiary that merged into a target with the target surviving. After the target's shareholders received the acquiring corporation's stock for their target stock, there was an upstream merger of the target into the acquiring corporation. The acquisition and upstream merger were treated as steps in an integrated plan resulting in a statutory merger of the target into the acquiring corporation. *Ltr Rul 200145039*.

An acquiring corporation's transfer of the target corporation's assets to a subsidiary controlled by the acquiring corporation as part of a plan of reorganization will not prevent a transaction that otherwise qualifies as a reorganization under *IRC § 368(a)(1)(D)* from so qualifying. *Rev Rul 2002-85, 2002-2 CB 986*. The Service will amend *Treas Reg § 1.367(a)-3(d)* to provide specifically that a reorganization under *IRC § 368(a)(1)(D)* followed by a transfer of all or part of a target corporation's assets to a controlled subsidiary pursuant to a plan of reorganization constitutes an indirect transfer of securities for purposes of *Treas Reg § 1.367(a)-3*. *Notice 2002-77, 2002-2 CB 997*.

(n5)Footnote 5. *Treas Reg § 1.358-6(b)(2)(iv)*.

(n6)Footnote 1. *Treas Reg § 1.1032-2(b)*. The rules applicable to *P* stock apply to an option to buy or sell *P* stock issued by *P*. *Treas Reg § 1.1032-2(e)*, effective for transfers of stock options occurring on or after May 16, 2000.

(n7)Footnote 2. *Treas Reg § 1.1032-2(c)*.

(n8)Footnote 3. *Treas Reg § 1.367(a)-3(d)(1)(i), (ii), (iii)*.

(n9)Footnote 4. *Treas Reg § 1.367(a)-3(a)*.

(n10)Footnote 1. *Treas Reg § 1.358-6(c)(1)(i)*. If, in applying *IRC § 358*, the amount of *T* liabilities assumed or to which the acquired *T* assets are subject equals or exceeds *T*'s aggregate adjusted basis in its assets, the amount of the adjustment is zero. *P* recognizes no gain under *IRC § 357(c)* as a result of the triangular reorganization.

(n11)Footnote 2. *Treas Reg § 1.358-6(c)(1)(i)*.

(n12)Footnote 3. *Treas Reg § 1.358-6(c)(2)(i)(A)*.

(n13)Footnote 4. *Treas Reg § 1.358-6(c)(2)(i)(B)*. The percentage of *T* stock not acquired in the transaction is determined by taking into account the fair market value of all classes of *T* stock. *Treas Reg § 1.358-6(c)(2)(i)(A)*.

(n14)Footnote 5. *Treas Reg § 1.358-6(c)(2)(i)(C)*.

(n15)Footnote 6. *Treas Reg § 1.358-6(c)(2)(ii)*.

(n16)Footnote 7. *Treas Reg § 1.358-6(c)(3)*.

(n17)Footnote 8. *Treas Reg § 1.358-6(d)(1)*. The provision does not apply to the amount of *T* liabilities assumed by *S* or to which the *T* assets acquired by *S* are subject. *Id.*

(n18)Footnote 9. *Treas Reg § 1.358-6(d)(2)*.

(n19)Footnote 10. All of the examples assume that (a) *P*, *S*, and *T* are domestic corporations, (b) *P* owns all of the only class of *S* stock outstanding, and (c) *P* and *S* do not file consolidated returns.



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Taxation of Securities Transactions

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CHAPTER 8 Reorganizations and Other Exchanges

1-8 Taxation of Securities Transactions § 8.06

§ 8.06 Divisive Reorganizations

[1] Introduction.

The preceding sections of this chapter have been devoted to the tax consequences of exchanges of stock or securities made in connection with acquisitive reorganizations. The focus in this section will be upon the effect which a divisive reorganization, a distribution which separates an existing business from the distributing corporation, has on shareholders and security holders.

A divisive reorganization may take one of three forms: (1) a spin-off, the distribution by a corporation to its shareholders of the stock of a subsidiary corporation without the surrender by the shareholders of any of their stock in the parent; (2) a split-off, the distribution by a parent corporation of stock in its subsidiary in exchange for some of the stock of the parent; or (3) a split-up, the distribution of stock in two or more corporations in return for all of the stock of the distributing corporation. Under the 1939 Code, the tax consequences of a corporate division depended on the method used to achieve the separation; under the present Code, the form of the division is not determinative of the result.ⁿ¹

[2] Effect on Distributees.

[a] Nonrecognition of Gain or Loss.

IRC Section 355 provides for the tax-free distribution of stock or securities in a corporation controlled by the distributing corporation immediately before the distribution,ⁿ¹ provided certain conditions are satisfied.ⁿ²

[i] The "Device" Rule. The distribution must not be used principally as a device for the distribution of earnings and profits (of either the distributing corporation or the controlled corporation).ⁿ³ The mere fact that stock or securities in the distributing corporation or the controlled corporation are sold following the distribution will not be construed to mean that the transaction is being used principally as a bail-out device.ⁿ⁴ However, a sale made pursuant to an arrangement negotiated or agreed upon prior to the distribution is strong evidence of an attempt to distribute earnings and profits, a sale that is not prearranged is only evidence of a device.ⁿ⁵

The regulations list two other factors that are evidence of a device. The first is a distribution that is pro rata or substantially pro rata among the shareholders of the distributing corporation.ⁿ⁶ The second takes into account the

nature, kind, amount, and use of the assets of the distributing and controlled corporations immediately after the transaction. The existence of assets that are not used in a trade or business that satisfies the active business requirement (for example, excess cash or liquid assets) is evidence of a device.ⁿ⁷ There is also such evidence if the business of either the distributing corporation or the controlled corporation is a "secondary business" that continues as such for a significant period of time and can be sold without adversely affecting the business of the other corporation.ⁿ⁸

The regulations also set forth three nondevice factors, namely, (1) a corporate business purpose for the transaction, (2) a distributing corporation that is publicly traded and has no shareholder who is directly or indirectly the beneficial owner of more than 5 percent of any class of stock, and (3) shareholders that are domestic corporations so that, if the transaction were not governed by *IRC Section 355*, the distributee would be entitled to a dividends received deduction.ⁿ⁹

The requirement, judicially originated,ⁿ¹⁰ but now part of the Regulations, that the distribution be in furtherance of a business purpose is designed to provide nonrecognition treatment only to distributions that are incident to readjustments of corporate structures required by business exigencies.ⁿ¹¹ The purpose must be a corporate business purpose, that is, a real and substantial nonfederal tax purpose.ⁿ¹² It is important to note that the business purpose requirement extends to the distribution. If a corporate business purpose can be carried out through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation, and that is neither impractical nor unduly expensive, the separation is not carried out for that business purpose.ⁿ¹³

The role of business purpose in corporate separations can be illustrated by comparing two situations presented in *Revenue Ruling 69-460*.ⁿ¹⁴ In the first, key employees desired to purchase stock in the distributing corporation. However, the purchase of such stock interest would have been expensive due to the inclusion of the controlled corporation's stock in the assets of the distributing corporation. Furthermore, the distributing corporation was not desirous of giving its employees any interest in the controlled corporation. By distributing stock in the controlled corporation to the shareholders of the distributing corporation, the sale of an interest in the distributing corporation became feasible. Thus, the distribution furthered a business purpose of the corporation. In the second situation, the sale to the key employee was of stock in the controlled corporation rather than in the distributing corporation. Since the sale could have been accomplished without any distribution of the controlled corporation's stock, the Service held that the distribution of that corporation's stock to the sole stockholder of the parent corporation was not undertaken for valid business reasons.

A final requirement, independent but related to the device rule, calls for a continuity of interest on the part of one or more persons who were owners of the enterprise prior to the transaction. In this context, those owners must own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified forms in which the enterprise is conducted after the separation.ⁿ¹⁵

[ii] The Active Business Requirement. Immediately following the distribution, both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business; but if immediately prior to the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations, then the Code requires that each of the controlled corporations be engaged in the active conduct of a trade or business immediately after the transaction.ⁿ¹⁶

A corporation will be considered to be engaged in the active conduct of a trade or business only if (1) it actively conducts the trade or business itself or substantially all of its assets consist of stock and securities in a controlled corporation which is so engaged;ⁿ¹⁷ (2) the trade or business has been actively conducted throughout the five-year period ending on the date of distribution; (3) the trade or business was not acquired during such five-year period in a transaction in which gain or loss was recognized to any extent; and (4) control of a corporation that (at the time of acquisition of control) was conducting the trade or business was not acquired by a distributee corporation or by the distributing corporation, directly or indirectly, within the five-year period, or if control was so acquired, in each instance

it was acquired only in nonrecognition transactions or by reason of such transactions combined with acquisitions before the five-year period.ⁿ¹⁸ For purposes of the last requirement, all distributee corporations that are members of the same affiliated group are treated as one distributee corporation.ⁿ¹⁹

IRC Section 355(b)(3)(A), applicable to distributions made after May 17, 2006, provides that a corporation is treated as meeting the active business requirement only if the corporation is engaged in the active conduct of a trade or business.^{n19.1} All members of the corporation's separate affiliated group are treated as one corporation.^{n19.2}

The regulations provide that a trade or business consists of a specific group of activities carried on for the purpose of earning income or profit from only such group of activities and that the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. The holding of investment property and the ownership of real property all or substantially all of which is used by the owner in the operation of a trade or business are excluded from the category of trade or business.ⁿ²⁰ At one time groups of activities which form a part of a business operated for profit, but do not themselves independently produce income were once considered not to be a trade or business. Although the Regulations no longer decree this as part of the active business requirement, such activities may constitute a secondary business as defined by the device rule.

[iii] The Distribution Requirement. The distributing corporation must either (a) distribute all of the stock and securities in the controlled corporation held by it immediately before the distribution, or (b) distribute at least 80 percent of the voting stock and at least 80 percent of the total number of shares of all other classes of stock of the controlled corporation, and establish to the satisfaction of the Service that the retention of stock or securities in the controlled corporation was not in pursuance of a plan of tax avoidance.ⁿ²¹

For purposes of determining the tax treatment of transfers of property to the controlled corporation by the distributing corporation, the fact that shareholders of the distributing corporation dispose of part or all of the distributed stock, or that the corporation whose stock was distributed issues additional stock, shall not be taken into account in determining control.ⁿ²²

Because the distribution must divest the distributing corporation of its control of the controlled corporation, a transfer of less than a controlling interest will disqualify the transaction, unless the transfer can be identified as a first step in a planned divestiture of control under a binding commitment to take all steps necessary to distribute control.ⁿ²³ However, it has been suggested that *IRC Section 355* would apply where control is distributed through multiple distributions actually taking place within a short period of time such as twelve months, even though the corporation is not under a binding obligation to distribute control.ⁿ²⁴

A distribution meeting the above requirements ("device" rule, active business requirement, and distribution requirement) will qualify for nonrecognition treatment whether or not it is pro rata with respect to all of the shareholders of the distributing corporation.ⁿ²⁵ Furthermore, although many corporate separations follow a "D" reorganization (the transfer of property to a corporation controlled after the transfer by the transferor corporation or its shareholders), the distribution need not be part of a reorganization, thereby permitting the tax-free distribution of stock or securities in an existing controlled corporation.ⁿ²⁶

[b] Limitations on Nonrecognition. *IRC Section 355(a)(3)(A)* restricts the scope of Section 355(a)(1) by making the latter provision inapplicable if the distribution consists of securities in the controlled corporation and such securities are in a principal amount greater than the principal amount of the securities surrendered by the taxpayer, or if securities are received and none are surrendered. In addition, under Section 355(a)(3)(B), any stock of the controlled corporation acquired by "the distributing corporation in a taxable transaction occurring within five years of the distribution will not be treated as stock, but as other property." The term "stock" as used in the previous sentence means stock interest and not merely stock certificate. Thus, a corporation that acquired stock in a controlled corporation in a taxable transaction occurring within five years of the distribution was held to have distributed other property, even though, prior to the

distribution and as part of a tax-free recapitalization, it had exchanged the acquired shares for the shares ultimately distributed.ⁿ²⁷

A further exception precludes nonrecognition treatment to the extent that any stock (including nonqualified preferred stock, as defined in *IRC Section 351(g)(2)*), securities, or other property received is attributable to interest that accrued on securities on or after the beginning of the holder's holding period.ⁿ²⁸ In addition, the amount so excluded is treated as interest income and not "boot," so that the amount must be taken into income even though no gain is realized on the transaction as a whole.ⁿ²⁹ Nonqualified preferred stock (as defined in *IRC Section 351(g)(2)*) received in a distribution with respect to stock other than nonqualified stock (as so defined) is not treated as stock or securities.ⁿ³⁰

For purposes of *IRC Section 355(a)(3)(D)*, preferred stock is qualified preferred stock, even though it is described in *IRC Section 351(g)(2)*, if it is received in exchange for, or in a distribution with respect to, preferred stock (the original preferred stock) that is qualified preferred stock, provided (i) (a) the original stock is qualified preferred stock solely because, on its issue date, either a right or obligation described in *IRC Section 351(g)(2)(A)(i)-(iii)* was not exercisable until after a 20-year period beginning on the issue date, or (b) the right or obligation was exercisable within the 20-year period but was subject to a contingency which made remote the likelihood of the redemption or purchase, or (c) the issuer's (or a related party's) right to redeem or purchase the stock was not likely to be exercised within the 20-year period, or (d) because of any combination of these reasons; and (ii) the stock received is substantially identical to the original preferred stock.ⁿ³¹ The stock received will continue to be treated as qualified preferred stock in subsequent transactions involving the stock.ⁿ³²

Stock is substantially identical to the original preferred stock if (i) the stock received does not contain any terms that, in relation to the terms of the original preferred stock, either decrease the period in which a right or obligation described in *IRC Section 351(g)(2)(A)(iii)* can be exercised, or increase the likelihood that the right or obligation will be exercised, or accelerate the timing of the returns from the stock, including the timing of actual or deemed dividends or other distribution received on the stock; and (ii) as a result of the exchange or distribution, exercise of the right or obligation does not become more likely than not to occur within the 20-year period beginning on the issue date of the original preferred stock.ⁿ³³

Preferred stock containing a right or obligation described in *IRC Section 351(g)(2)(B)(i)-(iii)* that is exercisable only upon the holder's separation from service from the issuer or a related person will be treated as transferred in connection with the performance of services, if the stock is received in exchange for, or in a distribution with respect to, existing stock containing a similar right or obligation that was issued in exchange for services.ⁿ³⁴ In applying the rules relating to nonqualified preferred stock, the preferred stock received will continue to be treated as transferred in connection with the performance of services in subsequent transactions involving the stock.

[c] Receipt of "Boot."

[i] Extent and Character of Recognized Gain. Although the tax-free character of a divisive reorganization is seemingly predicated on the distribution of "solely stock or securities," the receipt of other property in connection with the distribution is not a complete bar to nonrecognition. If the corporate separation involves a surrender of stock by the distributee (a split-off or split-up), *IRC Section 356(a)(1)* will operate to limit the recognized gain to the amount of money and the fair market value of other property received by the distributee.ⁿ³⁵ The character of the recognized gain will turn on whether the exchange has the effect of the distribution of a dividend, and if it does, then the taxpayer will be called upon to treat as a dividend so much of his *recognized* gain as is equal to his ratable share of the corporation's *accumulated* earnings and profits.ⁿ³⁶ But if the transaction is a spin-off where no stock is surrendered, then no matter whether gain or loss is *realized* on the distribution, the amount of cash and the value of other property received will be considered an *IRC Section 301* distribution, causing dividend consequences to attach to the extent of the corporation's *current and accumulated* earnings and profits.ⁿ³⁷

[ii] Securities as Other Property. The distributee in an *IRC Section 355* transaction will be the recipient of "boot" if he receives securities in the controlled corporation and either (1) he does not surrender securities in the distributing corporation, or (2) he surrenders securities in the distributing corporation, but the principal amount of the securities received exceeds the principal amount of the securities surrendered.ⁿ³⁸ The amount of "boot" when securities are received and none are surrendered is equal to the fair market value of the securities received;ⁿ³⁹ the fair market value of the excess principal amount will constitute the other property received when securities are surrendered and securities in a greater principal amount are received.ⁿ⁴⁰

[d] Basis and Holding Period. The basis of property received in an *IRC Section 355* distribution is governed by *IRC Section 358*, the operation of which has been examined previously in connection with incorporating exchanges under *IRC Section 351*ⁿ⁴¹ and reorganization exchanges under *IRC Section 354*.ⁿ⁴² Nonrecognition property (stock, and securities which are not treated as other property by *IRC Section 356(d)*) assumes a basis equal to the basis of the stock or securities with respect to which the distribution is made, with an adjustment downward in the amount of "boot" received and upward in the amount of gain recognized (including the amount of such gain treated as a dividend).ⁿ⁴³ If the transaction is a split-up, where the distributee exchanges all of his stock or securities in the distributing corporation for stock or securities in the controlled corporations, the basis determined under *IRC Section 358(a)* must be allocated among the stock and securities permitted to be received tax-free in proportion to their respective fair market values.ⁿ⁴⁴ Allocation is also mandated when the distribution takes the form of a split-off or spin-off, but here the allocation must take into account not only the stock or securities received, but also those of the distributing corporation which are retained.ⁿ⁴⁵ Property constituting "boot" will always take a basis equal to its fair market value.ⁿ⁴⁶

If a shareholder or security holder receives shares of stock or securities of more than one class, or receives "boot" in addition, then, to the extent the terms of the distribution specify that shares of stock or securities of a particular class or "boot" is received with respect to a particular share of stock or security or a particular class of stock or securities of the distributing corporation, the terms shall control the allocation of basis if they are economically reasonable.ⁿ⁴⁷ If such terms do not exist, a pro rata portion of the shares of stock and securities of each class received and a pro rata portion of the boot is treated as received with respect to each share of stock and security of the distributing corporation with respect to which the distribution is made, based on the fair market value of each share of stock or security.ⁿ⁴⁸

If a share of stock or security is received in exchange for, or with respect to, more than one share of stock or security and such shares or securities were acquired on different dates or at different prices, the share of stock or security received shall be divided into segments based on the relative fair market values of the shares of stock or securities surrendered in exchange for the share or security or the relative fair market values of the shares or securities with respect to which the share or security is received in a distribution.ⁿ⁴⁹

If a shareholder or security holder that acquired shares or securities on different dates or at different prices exchanges the shares or securities, or receives a distribution of shares or securities, and is not able to identify which particular share of stock is received in exchange for, or in respect to, a particular share of stock or security, the shareholder or security holder may designate which share of stock or security is received in exchange for, or with respect to, a particular share of stock or security, provided the designation is consistent with the terms of the exchange or distribution.ⁿ⁵⁰ The designation must be made on or before the first date on which the basis of a share of stock or a security of the distributing corporation or the controlled corporation is relevant, as when the shares or securities are sold or otherwise transferred.ⁿ⁵¹ If the designation is not made in a case in which the shareholder is unable to identify which share of stock is received in exchange for, or in respect to, a particular share of stock, the shareholder will be treated as selling or transferring the share received in respect of the earliest share purchased or acquired.ⁿ⁵²

As a general rule, the period for which the taxpayer held the stock or securities surrendered in a split-off or split-up, or for which he held the shares retained in a spin-off, will be added to the holding period of the stock and securities received tax-free in the distribution.ⁿ⁵³ The holding period of any other property received in the distribution will start with its acquisition.

[3] Effect on the Distributing Corporation.**[a] Gain or Loss.**

As a general rule, a distribution of stock or securities in the controlled corporation ("qualified property") as part of a corporate division does not require the recognition of gain or loss by the distributing corporation.ⁿ¹ A distribution of appreciated property other than stock or securities in the controlled corporation ("disqualified property") results in the recognition of gain by the distributing corporation; no loss is recognized if the disqualified property has a value less than basis.ⁿ²

Recognition of corporate-level gain (but not shareholder gain) will be required for any "disqualified distribution" of stock or securities in the controlled corporation made after October 9, 1990.ⁿ³ An *IRC Section 355* distribution is a disqualified distribution if, immediately after the distribution, any person holds "disqualified stock" in either the distributing corporation or any distributed controlled corporation constituting a 50-percent or greater interest in such corporation.ⁿ⁴ Under the regulations, a distribution is not a disqualified distribution if the distribution does not violate the purposes of *IRC Section 355(d)*, namely, the effect of the distribution is neither to increase ownership (combined direct and indirect) in the distributing corporation or any controlled corporation by a disqualified person, nor to provide a disqualified person with a purchased basis in the stock of any controlled corporation.ⁿ⁵

A person has a 50-percent or greater interest in the distributing corporation or any controlled corporation if that person owns stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of all shares entitled to vote.ⁿ⁶ Related persons (determined under the rules contained in *IRC Sections 267(b)* and *707(b)(1)*) are treated as one person, as are two or more persons acting pursuant to a plan or arrangement with respect to acquisitions of stock or securities in the distributing or controlled corporation.ⁿ⁷ In addition, the entity-shareholder attribution rules of *IRC Section 318(a)(2)* apply, with the ownership threshold reduced from 50 percent to 10 percent, and with the rules also applied to attribute ownership of securities held by the entity to the shareholder.ⁿ⁸

Stock in the distributing corporation or any controlled corporation is disqualified stock if acquired by purchase after October 9, 1990, and during the five-year period ending on the date of distribution.ⁿ⁹ Stock in any controlled corporation is also disqualified stock if received in the distribution, to the extent attributable to stock or securities in the distributing corporation acquired during the same five-year period.ⁿ¹⁰ The running of the five-year period is suspended for any period during which the holder's risk of loss with respect to stock or securities, or with respect to any portion of the activities of the corporation, is (directly or indirectly) substantially diminished by an option, a short sale, any special class or stock, or any other device or transaction.ⁿ¹¹

Generally, an option is not treated as exercised for purposes of *IRC Section 355(d)*.ⁿ¹² However, in determining whether a person has acquired a 50 percent or greater interest under *IRC Section 355(d)(4)*, an option that has not been exercised when a distribution occurs is treated as exercised on the date it was issued or most recently transferred if (a) its exercise (whether by itself or in conjunction with the deemed exercise or one or more other options) would cause a person to become a disqualified person; and (b) immediately after the distribution, it is reasonably certain that the option will be exercised.ⁿ¹³ An option that is treated as exercised is so treated both for purposes of determining the percentage of voting power owned by the holder and for purposes of determining the percentage of the value of stock owned by the holder.ⁿ¹⁴

Stock acquired by purchase ceases to be acquired by that purchase if the basis relating from that purchase is eliminated.ⁿ¹⁵ Basis in the stock of a corporation (or an interest in another entity) is eliminated if and when it would no longer be taken into account by any person in determining gain or loss on a sale or exchange of any stock of the corporation (or an interest in another entity).ⁿ¹⁶ However, basis is not eliminated if it is allocated between the stock of two corporations under *Section 1.358-2(a) of the regulations*. In addition, the basis resulting from a purchase of the

stock of a distributing corporation that is exchanged for stock in a controlled corporation is not eliminated, notwithstanding the basis elimination rule.ⁿ¹⁷

Stock or securities are generally considered acquired by purchase if they are acquired (i) in a transaction in which the acquirer's basis is not determined in whole or in part by reference to the basis of the stock or securities in the hands of the person from whom acquired, (ii) from a decedent, or (iii) pursuant to an incorporating transfer or acquisitive or divisive reorganization.ⁿ¹⁸ However, property acquired in an acquisition to which *IRC Section 351* applies will be deemed to be acquired by purchase to the extent acquired in exchange for any cash, cash item, marketable stock or security, or debt of the transferor.ⁿ¹⁹

If property is acquired in a carryover basis transaction from a transferor who acquired the property by purchase, the acquirer is generally considered to have acquired the property by purchase on the date that the transferor actually acquired it by purchase.ⁿ²⁰

A deemed purchase will occur if a person acquires by purchase an interest in an entity and any stock or securities held by the entity are attributed to that person under the rules of *IRC Section 318(a)(2)*, modified as described above.ⁿ²¹ In such case, the person is treated as having acquired the stock or securities by purchase on the later of the date of purchase of the interest in the entity or the date the stock or securities are purchased by the entity (or considered as purchased under the carryover basis rules).ⁿ²² The "deemed purchase" rule also applies to determine the timing of a purchase where a person and an entity are treated as a single person under the related party rules.ⁿ²³

Corporate gain recognition is required as well, if, pursuant to a plan or arrangement related to the distribution, a person acquires a 50-percent or more interest (by vote or value) in either the distributing corporation or any controlled corporation.ⁿ²⁴ The amount of gain is the same whether the acquisition is of the distributing corporation or the controlled corporation, namely, the amount of gain that the distributing corporation would have recognized had the stock of the controlled corporation been sold for fair market value on the date of distribution; the gain is recognized immediately before the distribution.ⁿ²⁵ No adjustment to the basis of the stock or assets of either corporation is allowed by reason of the recognition of gain.

Acquisitions occurring within the four-year period beginning two years before the date of distribution are presumed to have occurred pursuant to a plan or arrangement, unless it can be shown that the acquisition during the four-year period was unrelated to the distribution.ⁿ²⁶ In the case of a post-distribution acquisition (other than involving a public offering), the distribution and acquisition can be part of a plan only if there was an agreement, understanding, arrangement, or substantial negotiation regarding the acquisition or similar acquisition at some time during the two-year period ending on the date of the distribution.ⁿ²⁷ The existence of an agreement or the like within the two-year period tends to show that the distribution and acquisition are part of the plan. However, all facts and circumstances must be considered to determine if the distribution and acquisition are part of a plan.ⁿ²⁸

If stock of the distributing or controlled corporation is acquired pursuant to an option, the option will be treated as an agreement, understanding, or arrangement to acquire the stock on the earliest of the following dates: the date that the option is written, if the option was more likely than not to be exercised as of that date; the date that the option is transferred, if the option is more likely than not to be exercised as of that date; and the date that the option is modified in a manner that materially increases the likelihood of exercise, if the option was more likely than not to be exercised as of that date.ⁿ²⁹ However, if the writing, transfer, or modification of the option had a principal purpose of avoiding *IRC Section 355(e)*, the option will be treated as an agreement, understanding, arrangement, or substantial negotiation to acquire the stock on the date of the distribution.

A plan (or series of related transactions) is not one that will cause gain recognition if, immediately after completion of the plan or transactions, the distributing corporation and all controlled corporations are members of a single affiliated group of corporations.ⁿ³⁰

Example 1:

P Corp. owns all of the stock of *S* Corp., which in turn owns all of the stock of *S1* Corp. The three are members of an affiliated group of corporations. *P* is merged into unrelated *X* Corp. in a transaction in which the former shareholders of *X* will own 50 percent or more of the vote or value of *X* after the merger. As part of the plan of merger, *S1* will be distributed by *S* to *X* in a transaction that otherwise qualifies under *IRC Section 355*. After the distribution, *S*, *S1* and *X* will remain members of a single affiliated group of corporations. Even though there has been an acquisition and a distribution that is part of a plan or series of related transaction, corporate gain recognition is not required because the distributing corporation, *S*, and the controlled corporation, *S1*, remain within a single affiliated group of corporations after the distribution.

Under *IRC Section 355(e)(3)(A)*, the following acquisitions are not taken into account, provided that stock held before the acquisition was not acquired pursuant to a plan or series of related transactions to acquire a 50-percent or greater ownership in either the distributing or controlled corporation:

- (1) The acquisition of stock in any controlled corporation by the distributing corporation.
- (2) The acquisition by a person of stock in any controlled corporation by reason of holding stock or securities in the distributing corporation (eg, the receipt by a distributing corporation shareholder of controlled corporation stock in a distribution in which a shareholder that did not own 50 percent or more of the stock of the distributing corporation owns 50 percent or more of the stock of the controlled corporation).
- (3) The acquisition by a person of stock in any successor corporation of the distributing corporation or any controlled corporation by reason of holding stock or securities in the distributing or controlled corporation (eg, the receipt by former shareholders of the distributing corporation of 50 percent or more of the stock of a successor corporation in a merger of the distributing corporation).
- (4) The acquisition of stock in the distributing corporation or any controlled corporation to the extent that the percentage of stock owned directly or indirectly in such corporation by each person owning stock in such corporation immediately before the acquisition does not decrease.

Example 2:

A owns all of the stock of *P* Corp. which owns all of the stock of *S* Corp. The stock of *S* is distributed to *A* in a transaction that otherwise qualifies under *IRC Section 355*. As part of a plan, *P* then merges with *X* Corp., all of the stock of which is owned by *A*. Gain recognition is not required because *A* owns directly or indirectly 100 percent of the stock of both *X*, the successor to *P*, and *S* before and after the transaction.ⁿ³¹

If the assets of the distributing corporation or any controlled corporation are acquired by a successor corporation in an "A," "C," or "D," reorganization, or any other transaction specified in regulations, the shareholders (immediately before the acquisition) of the corporation acquiring the assets are treated as acquiring stock in the corporation from which the assets were acquired.ⁿ³²

IRC Section 355 (or so much of *IRC Section 356* as relates to it) does not apply to any distribution of stock from one member of an affiliated group of corporations to another member of the group (an "intragroup spinoff") if the distribution is part of a plan or series of related transactions pursuant to which one or more persons acquire directly or

indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.ⁿ³³

Example 3:

P Corp. owns all of the stock of *S* Corp., which in turn owns all of the stock of *S1* Corp. *S* distributes the stock of *S1* to *P* as a part of a plan or series of transactions in which *P* then distributes *S* to its shareholders and then *P* is merged into unrelated *X* Corp. After the merger, former shareholders of *X* Corp. own 50 percent or more of the voting power or value of the merged corporation. Because the distribution of *S1* by *S* is part of a plan or series of transactions in which *S* is distributed by *P* outside the *P* affiliated group and *P* is then acquired in a transaction governed by *IRC Section 355(e)*, application of *IRC Section 355(f)* causes *IRC Section 355* to be inapplicable to the intragroup spinoff of *S1* to *P*. In addition, the distribution of *S* by *P* is subject to the gain recognition rule of *IRC Section 355(e)*.

If there is a distribution governed by *IRC Section 355(e)(1)*, the statutory period for the assessment of any deficiency attributable to any part of the gain recognized by reason of the distribution does not expire before three years from the date the Service is notified by the taxpayer that the distribution occurred, and the deficiency may be assessed at any time during that three-year period.ⁿ³⁴

[i] Distributions Involving Foreign Corporations. If the distributing corporation is a domestic corporation and the controlled corporation is a foreign corporation, the controlled corporation will be considered to be a corporation and no gain will be recognized to the distributing corporation.ⁿ³⁵ If the distributee is an individual, then, solely for the purposes of determining gain recognized by the distributing corporation, the controlled corporation will not be considered to be a corporation, and the distributing corporation will recognize any gain (but not loss) realized on the distribution.ⁿ³⁶ The rules do not apply to a foreign distributee to the extent gain is recognized under *IRC Section 367(e)(1)* (transfer by a domestic corporation to a person who is not a United States person).ⁿ³⁷

If the distributing corporation is a controlled foreign corporation, *pro rata* distributions of stock of the controlled corporation will result in a reduction in the distributee shareholder's basis to the extent that the distributee's Section 1248 amount is reduced.ⁿ³⁸ If the distribution by the controlled foreign corporation is not *pro rata*, United States shareholders receive income to the extent that the shareholders' potential dividend under *IRC Section 1248* is reduced.ⁿ³⁹ Any deemed dividend included in income by a foreign corporation is not treated as foreign personal holding company income under the controlled foreign corporation rules.ⁿ⁴⁰

Under *IRC Section 1248(f)(1)*, a distribution by a domestic corporation of stock in a controlled foreign corporation produces a dividend for the distributing corporation to the extent of the earnings and profits of the foreign corporation attributable to the stock that were accumulated in taxable years of the foreign corporation beginning after 1962, and during the period the stock was held by the domestic corporation while the foreign corporation was a controlled foreign corporation. In addition, as mentioned above, any distribution of stock of a foreign subsidiary to foreign persons (persons other than citizens or residents of the United States, or domestic corporations) requires the recognition of gain (but not loss) by the distributing corporation.ⁿ⁴¹

[b] Earnings and Profits. *IRC Section 312(h)(1)* decrees that "proper allocation with respect to the earnings and profits of the distributing corporation and the controlled corporation (or corporations) shall be made under regulations prescribed by the Secretary or his delegate." The Regulations that have been prescribed condition the mode of allocation on the form of the transaction. If the corporate separation follows a "D" reorganization, earnings and profits are allocated between the distributing corporation and the newly created controlled corporation in proportion to the fair market values of the assets transferred and the assets retained.ⁿ⁴² However, the Regulations go on to provide that in a proper case, the allocation should be made "in proportion to the net basis of the assets transferred and of the assets retained or by such other method as may be appropriate under the facts and circumstances of the case."ⁿ⁴³ On the other hand, if the *IRC Section 355* distribution or exchange is not made as part of a "D" reorganization, the Regulations call

for a decrease in the earnings and profits of the distributing corporation to the extent of the lesser of (1) the amount by which earnings and profits would have been decreased if the distributing corporation had transferred the stock of the controlled corporation to a new corporation as part of a "D" reorganization, and immediately thereafter distributed the stock of such new corporation in an *IRC Section 355* distribution, or (2) the net worth of the controlled corporation.ⁿ⁴⁴ But whether the *IRC Section 355* distribution is part of a "D" reorganization or not, a deficit of the distributing corporation can never be allocated to the controlled corporation.ⁿ⁴⁵

[4] Distributions Involving Disqualified Investment Corporations.

IRC Section 355 does not apply to any distribution that is part of a transaction (or series of transactions) if, immediately after the transaction (or series), (i) either the distributing corporation or controlled corporation is a disqualified investment corporation, and (ii) any person holds a 50-percent or greater interest in any disqualified investment corporation, but only if the person did not hold such an interest in the corporation immediately before the transaction (or series).ⁿ¹ A disqualified investment corporation is defined as a distributing or controlled corporation with a fair market value of investment assets of 2.3 or more of the fair market value of all assets of the corporation.ⁿ²

Investment assets include cash, stock or securities in a corporation, any interest in a partnership, any debt instrument or other evidence of indebtedness, any option, any forward or futures contract, any notional principal contract, any derivative, any foreign currency, or any similar asset.ⁿ³ Investment assets do not include:

- (1) any asset that is held for use in the active and regular conduct of (a) a lending or finance business within the meaning of *IRC Section 954(h)(4)*, (b) a bank (as defined in *IRC Section 581*), a domestic building and loan association (within the meaning of *IRC Section 7701(a)(19)*, or (c) any similar institution specified by the Service;ⁿ⁴
- (2) any security (as defined in *IRC Section 475(c)(2)*) that is held by a dealer in securities and is marked to market;ⁿ⁵
- (3) any stock or securities, any debt instrument or other evidence of indebtedness, or any option, any forward or futures contract, any notional principal contract, or any derivative issued by a corporation that is a 20-percent controlled entity with respect to the distributing or controlled corporation;ⁿ⁶ or
- (4) any interest in a partnership, or any debt instrument or other evidence of indebtedness issued by the partnership, if one or more of the trades or businesses are (or, without regard to the five-year requirement of *IRC Section 355(b)(2)(B)*, would be) taken into account by the distributing or controlled corporation in determining whether the active business requirements are met with respect to the distribution.ⁿ⁷

[5] Filing Requirements.

Every corporation that engages in an *IRC Section 355* distribution shall attach to its return for the year of distribution a detailed statement setting forth "such data as may be appropriate in order to show compliance with the provisions of the section."ⁿ¹ Every taxpayer who receives such a distribution shall attach to the return for the year of distribution a statement containing such data as may be appropriate in order to show the applicability of *IRC Section 355*.ⁿ² The taxpayer's statement should include a description of the stock and securities received and surrendered and the names and addresses of all corporations involved in the transactions.ⁿ³

FOOTNOTES:

(n1)Footnote 1. For purposes of *IRC § 367*, the provision designed to protect against tax-avoidance transfers from United States persons to foreign corporations, any *IRC § 355* distribution is treated as an exchange whether or not in fact it is an exchange. *IRC § 367(c)*. In addition, gain may be recognized by the distributing corporation if the

distribution is made by a domestic shareholder to a person who is not a US person. *IRC* § 367(e)(1). See *Treas Reg* § 1.367(e)-1 for exceptions to the gain recognition rule and the manner in which the amount of recognized gain will be determined.

(n2)Footnote 1. A corporation controls another if it owns 80 percent of the voting stock and 80 percent of the total number of shares of all other classes of stock of such other corporation. *IRC* § 368(c). The required control must be more than transitory or illusory. *Rev Rul* 63-260, 1963-2 CB 147 ; but see *Rev Rul* 69-407, 1969-2 CB 50 , upholding a distribution of stock of a controlled corporation after 80 percent control was achieved in a recapitalization.

(n3)Footnote 2. A more detailed discussion of the conditions can be found in 3A Rabkin & Johnson, *Federal Income, Gift and Estate Taxation*, § 31.14 (Matthew Bender). See also Jacobs, "The Anatomy of A Spin-Off," 1967 *Duke LJ* 1.

A checklist of the information which must be included in a request for ruling under *IRC* § 355 can be found in *Rev Proc* 96-30, 1996-1 CB 696 , modified and amplified by *Rev Proc* 2003-48, 2003-2 CB 86 , reprinted in App E.

Steinberg, "Selected Issues in the Taxation of Section 355 Transactions," 51 *Tax Lawyer* 7 (1997).

Beller & Harwell, "After the Spin: Preserving Tax-Free Treatment Under Section 355," 92 *Tax Notes* 1587 (*Tax Analysts* 2001).

(n4)Footnote 3. *IRC* § 355(a)(1)(B). A distribution cannot run afoul of the device rule where neither the distributing corporation nor the controlled corporation has earnings of profits, *Treas Reg* § 1.355-2(d)(5); or where the distribution, if taxable, would not result in dividend income to the distributees. *Treas Reg* § 1.355-2(d)(5)(iii), (iv). *Rev Rul* 71-383, 1971-2 CB 180 (distribution would have been substantially disproportionate redemption, taxable as capital gain).

(n5)Footnote 4. *IRC* § 355(a)(1)(B).

(n6)Footnote 5. *Treas Reg* § 1.355-2(d)(2)(iii). The greater the percentage of stock sold after the distribution, and the shorter the period of time between distribution and sale, the greater the evidence of a device. See, eg, *South Tulsa Pathology Laboratory, Inc v Commr*, 118 TC 84 (2002) .

A prearranged sale defeated the transaction in *Rev Rul* 55-103, 1955-1 CB 31 . However, in *Rev Rul* 59-197, 1959-1 CB 77 , the sale had a valid business purpose (to give a key employee a proprietary interest in the corporation) so that the transaction was not considered a "device." A similar conclusion was reached in *Pulliam v Commr*, *TC Memo* 1997-274 , nonacq 1999-1 IRB 5 .

(n7)Footnote 6. *Treas Reg* § 1.355-2(d)(2)(ii).

(n8)Footnote 7. *Treas Reg* § 1.355-2(d)(2)(iv)(B).

(n9)Footnote 8. *Treas Reg* § 1.355-2(d)(2)(iv)(C). A secondary business is one whose principal function is to serve the other corporation.

(n10)Footnote 9. *Treas Reg* § 1.355-2(d)(3). The stronger the evidence of a device, the stronger the business purpose required to prevent the determination that the transaction was used principally as a device.

(n11)Footnote 10. *Gregory v Helvering*, 293 US 465 (1935) . It has been held that even if there is no tax avoidance motive, a distribution lacking a business purpose will not come within *IRC* § 355. *Commr v Wilson*, 353 F2d 184 (9th Cir 1965) .

(n12)Footnote 11. *Treas Reg § 1.355-2(b)(1)*. See, eg, *Rev Rul 2003-52, 2003-1 CB 960* . Coakley, "The Evolving Business Purpose Requirement for Spin-Off Transactions," *103 Tax Notes 1141 (2004)*; Beller, "Business Purpose Under Section 355: What Works and What Doesn't?" *58 Tax Notes 1109 (1993)*.

In determining whether a distribution of stock of a controlled corporation satisfies the business purpose requirement, the fact the *IRC § 355* permits a distributing corporation to distribute stock of a controlled corporation without recognition of gain does not present a potential for avoidance of federal taxes. *Rev Rul 2003-110, 2003-2 CB 1083* .

(n13)Footnote 12. *Treas Reg § 1.355-1(b)(2)*. A shareholder purpose is not a corporate business purpose. However, a shareholder purpose for a transaction may be so nearly coextensive with a corporate business purpose so as to preclude any distinction between them. In such case, the transaction satisfies the business purpose requirement.

According to *Rev Rul 2003-55, 2003-1 CB 961* , the regulations do not require that the corporation succeed in meeting its corporate business purpose, as long as, at the time of the distribution, such a purpose exists and motivates, in whole or substantial part, the distribution. An unexpected change in market or business conditions following a distribution that prevents accomplishment of the business purpose will not prevent satisfaction of the requirement. The spinoff, in *Rev Rul 2003-55* , was undertaken in order to permit a public offering of the controlled corporation's stock. However, an unexpected deterioration in market conditions led the corporation and its advisors to a decision to postpone, and eventually abandon, the public offering.

A distribution that is expected to cause the aggregate value of the stock of a distributing corporation and the stock of a controlled corporation to exceed the pre-distribution value of the distributing corporation's stock satisfies the corporate business requirement where the increased value is expected to serve a corporate business purpose of either the distributing corporation or the controlled corporation (or both), even if it benefits the shareholders of the distributing corporation. *Rev Rul 2004-23, 2004-1 CB 585* .

(n14)Footnote 13. *Treas Reg § 1.355-2(d)(3)*. For examples of transactions involving a business purpose, see, eg, *King v Commr, 458 F2d 245 (6th Cir 1972)* ; *Rev Rul 2003-75, 2003-2 CB 79* ; *Rev Rul 2003-74, 2003-2 CB 77* ; *Rev Rul 89-101, 1989-2 CB 67* ; *Rev Rul 88-33, 1988-1 CB 115* ; *Rev Rul 85-127, 1985-2 CB 119* ; *Rev Rul 85-122, 1985-2 CB 118* ; *Rev Rul 82-131, 1982-2 CB 83* ; and *Rev Rul 77-22, 1977-1 CB 91* .

(n15)Footnote 14. *1969-2 CB 51* .

(n16)Footnote 15. *Treas Reg § 1.355-2(c)*. The requirement does not mandate that all owners of the distributing corporation prior to the distribution own stock in all of the corporations resulting from the separation. See, eg, *Treas Reg § 1.355-2(c)(2)*, Ex (1), involving a split-off in which one of two equal shareholders becomes the sole owner of the distributing corporation while the other owns 100 percent of the distributed corporation.

An example of a distribution made in furtherance of a business purpose that failed to meet the continuity of interest test can be found in *Rev Rul 69-293, 1969-1 CB 102* , where the shareholders lost their proprietary interest after the corporation amended its charter to become a nonprofit membership corporation.

(n17)Footnote 16. *IRC § 355(a)(1)(C), (b)(1)*.

The fact that the controlled corporation does not have any employees is one factor to consider in determining whether the corporation is actively engaged in a trade or business, but does not automatically prevent the transaction from qualifying under *IRC § 355*. *Rev Rul 80-181, 1980-2 CB 121* . The Service has held that a corporation, acting as a general partner in a real estate limited partnership, was engaged in the active conduct of a trade or business where its officers performed active and substantial management functions for the partnership, including decision-making regarding significant business decisions of the partnership and regular participation in the overall supervision, direction and control of the employees of the partnership in operating the partnership's rental business. The fact that the

corporation lacked employees to perform the operational services necessary to operate, the partnership's properties did not, of itself, cause the corporation to fail the active trade or business test. *Rev Rul 92-17, 1992-1 CB 142*. See also *Rev Rul 2002-49, 2002-2 CB 288*, and *Rev Rul 79-394, 1979-2 CB 141*, amplified by *Rev Rul 80-181, 1980-2 CB 121*.

Rev Rul 92-17 has been modified by *Rev Rul 2007-42, 2007-28 IRB 44*, to remove any requirement that a corporate partner must perform management functions in order for the partner to be treated as engaged in the active conduct of the trade or business of the partnership. Apparently, one crucial aspect is the extent of the corporate partner's interest in the partnership.

A REIT can be engaged in the active conduct of a trade or business solely by virtue of functions with respect to rental activity that produces income qualifying as rents from real property within the meaning of *IRC § 856(d)*. *Rev Rul 2001-29, 2001-1 CB 1348*.

(n18)Footnote 17. The "substantially all of its assets" requirement is satisfied for ruling purposes if 90 percent or more of the controlling corporation's gross assets consists of stock in corporations engaged in active conduct of a trade or business. *Rev Proc 77-37, 1977-2 CB 568*.

(n19)Footnote 18. *IRC § 355(b)(2)(A)-(D)*. The regulations provide an exception to the general no gain or loss rule in *IRC § 355(b)(2)(C)* and *(D)*, namely, that a direct or indirect acquisition of a trade or business by one member of an affiliated group from another member of the group is not the type of transaction to which the provisions were intended to apply. *Treas Reg § 1.355-3(b)(4)(iii)*.

A corporation was engaged in the active conduct of a trade or business during the five-year period even though it did not have any income in one of those years, where the reason for the lack of income was the unexpected bankruptcy of its single customer. *Rev Rul 82-219, 1982 CB 82*.

Gain recognition under *IRC § 357(c)*, because of an incorporating transfer where assumed liabilities exceeded the adjusted bases of the transferred assets, does not run afoul of the active business provisions. The prohibition against the acquisition of a trade or business in a taxable transaction contemplates the acquisition of the business from an outside source. *Rev Rul 78-442, 1978-2 CB 43*.

A Subchapter S corporation, that owned 50 percent of a subsidiary, acquired control of the subsidiary when the stock of the other 50 percent shareholder was redeemed by the subsidiary. Therefore, a spinoff of the subsidiary on the same day as the redemption was not tax-free. *McLaulin v Commr, 276 F3d 1269 (11th Cir 2001)*.

The Service will not ordinarily rule whether the active business requirement is met when, within the five-year period, a distributing corporation acquired control of a controlled corporation as a result of the distributing corporation transferring cash or other liquid or inactive assets to the controlled corporation in a transaction in which gain or loss was not recognized under *IRC § 351* or *368(a)(1)(D)*. *Rev Proc 2010-3, 2010-1 IRB 110, 116-117 (§ 4.01(27))*.

If a corporation engaged in the active conduct of one trade or business during the five-year period purchased, created, or otherwise acquired another trade or business in the same line of business, the acquisition of the other business is ordinarily treated as an expansion of the original business, all of which is treated as having been actively conducted during the five-year period, unless the acquisition effects a change of such character as to constitute the acquisition of a new or different business. *Treas Reg § 1.355-3(b)(3)(ii)*; *Rev Rul 2003-18, 2003-1 CB 467*. See also *Rev Rul 2003-38, 2003-1 CB 811*, where a retail store's creation of an Internet site to sell its products was treated as an expansion of the existing business.

(n20)Footnote 19. The *IRC § 1504(a)* definition of affiliated corporation is applied without regard to the definition of includible corporation contained in *IRC § 1504(b)*.

(n21)Footnote 19.1. The Service has interpreted *IRC § 355(b)(3)* as calling into question whether *Treas Reg § 1.355-3(b)(4)(iii)* appropriately reflects the 2006 amendment. However, the Service has given notice that it will not challenge transactions that would have come within *IRC § 355(b)(2)(C)* and *(D)* prior to the enactment of *IRC § 355(b)(3)* if the distributions are made before temporary or final regulations changing the rule are effective. *Notice 2007-60, 2007-35 IRB 466* .

IRC § 355(b)(3)(C) contains transitional rules providing that *IRC § 355(b)(3)(A)* shall not apply to any distribution made pursuant to a transaction that was (i) governed by an agreement binding on May 17, 2006, and at all times thereafter; (ii) described in a ruling request submitted to the Service on or before May 17, 2006; or (iii) described on or before May 17, 2006, in a public announcement or in a filing with the Securities and Exchange Commission. The provision requires a corporation to make an irrevocable election if the purpose of the election is to disqualify the distribution under *IRC § 355(a)*. The form and manner of the election are set forth in *Notice 2006-81, 2006-2 CB 595* .

(n22)Footnote 19.2. *IRC § 355(b)(3)(B)*. A corporation's separate affiliated group is the affiliated group that would be determined under *IRC § 1504(a)* if the corporation were the common parent and *IRC § 1504(b)* did not apply.

(n23)Footnote 20. *Treas Reg § 1.355-3(b)(2)(iv)*.

(n24)Footnote 21. *IRC § 355(a)(1)(D)*. A distribution of rights or warrants to purchase stock in the controlled corporation does not satisfy the distribution requirement. *Redding v Commr, 630 F2d 1169 (7th Cir 1980)* , *cert denied 450 US 913* .

The Service will not apply the *Court Holding* doctrine (or any formulation of the step transaction doctrine) to determine whether the distributed corporation was a controlled corporation immediately before the distribution solely because of any postdistribution acquisition or restructuring of the distributed corporation, whether prearranged or not. *Rev Rul 98-27, 1998-2 CB 315* .

(n25)Footnote 22. *IRC § 351(c)(2)*.

(n26)Footnote 23. *Commr v Gordon, 391 US 83 (1968)* .

(n27)Footnote 24. Note, "Federal Taxation: Multi-Step Stock Purchase Right Distribution Disqualified as Tax-Free Spin-Off," 1969 *Duke L J* 179.

(n28)Footnote 25. *IRC § 355(a)(2)(A)*.

(n29)Footnote 26. *IRC § 355(a)(2)(C)*.

(n30)Footnote 27. *Rev Rul 65-286, 1965-2 CB 92* .

(n31)Footnote 28. *IRC § 355(a)(3)(C)*. See § 3.02[2] for a description of nonqualified preferred stock.

(n32)Footnote 29. *IRC § 355(a)(3)(G)*. S Rep No 96-1035, 96th Cong, 2d Sess 38 (1980).

(n33)Footnote 30. *IRC § 355(a)(3)(D)*.

(n34)Footnote 31. *Treas Reg § 1.356-7(b)(1)*. The principles apply to rights to acquire stock. *Treas Reg § 1.356-7(d)*.

(n35)Footnote 32. *Treas Reg § 1.356-7(b)(3)*.

(n36)Footnote 33. *Treas Reg § 1.356-7(b)(2)*.

(n37)Footnote 34. *Treas Reg § 1.356-7(c)*. The rules apply for the purposes of *IRC §§ 354(a)(2)(C)(i)* and *356(e)(2)* as well as *IRC § 355(a)(3)(D)*.

(n38)Footnote 35. The receipt of "boot" does not permit the recognition of any loss realized on the distribution. *IRC § 356(c)*.

(n39)Footnote 36. *IRC § 356(a)(2)*. The provision is discussed in § 8.03[1][c][ii].

If Section 306 stock is exchanged, then the "boot" will be treated as a distribution to which *IRC § 301* applies. *IRC § 356(f)*.

(n40)Footnote 37. *IRC § 356(b)*; *Treas Reg § 1.356-2(b)*.

(n41)Footnote 38. *IRC § 356(d)(1)*. Rights issued by the distributing corporation or the controlled corporation are treated as securities with no principal amount for the purpose of *IRC § 355*. *Treas Reg § 1.355-1(c)*. Excluded is any right to acquire nonqualified preferred stock received in exchange for (or in a distribution with respect to) stock, or a right to acquire stock, other than nonqualified preferred stock. *Treas Reg § 1.356-6(a)(2)*. The term "rights to acquire stock" has the same meaning as it does under *IRC Sections 305* and *317*, discussed in Chapter 4.

(n42)Footnote 39. *IRC § 356(d)(2)(B)*. The combined effect of this rule and the treatment given to "boot" in spin-offs completely removes a spin-off in which securities only are distributed from the ambit of *IRC § 355*.

(n43)Footnote 40. *IRC § 356(d)(2)(C)*. Examples of the application of this provision can be found in § 8.03[1][c][iii].

(n44)Footnote 41. See § 3.03.

(n45)Footnote 42. See § 8.03[3].

(n46)Footnote 43. *IRC § 358(a)(1)*.

(n47)Footnote 44. *IRC § 358(b)(1)*.

(n48)Footnote 45. *IRC § 358(b)(2)*. A spin-off is considered an exchange for purposes of *IRC § 358*. Basis is allocated among the stock and securities of the distributing corporation that are retained and those of the controlled corporation that are received.

(n49)Footnote 46. *IRC § 358(a)(2)*.

(n50)Footnote 47. *Treas Reg § 1.358-2(a)(2)(v)*.

(n51)Footnote 48. *Id.*

(n52)Footnote 49. *Treas Reg § 1.358-2(a)(2)(vi)*.

(n53)Footnote 50. *Treas Reg § 1.358-2(a)(2)(vii)*.

(n54)Footnote 51. *Id.*

(n55)Footnote 52. *Id.*

(n56)Footnote 53. *IRC § 1223(1)*.

(n57)Footnote 1. *IRC §§ 355(c)(1), 361(c)(1)*. The first provision is applicable if the corporate separation is not

preceded by a "D" reorganization, the latter if it is.

(n58)Footnote 2. *IRC §§ 355(c)(2)(A), 361(c)(2)(A)*. The gain is measured by the excess of fair market value over adjusted basis in the hands of the distributing corporation. If the property is subject to a liability or the shareholder assumes a liability of the distributing corporation in connection with the distribution, the fair market value of the property is treated as not less than the amount of the liability. *IRC §§ 355(c)(2)(C), 361(c)(2)(C)*.

(n59)Footnote 3. The disqualified distribution rule does not apply to distributions made pursuant to a written binding contract in effect on Oct 9, 1990, and at all times thereafter before the distribution.

(n60)Footnote 4. *IRC § 355(d)(2)*. An anti-avoidance rule contained in the regulations provides that the Service can treat a distribution as a disqualified distribution if it or another transaction is engaged in or structured with a principal purpose to avoid the purposes of *IRC § 355(d)*. In doing so, the Service can determine that the existence of an intermediary (a related person, intermediary, pass-through entity, or similar person) should be disregarded, in whole or in part, if the intermediary is formed or availed of to avoid the purposes of *IRC § 355(d)*. *Treas Reg § 1.355-6(b)(4)*.

(n61)Footnote 5. *Treas Reg § 1.355-6(b)(3)(i)*. A disqualified person is a person that, immediately after a distribution, holds disqualified stock that the person acquired by purchase or received such stock in a distribution as a result of owning purchased stock. *Treas Reg § 1.355-6(b)(3)(ii)*.

(n62)Footnote 6. *IRC § 355(d)(4)*. Generally, all shares of stock within a single class are considered to have the same value. *Treas Reg § 1.355-6(c)(2)*.

(n63)Footnote 7. *IRC § 355(d)(7)*. Two or more persons act pursuant to a plan or arrangement if they have a formal or informal understanding among themselves to make a coordinated acquisition of stock. A principal element in determining if such an understanding exists is whether the investment decision of each person is based on the investment decision of one or more other existing or prospective shareholders. *Treas Reg § 1.355-6(c)(4)(ii)*. The participation of creditors in an insolvency workout or bankruptcy reorganization is not considered action pursuant to a plan or arrangement.

If two or more persons do not act pursuant to a plan or arrangement with respect to the acquisition of stock in a corporation, a subsequent acquisition in which such persons exchange their stock in that corporation for stock in a second corporation in an exchange basis transaction will not result in their being treated as one person, even if the acquisition of the second corporation's stock is pursuant to a plan or arrangement. *Treas Reg § 1.355-6(c)(4)(iv)*.

(n64)Footnote 8. *IRC § 355(d)(8)(A)*.

(n65)Footnote 9. *IRC § 355(d)(3)(A)*.

(n66)Footnote 10. *IRC § 355(d)(3)(B)*.

(n67)Footnote 11. *IRC § 355(d)(6)*.

(n68)Footnote 12. *Treas Reg § 1.355-6(c)(3)(i)*. The following are treated as options: a call option, warrant, convertible obligation, the conversion feature of convertible stock, put option, redemption agreement, notional principal contract that provides for the payment of amounts in stock, stock purchase agreement or similar arrangement, or any other instrument that provides for the right to purchase, issue, redeem, or transfer stock (including an option on an option). *Treas Reg § 1.355-6(c)(3)(v)*. For instruments not generally treated as options, see *Treas Reg § 1.355-6(c)(3)(vi)*.

(n69)Footnote 13. *Treas Reg § 1.355-6(c)(3)(ii)*. The determination of whether, immediately after the distribution, an option is reasonably certain to be exercised is based on all of the facts and circumstances, with the fair market value

of stock underlying the option determined by taking into account control premiums and minority and blockage discounts. *Treas Reg § 1.355-6(c)(3)(vii)*. A stock purchase or similar agreement is treated as reasonably certain to be exercised if the parties' obligations to complete the transaction are subject only to reasonable closing conditions.

(n70)Footnote 14. *Treas Reg § 1.355-6(c)(3)(iv)*. If a stock purchase agreement or similar arrangement is deemed exercised, the purchaser is treated as having purchased the stock under the terms of the agreement or arrangement as though all covenants had been satisfied and all contingencies met. The agreement or arrangement is deemed to have been exercised on the date it is entered into or most recently assigned.

(n71)Footnote 15. *Treas Reg § 1.355-6(b)(2)(iii)(A)*.

(n72)Footnote 16. *Treas Reg § 1.355-6(b)(2)(iii)(C)(1)*. Generally, the basis of stock resulting from a purchase is eliminated as well if the stock is exchanged or transferred in a carryover basis or exchange basis transaction. *Treas Reg § 1.355-6(b)(2)(iii)(C)(2)*.

(n73)Footnote 17. *Treas Reg § 1.355-6(b)(2)(iii)(C)(3)*.

(n74)Footnote 18. *IRC § 355(d)(5)(A)*. Stock treated as "boot" under *IRC § 351(b)* or *356(a)(1)* is treated as purchased on the date of the exchange or distribution for purposes of *IRC § 355(d)*. *Treas Reg § 1.355-6(d)(2)(i)(A)(2)*.

Stock acquired in a qualified stock purchase with respect to which an *IRC § 338* election (or an *IRC § 338(h)(10)* election) is made is not treated as a purchase for purposes of *IRC § 355(d)(5)(A)*. However, any stock (or an interest in another entity) held by an old target that is treated as purchased by a new target is treated as acquired by a purchase unless an *IRC § 338* election or an *IRC § 338(h)(10)* election is made for that stock. *Treas Reg § 1.355-6(d)(2)(iv)*.

(n75)Footnote 19. *IRC § 355(d)(5)(B)*. If the transferred items are used in an active trade or business and do not exceed the reasonable needs of the business, the acquisition is not a purchase. *Treas Reg § 1.355-6(d)(3)(iv)*. The same holds true for an acquisition of stock in exchange for an amount of stock in another corporation that meets the requirements of *IRC § 1504(a)(2)* (the ownership of stock that possesses 80 percent of the total voting power and 80 percent of the total value of the stock of the corporation). *Treas Reg § 1.355-6(d)(3)(iii)*.

Stock is not treated as purchased if the transferor, the transferee, and any distributed controlled corporation are members of the same affiliated group. However, the transferred cash, marketable stock, or debt must not have been acquired from a nonmember in a related transaction to which *IRC § 362(a)* or *IRC § 362(b)* applies to determine the basis in the acquired assets. *Treas Reg § 1.355-6(d)(3)(v)*.

(n76)Footnote 20. *IRC § 355(d)(5)(C)*. If a distributing corporation distributes any stock of a controlled corporation with respect to recently purchased stock in a distribution that qualifies under *IRC § 355*, the controlled corporation stock is deemed acquired by purchase by the distributee on the date the distributee acquired the recently acquired stock. *Treas Reg § 1.355-6(e)(4)*. If a corporation distributes a tax-free stock dividend under *IRC § 305(a)*, the stock received in the distribution (to the extent *IRC § 307(a)* determines the distributee's basis) is deemed to be acquired by purchase by the distributee on the date that the distributee acquired the stock with respect to which the distribution is made.

(n77)Footnote 21. *IRC § 355(d)(8)(B)*.

(n78)Footnote 22. *Treas Reg § 1.355-6(e)(1)(i)*. If a person treated as holding stock under *IRC § 355(d)(8)(A)* later directly purchases the stock, the date of the later direct purchase is used in determining when the five-year period begins. *Treas Reg § 1.355-6(e)(1)(iv)*.

(n79)Footnote 23. *Treas Reg § 1.355-6(e)(1)(ii)*. If a person and an entity are treated as a single person under *IRC § 355(d)(7)*, and the person later purchases an additional interest in the entity, the person is treated as purchasing on the

date of the later purchase the amount of stock attributed from the entity to the person under *IRC* § 355(d)(8)(A) as a result of the additional interest. *Treas Reg* § 1.355-6(e)(1)(ii). If two persons are treated as one person under *IRC* § 355(d)(7), and one later purchases stock from the other, the date of the later purchase is used in determining when the five-year period begins. *Treas Reg* § 1.355-6(e)(a)(iii).

(n80)Footnote 24. *IRC* § 355(e)(1), (2), 4(A). *IRC* § 355(e)(1) does not apply to any distribution governed by *IRC* § 355(d). *IRC* § 355(e)(2)(D).

The entity-individual rules of *IRC* § 318(a)(2) apply in determining whether a person holds stock or securities in any corporation, with corporation-shareholder attribution being applied without the 50-percent threshold specified in *IRC* § 318(a)(2)(C). The aggregation rules of *IRC* § 355(d)(7) also apply. *IRC* § 355(e)(4)(C).

No gain recognition is required if the distribution is made in a bankruptcy or similar case. *IRC* § 355(e)(4)(B).

(n81)Footnote 25. This result obtains because stock and securities in the controlled corporation are not treated as qualified property for purposes of *IRC* §§ 355(c)(2) and 361(c)(2). *IRC* § 355(e)(1).

(n82)Footnote 26. *IRC* § 355(e)(2)(B). Whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. *Treas Reg* § 1.355-7(b)(1).

Treas Reg § 1.355-7(d) lists nine safe harbors that apply in determining that a distribution and acquisition are not part of a plan.

(n83)Footnote 27. *Treas Reg* § 1.355-7(b)(2). Substantial negotiations in the case of an acquisition (other than involving a public offering) generally requires discussions of significant economic terms (eg, the exchange ratio in a reorganization) by one of more officers, directors, or controlling shareholders of the distributing or controlled corporation, or another person who has the permission of the distributing or controlled corporation, with the acquirer or a person having the permission of the acquirer. *Treas Reg* § 1.355-7(h)(1)(iv).

(n84)Footnote 28. Facts and circumstances tending to show that a distribution and acquisition are part of a plan are set forth in *Treas Reg* § 1.355-7(b)(3). Facts and circumstances tending to show that a distribution and acquisition are not part of a plan are contained in *Treas Reg* § 1.355-7(b)(4).

For an example of a transaction in which the facts and circumstances indicated that the acquisition and the distribution were not part of a plan under *IRC* § 355(e) and *Treas Reg* § 1.355-7(b), see *Rev Rul* 2005-65, 2005-42 CB 684 .

(n85)Footnote 29. *Treas Reg* § 1.355-7(e)(1)(i). The determination of whether an option was more likely than not to be exercised is based on all of the facts and circumstances, taking control premiums and minority and blockage discounts into account in determining the fair market value of stock underlying an option.

Generally, the following are not treated as options for this purpose: (1) an option that is part of a security arrangement in a typical lending transaction, if the arrangement is subject to customary commercial conditions; (2) options exercisable only upon death, disability, mental incompetency, or separation from service; or (3) rights of first refusal. *Treas Reg* § 1.355-7(e)(4).

(n86)Footnote 30. *IRC* § 355(e)(2)(C).

(n87)Footnote 31. Any reference to a controlled corporation or a distributing corporation includes a reference to any predecessor or successor corporation. *IRC* § 355(e)(4)(D).

(n88)Footnote 32. *IRC* § 355(e)(3)(B).

(n89)Footnote 33. *IRC § 355(f)*.

(n90)Footnote 34. *IRC § 355(e)(4)(E)*.

(n91)Footnote 35. *Treas Reg § 1.367(b)-(5)(b)(1)(i)*.

(n92)Footnote 36. *Treas Reg § 1.367(b)-5(b)(1)(ii)*. All distributees in a distribution where the distributing corporation is a domestic corporation and the controlled corporation is a foreign corporation are presumed to be individuals. *Treas Reg § 1.367(b)-5(b)(3)*. The presumption can be rebutted using certain shareholder identification principles contained in *Treas Reg § 1.367(e)-1(d)*.

(n93)Footnote 37. *Treas Reg § 1.367(b)-5(b)(2)*.

(n94)Footnote 38. *Treas Reg § 1.367(b)-5(c)*. The § 1248 amount with respect to stock in a foreign corporation is the net positive earnings and profits that would have been attributable to that stock an includable in income under *IRC § 1248* if the stock had been sold by the shareholder. *Treas Reg § 1.367(b)-2(c)(1)*. See § 20.04[4] for a discussion of *IRC § 1248*.

The distributee's basis in the stock cannot be reduced below zero, and to the extent that the reduction would have reduced the basis below zero, the distributee must include the amount in income as a deemed dividend.

(n95)Footnote 39. *Treas Reg § 1.367(b)-5(d)*. All persons owning stock in the distributing corporation immediately after the distribution are treated as distributees of the stock. *Treas Reg § 1.367(b)-5(d)(2)*.

(n96)Footnote 40. *Treas Reg § 1.367(b)-5(f)*.

(n97)Footnote 41. *IRC § 367(e)(1)*; *Treas Reg § 1.367(e)-1(b)(1)*.

(n98)Footnote 42. *Treas Reg § 1.312-10(a)*.

(n99)Footnote 43. *Treas Reg § 1.312-10(a)*. Unfortunately the regulations do not define what a proper case is. The Court of Claims refused to apply the net basis method in *Bennett v US*, 427 F2d 1202 (Ct Cl 1970), on the ground that to do so would have disturbed the purpose of *IRC § 312(i)* and *Treas Reg § 1.312-10(a)*, namely, to neutralize the effect of a divisive reorganization on future shareholder taxability.

(n100)Footnote 44. *Treas Reg § 1.312-10(b)*.

(n101)Footnote 45. *Treas Reg § 1.312-10(c)*.

(n102)Footnote 1. *IRC § 355(g)(1), (4)*. A 50-percent or greater interest means stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of all classes of stock. *IRC §§ 355(d)(4), 355(g)(3)(A)*. The attribution rules of *IRC § 318* apply in determining ownership. *IRC § 355(g)(3)(B)*.

(n103)Footnote 2. *IRC § 355(g)(2)(A)*. In the case of distributions made before May 17, 2007, a corporation is a disqualified investment corporation if investment assets constitute 3.4 or more of the fair market value of all assets of the corporation.

(n104)Footnote 3. *IRC § 355(g)(2)(B)(i)*.

(n105)Footnote 4. *IRC § 355(g)(2)(B)(ii)*.

(n106)Footnote 5. *IRC § 355(g)(2)(B)(iii)*.

(n107)Footnote 6. *IRC § 355(g)(2)(B)(iv)*. The distributing or controlled corporation is treated as owning its ratable share of the assets of any 20-percent controlled entity.

A 20-percent controlled entity is any corporation with respect to which the distributing or controlled corporation owns directly or indirectly stock meeting the requirements of *IRC § 1504(a)(2)*, except that that provision will be applied by substituting 20% for 80% and without regard to stock described in *IRC § 1504(a)(4)*.

(n108)Footnote 7. *IRC § 355(g)(2)(B)(v)*. The distributing or controlled corporation is treated as owning its ratable share of the assets of the partnership.

(n109)Footnote 1. *Treas Reg § 1.355-5(a)*.

(n110)Footnote 2. *Treas Reg § 1.355-5(b)*.

(n111)Footnote 3. *Treas Reg § 1.355-5(b)*.



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Taxation of Securities Transactions

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CHAPTER 8 Reorganizations and Other Exchanges

1-8 Taxation of Securities Transactions § 8.07

§ 8.07 Other Exchanges of Stock and Securities

[1] Recapitalizations.

A recapitalization, although denominated a reorganization by *IRC Section 368(a)(1)(E)*, differs from other reorganizations in that one corporation does not acquire the stock or assets of another. Rather, a recapitalization contemplates the "reshuffling of a capital structure within the framework of an existing corporation ... "n1 The Code gives no aid in determining when a change in capital structure takes on the characteristics of a recapitalization. However, one thing is clear--a transaction viewed as a recapitalization by the financial community will not necessarily be considered one for tax purposes; the transaction must partake of the essential nature of a reorganization and not be solely a vehicle for extracting earnings and profits from the corporation.n2

The regulations fill some of the void created by the absence of a statutory definition, for they indicate that a recapitalization takes place if:

- (1) a corporation discharges outstanding bonds by issuing preferred shares to the bondholders;n3
- (2) a corporation issues preferred stock in exchange for common stock or common stock in exchange for preferred;n4 or (1954)
- (3) a corporation's outstanding preferred stock with dividends in arrears is surrendered and the shareholder receives stock in exchange for the old shares and stock in discharge of the dividend arrearages.n5 However, if pursuant to the exchange, there is an increase in the proportionate interest of the preferred shareholders in the assets or earnings and profits of the corporation, then an amount equal to the lesser of (1) the amount by which the fair market value or liquidation preference, whichever is greater, of the stock received in the exchange exceeds the issue price of the preferred stock surrendered, or (2) the amount of the dividends in arrears, will be treated as a taxable stock dividend under *IRC Section 305(b)(4)*.n6

The concept of recapitalization is not limited to the instances set forth in the Regulations. For example, the Service has ruled that exchanges of common for common and preferred for preferred qualify as recapitalizations.n7 And it is now well settled that an exchange of outstanding securities for new securities will also constitute a recapitalization,n8

although the receipt of securities in a principal amount greater than the principal amount of the surrendered securities will render the transaction taxable to the extent provided in *IRC Section 356*.ⁿ⁹

The final transactional form--the exchange of stock for stock and securities--is also the most troublesome, for it is here that the financial notion of a recapitalization runs headlong into the requirement that a reorganization meet not only the technical specifications prescribed by law, but also the underlying assumptions and purposes of the reorganization provisions. To illustrate, in *Bazley v. Commissioner*,ⁿ¹⁰ a husband and wife exchanged all of a corporation's 1,000 shares of \$100 par value common stock for 5,000 shares of common stock, each share having a stated value of \$60, and \$400,000 of new debentures payable in ten years but callable at any time. The taxpayer reported the transaction as a tax-free recapitalization under the predecessor of *IRC Section 368(a)(1)(E)*. The Commissioner charged the taxpayer with an amount of income equal to the full value of the debentures. The Government's action was approved by the Tax Court, the Third Circuit, and the Supreme Court, the latter concluding that

"No doubt there was a recapitalization of the Bazley corporation in the sense that the symbols that represented its capital were changed, so that the fiscal basis of its operations would appear very differently on its books. But the form of a transaction as reflected by correct corporate accounting opens questions as to the proper application of a taxing statute; it does not close them. ... What is controlling is that a new arrangement intrinsically partake of the elements of reorganization which underlie the Congressional exemption and not merely give the appearance of it to accomplish a distribution of earnings. In the case of a corporation which has undistributed earnings, the creation of new corporate obligations which are transferred to stockholders in relation to their former holdings, so as to produce, for all practical purposes, the same result as a distribution of cash earnings of equivalent value, cannot obtain tax immunity because cast in the form of a recapitalization-reorganization."ⁿ¹¹

A number of factors appear to have influenced the Court in *Bazley*. The debentures were distributed pro rata to the holders of common stock of the corporation. They were worth at least their principal amount and were callable at any time by the corporation, the stock of which was so closely held that the will of the corporation was, in substance, the will of the shareholders. Finally, the transaction did not accomplish anything that could not have been accomplished by an outright dividend distribution of the debentures.

Exchanges of stock for securities are not always barred from achieving the status of recapitalization. For example, in *Davis v. Penfield*,ⁿ¹² the Fifth Circuit found an exchange of 7 percent preferred stock for 7 percent debentures of equal value to be a recapitalization, distinguishing *Bazley* on the ground that no one shareholder held a majority of the voting sharesⁿ¹³ and that the exchange did not step up the tax position of the former preferred shareholders; they received nothing that was not fully assured to them had they continued to hold the preferred shares. In *Seide v. Commissioner*,ⁿ¹⁴ an exchange of 3,200 shares of \$100 par value 8 percent cumulative preferred stock for \$320,000 face amount 8 percent debentures was likewise held to be a recapitalization, the Tax Court rested its decision on the following facts: (1) the ownership of preferred did not "track" the ownership of common, (2) the debentures were not readily marketable, and (3) the debentures were issued for a valid business purpose--to eliminate dividends in arrears on the preferred stock. Although an exchange solely of stock for securities may still be considered a recapitalization, the transaction will not be tax free because of *IRC Section 354(a)(2)(A)(ii)*; instead, it will be treated as a redemption of the stock.ⁿ¹⁵ However, the factors relied on by the courts in *Davis v. Penfield* and *Seide v. Commissioner* retain their validity as determinants of the existence of a recapitalization.

[2] Exchanges of Stock for Stock of the Same Corporation.

We have seen that an exchange of common for common or preferred for preferred can qualify as a capitalization, and, thus, as a reorganization. However, such exchanges need not achieve recapitalization status to be tax free. *IRC Section 1036(a)* provides that "no gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in the same corporation." Application of the section is not

limited to exchanges involving shares of the same class of stock. Thus, nonvoting common stock can be exchanged for voting common stock without giving rise to recognized gain or loss.ⁿ¹ Moreover, the section will be applicable whether the exchange is between shareholders or between shareholder and corporation.ⁿ²

If the exchanging shareholder receives money or other property in addition to stock which he can receive tax free under *IRC Section 1036(a)*, he will be required to recognize any gain realized to the extent of the "boot."ⁿ³ It should be noted that here, unlike certain other nonrecognition situations, consideration received in the form of an assumption of liability or the transfer of property subject to a liability is treated as other property.ⁿ⁴ But like other nonrecognition exchanges, the receipt of "boot" will not permit the recognition of any loss realized on the exchange.ⁿ⁵

If no "boot" is received, the stock received will assume the basis of the surrendered stock.ⁿ⁶ If "boot" is received and gain is recognized under *IRC Section 1031(b)*, the aggregate basis of the stock and property other than money received in the exchange will be the basis of the old stock, decreased in the amount of money received and increased in the amount of gain recognized.ⁿ⁷ The basis so determined must then be allocated to the stock and property other than money, the latter taking so much of the basis as is equal to its fair market value and the stock taking the balance.ⁿ⁸

Example:

If a taxpayer exchanges common stock with a basis of \$5,000 for common stock in the same corporation having a value of \$7,000, other property of a value of \$2,000, and cash of \$1,000, the taxpayer's realized gain of \$5,000 will be recognized only to the extent of \$3,000, the sum of the amount of money and the value of other property received. The aggregate basis of the property received in the exchange is \$7,000 (\$5,000 basis of the surrendered stock, less \$1,000, the amount of money received, plus \$3,000, the amount of gain recognized), of which \$2,000 will be assigned to the other property and \$5,000 to the new common stock.

Coupling the substituted basis of the acquired stock with the fact that, in most cases, the surrendered stock will have been a capital asset in the hands of the exchanging shareholder permits the shareholder to include the period for which he held the surrendered stock in the holding period of the stock received in the exchange.ⁿ⁹ Since the basis of any other property received in the exchange will be equal to its fair market value, the shareholder's holding period for such property runs from the time of the exchange.

[3] Exchanges of United States Obligations Issued Under the Second Liberty Bond Act.

[a] General Rule. *IRC Section 1037(a)* provides for nonrecognition of gain or loss on the surrender to the United States of obligations issued under the Second Liberty Bond Actⁿ¹ when (1) such obligations are exchanged solely for other obligations issued under the Act, and (2) the Treasury has issued regulations to the effect that gain or loss is not to be recognized in connection with a particular exchange. The Regulations under *IRC Section 1037* permit the necessary regulations to take the form of a Treasury Department circular containing the exchange offer,ⁿ² and the Treasury Department has announced that it will exercise its authority to designate certain exchanges as nontaxable by so declaring in the circular that announces the particular offer to exchange and sets forth the terms and conditions thereof.ⁿ³ In addition, announcements as to such circulars will be made in the Internal Revenue Bulletins.ⁿ⁴

If the conditions of *IRC Section 1037(a)* are met, gain or loss will go unrecognized whether the surrendered obligation is a capital asset or not.ⁿ⁵ Moreover, the fact that the taxpayer is required to pay money on the exchange will not defeat the application of *IRC Section 1037*.ⁿ⁶ However, if the taxpayer receives money on the exchange, he will be required to treat the money as "boot" and recognize gain to the extent thereof.ⁿ⁷

If obligations are exchanged solely for obligations, the obligations received will assume the basis of those surrendered to the United States.ⁿ⁸ If the taxpayer is required to pay additional consideration as part of the exchange, his basis for the new obligation will be increased accordingly.ⁿ⁹ On the other hand, if the taxpayer receives cash (other than in

payment of interest), the basis of the obligations received on the exchange will be reduced by the amount of such cash, but increased by the amount of any gain required to be recognized on account of the receipt of "boot."ⁿ¹⁰

Gain or loss not recognized because of the application of *IRC Section 1037(a)* will be recognized, at least in part, when the obligation received on the exchange reaches final maturity, or is disposed of or redeemed before maturity in a transaction that does not qualify as an *IRC Section 1037(a)* exchange, but the extent of such recognition is limited to the amount of gain or loss realized on the later transaction.ⁿ¹¹

[b] Exchanges Involving Discount Bonds. The treatment accorded exchanges of obligations issued under the Second Liberty Bond Act is unaffected by the fact that the surrendered obligation was originally issued at a discount. However, if any portion of the gain realized on the exchange of the discount obligation would have been converted into ordinary income by *IRC Section 1271(c)(2)*,ⁿ¹² were it not for the shelter provided by *IRC Section 1037(a)*, the fact that an original issue discount bond is surrendered will have an effect on the character of the gain recognized on the later disposition or maturity of the acquired obligation. The later recognized gain will be treated as ordinary income to the extent that the gain realized but not recognized on the original exchange would have been treated as such.ⁿ¹³

The rule just described is subject to a number of exceptions. The character of any gain recognized on the later disposition will be unaffected by the fact that a discount bond was surrendered in the original exchange if that exchange produced a loss for the taxpayer. Furthermore, if application of *IRC Section 1031(b)* requires any gain to be recognized on the earlier exchange and such recognized gain is treated as ordinary income, the amount of gain recognized on the subsequent disposition and required to be treated as ordinary income will be reduced by the amount of ordinary income previously recognized.ⁿ¹⁴ Finally, if the obligation surrendered to the United States on the earlier exchange was a noninterest bearing, nontransferable obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals, or a Series E savings bond held beyond maturity, the amount of ordinary income that can be recognized on the later disposition is limited to the difference between the issue price of the surrendered obligation and the stated redemption price of that obligation at the time of the original exchange.ⁿ¹⁵

The following example illustrates the application of the foregoing rules:

Example:

The taxpayer purchased a noninterest bearing, nontransferable obligation issued under the Second Liberty Bond Act for \$75 and redeemable in ten years at \$100. Some years later, when the stated redemption price of the obligation was \$90, the taxpayer exchanged it for a marketable bond having a face value and market value of \$100. A few days after the exchange, the newly acquired obligation was sold for \$100. The tax consequences of the exchange and sale are:

- (1) Gain realized on the original exchange--\$25 (\$100, value of the new obligation, less \$75, basis of the surrendered obligation);
- (2) Gain recognized on the original exchange--none, under *IRC Section 1037(a)*;
- (3) Basis of the new obligation--\$75, as determined under *IRC Section 1031(d)*;
- (4) Gain realized on the sale of the new obligation--\$25;
- (5) Gain recognized on the sale of the new obligation--\$25, under *IRC Section 1001(c)*;
- (6) Character of the gain recognized on the sale of the new obligation:ⁿ¹⁶

(a) Ordinary income--\$15, the difference between the issue price of the surrendered obligation and the stated redemption price at the time of the original exchange (the surrendered obligation was not transferable and did not bear interest).ⁿ¹⁷

(b) Long-term capital gain--\$10. Had the taxpayer received a bond worth \$99 and cash of \$1, *IRC Section 1031(d)* would have required the recognition of \$1 of the gain realized on the exchange. If this \$1 was considered ordinary income, then the amount of ordinary income arising on the disposition of the new obligation would be decreased by \$1 and the amount of long-term capital gain arising therefrom increased by \$1.

[4] Exchanges of Convertible Securities.ⁿ¹

Despite the fact that the issuance of convertible bonds and convertible preferred stock is not an infrequent occurrence, the Internal Revenue Code is strangely silent as to the consequences of the exercise of the conversion privilege. Thus, the task of defining the tax effect of an exchange of a convertible security has been left to the courts and the Treasury, with the latter assuming a major role in this regard.

[a] Conversion Into Stock or Other Securities of the Issuer or Obligor.

[i] Conversion Privilege Contained in the Instrument. It has long been the rule that the holder of a bond does not realize gain or loss when he exercises a conversion privilege contained in the instrument and exchanges the bond for another bond of the obligor corporation or for stock of such corporation.ⁿ² The rationale given for this conclusion is that the transaction is not closed for purposes of income taxation until there is a disposition of the bond or stock acquired on the exchange.ⁿ³

The rule obtaining with respect to convertible bonds has been held applicable to a conversion of preferred stock into common stock of the same corporation. In the language of the Service:

"[T]he exercise of a conversion privilege provided for in the preferred stock certificate into common stock of the same corporation results in no taxable income or deductible loss to the shareholder."ⁿ⁴

This rule is based on the assumption that the conversion merely changes the form of the investment and not its substance, and that a change in substance would produce gain or loss. However, it is not always clear where there is a mere change in form. In *Revenue Ruling 90-7*^{n4.1} the IRS ruled that the owner of a certificate in an investment trust who traded the certificate for proportionate amounts of stock held by the trust would not recognize gain or loss in the exchange. This revoked the earlier *Revenue Ruling 68-633*, which held otherwise.ⁿ⁵

There are times when a surrender of convertible securities can be considered part of a recapitalization, and the tax consequences of the exchange governed accordingly. Such a result seems warranted when the issuing corporation has undertaken a plan of reorganization involving the entire issue of convertible securities, or at least a substantial part thereof. Yet the Service has classified conversions made solely at the option of the holders of the stock or securities as recapitalizations. For example, in *Revenue Ruling 56-179*,ⁿ⁶ the issuing corporation proposed to redeem its first preference stock, each share of which was convertible into seven shares of common. In order to avoid the issuance of a large number of common shares (resulting from the exercise of the conversion privilege), the corporation gave each owner of first preference stock who chose not to convert his shares into common, an additional option to acquire a bond, a lesser amount of common stock, and cash. The Service accorded recapitalization status to the exchange made pursuant to the additional option granted by the corporation, a necessary step if the exchange was to be at least partially tax-free. But, in addition, the Service found the exercise of the conversion privilege to be a recapitalization as well. This was unnecessary, since the same result would have obtained had it been held that the transaction would not be considered closed until the exchanging shareholder disposed of the common stock received in the conversion.ⁿ⁷

[ii] Conversion Privilege Not Contained in the Instrument. The conversion of a convertible security will be tax-free only if it is made pursuant to a conversion privilege contained in the converted instrument. A later consent to conversion will not supply the defect caused by the initial absence of the privilege from the instrument.ⁿ⁸

There have been some cases where an exchange of bonds of the same obligor has been found to be nontaxable even though the exchange was not made pursuant to a conversion privilege contained in the instrument or as part of a recapitalization. In the main, these have concerned refundings of defaulted municipal bonds, the new bonds containing substantially the same terms as the old. The theory underlying nontaxability has been that the bonds received on the exchange represented a continuation of the old debt and did not evidence a new indebtedness. In most cases, the only thing changed was the maturity date of the obligation,ⁿ⁹ although in one case, the court found that even the existence of a new interest rate did not produce a different obligation.ⁿ¹⁰ However, where the change in interest rate was coupled with changes in maturity date and call date, something more than a continuation of the old debt was effected and the exchange was held to be taxable.ⁿ¹¹

[b] Conversion Into Stock or Securities of Another Corporation or Issuer. The exchange of stock or securities of one issuer or obligor into those of another, even if made pursuant to a conversion privilege in the instrument, will be a taxable event, unless the transaction qualifies as a reorganization.ⁿ¹² This rule is grounded on the assumption that the securities of different entities are essentially different, so that the exchange produces a change in the substance, as well as in the form, of the investment.

[c] Use of Convertible Obligations in Corporate Acquisitions. The acquisition by one corporation of the stock of another cannot qualify as a reorganization if the consideration for the acquisition consists solely of securities of the acquiring corporation; securities can never provide a continuing proprietary interest in the acquiring corporation, and such an interest is a condition precedent to reorganization status.ⁿ¹³ However, the need to qualify the transaction as a reorganization would be obviated if the taxpayer could employ the installment method of reporting income and effectively defer the recognition of gain until he disposed of the obligations received on the exchange.ⁿ¹⁴ And if the obligation was convertible into the stock of the acquiring corporation, the exchanging shareholder would be given the opportunity to participate in the future growth of the corporation.ⁿ¹⁵ Thus, the combination of a convertible obligation and the installment method of reporting could give the exchanging shareholder a tax result substantially equivalent to the one he would achieve in a tax-free reorganization.

At the same time, the use of the convertible obligation would provide the acquiring corporation with an attractive and rather inexpensive method of obtaining the stock of the acquired corporation. There would be no cash outlay on account of the "purchase price" until the maturity of the obligation or its prior redemption. The acquiring corporation's cost in carrying the debt would be minimal, for it would be allowed to deduct 85 percent of the dividends received on the acquired stock, while deducting all of the interest paid by it to holders of the obligations.

The availability of installment reporting in a debt-financed acquisition is severely limited by *IRC Section 453(f)(4)*,ⁿ¹⁶ which requires a taxpayer to treat an obligation as a payment if it is:

- (1) payable on demand; or
- (2) issued with interest coupons attached or in registered form or in any other form designed to make the obligation readily tradable in an established securities market.

Before the enactment of the Installment Sales Revision Act of 1980,ⁿ¹⁷ which amended the Code to provide for installment reporting when only one payment is received,ⁿ¹⁸ installment reporting by the exchanging shareholder was not an absolute certainty even if the taxpayer could establish that the obligation should be treated as an evidence of indebtedness of the purchaser and not as a payment. The threshold problem was whether the installment method could be used when the only payment called for by the obligation would come at maturity or at prior redemption. There was

nothing in either the Code or Regulations which prescribed a minimum number of payments as a prerequisite for electing the installment method to report the gain realized on a casual sale of personalty. On the other hand, the Regulations applicable to dealers in personal property defined a sale on the installment plan as one which contemplates that the purchase price will be paid for in two or more payments.ⁿ¹⁹ Seizing upon this definition, the Internal Revenue Service took the position, in *Revenue Ruling 69-462*,ⁿ²⁰ that a sale of real property could not qualify for installment reporting when the total purchase price was payable in a lump sum in a year subsequent to the year of sale. The Service recognized that *IRC Section 453(b)* did not expressly prescribe multiple payments as a prerequisite for installment reporting of gain on sales of real property. It overcame this problem by stating that

"[S]uch a requirement [multiple payments] is implicit in Section 453(b) of the Code, inasmuch as income from sales of personal property by dealers may be returned on the installment method only if the plan of sale contemplates multiple payments of the purchase price and income from sales of real property may be returned on the basis' prescribed for dealers, i.e., as each of the payments against the purchase is actually received."ⁿ²¹

The Service also found support for its multiple payment requirement in some earlier decided cases. In one of these, *Prendergast v. Commissioner*,ⁿ²² real property was sold for a consideration consisting of two of the purchaser's ten-year bonds, both bonds maturing on the same date. The Board of Tax Appeals upheld the Commissioner's position that the transaction could not be considered an installment sale, in part basing its decision on the dictionary definition of "installment"--a portion of a debt or sum which is divided into portions that are made payable at different times. In *James McCutchen & Company v. Commissioner*,ⁿ²³ the agreement fixed only a single date for payment, although any dividends paid on the stock which formed the subject matter of the sale would be applied against the purchase price. Although dividends were in fact paid in the year of sale, the Board of Tax Appeals again denied installment treatment; it could find only one payment that had to be paid in all events.

One might wonder why the Service felt it necessary to rule on single-payment transactions in 1969 when prior case law had denied the availability of installment reporting to such transactions. The answer lies in General Counsel's Memorandum 12148,ⁿ²⁴ which cited *Prendergast* solely for the proposition that the installment method could not be used where there was no payment in the year of sale and the entire purchase price was payable in a lump sum in post-sale year (the Revenue Act then in effect did not contain any provision expressly negating the necessity of a year-of-sale payment). It is interesting to note that the view taken by General Counsel's Memorandum 12148 had been earlier rejected by the Court of Claims,ⁿ²⁵ and was later rejected by the Ninth Circuit.ⁿ²⁶

A second problem arises whenever the obligation is convertible.ⁿ²⁷ The issue here is whether the conversion feature must be treated apart from the evidence of indebtedness and considered a payment. The Proposed Regulations under *IRC Section 1273* would seem to negate a separate value for the conversion privilege when they say that the issue price of a convertible obligation "includes any amount paid in respect of the conversion privilege."ⁿ²⁸ But those same Regulations make it clear that when the obligation is part of an investment unit consisting of an option or warrant and a debt instrument, the component parts must be separately valued. Another argument for separate valuation is that the conversion privilege, although contained in a debt obligation, is not an evidence of indebtedness of the purchaser, and therefore, cannot be excluded from the payments received in the year of sale or exchange. The proper answer is in doubt--there are no decided cases on the issue.

We have seen that *IRC Section 453(f)(4)* seeks to thwart debt-financed acquisitions by affecting the tax consequences of the recipient. *IRC Section 279*, another provision added by the Tax Reform Act of 1969, works against the acquiring corporation by limiting the corporation's deduction for interest paid or incurred with respect to its "corporate acquisition indebtedness" to a maximum of \$5 million.ⁿ²⁹ An obligation will constitute such indebtedness only if:

- (1) the obligation is issued as the consideration for the acquisition of (a) the stock of another corporation, or (b) the assets of another corporation pursuant to a plan under which at least two-thirds (in value) of the

assets (other than money) used in the trades and businesses carried on by such corporation are acquired;ⁿ³⁰

(2) the obligation is either (a) subordinated to the claims of trade creditors of the issuing corporation or (b) expressly subordinated in right of payment to the payment of any substantial amount of then outstanding or later issued unsecured indebtedness of the corporation;ⁿ³¹

(3) the obligation is either (a) convertible into the stock of the issuing corporation or (b) part of an investment unit which includes an option to acquire stock in the issuing corporation;ⁿ³² and

(4) as of the last day of any taxable year in which the corporation issues an obligation to acquire the stock or assets of another corporation, either (a) the ratio that the total indebtedness of the corporation bears to the sum of its money and the adjusted bases of all of its other assets less such total indebtedness--its debt-equity ratio--is greater than 2-to-1, or (b) the projected earnings of the corporation (and of the acquired corporation in any case where the issuing corporation acquired control of, or substantially all of the assets of, the acquired corporation) do not exceed three times the annual interest to be paid and incurred on the total outstanding indebtedness of the issuing corporation (and of the acquired corporation in any case in which projected earnings include those of the acquired corporation).ⁿ³³

The deduction will not be disallowed before the first taxable year in which application of condition (4) specified above results in an obligation being treated as corporate acquisition indebtedness.ⁿ³⁴ But once an obligation is determined to be corporate acquisition indebtedness, it will continue to be such,ⁿ³⁵ unless either (1) the issuing corporation acquires control of the acquired corporation in a later year, and in such year the projected earnings of both corporations exceed three times the annual interest paid or incurred on the total indebtedness of both corporations;ⁿ³⁶ (2) for each of the three years immediately following any year in which an obligation is determined to be corporate acquisition indebtedness, the corporation's debt-equity ratio is less than 2-to-1 and its projected earnings are more than three times as great as the annual interest to be paid and incurred, in which case the obligation will lose its "taint" after the three-year period;ⁿ³⁷ or (3) the obligation was issued to provide the consideration for the acquisition of stock in another corporation, and the issuing corporation has not owned 5 percent or more of the voting stock of such other corporation at any time between October 9, 1969 and the close of the taxable year in which the acquisition occurs.ⁿ³⁸

While an extension, renewal or refinancing of an obligation evidencing a preexisting indebtedness is not the issuance of a new obligation,ⁿ³⁹ any obligation that constitutes corporate acquisition indebtedness of the issuing corporation will also be corporate acquisition indebtedness of any corporation that assumes the obligation or becomes liable for such obligation as a guarantor, endorser, or indemnitor.

The thrust of *IRC Section 279* is the denial of excessive interest deductions when the underlying instrument is endowed with some of the characteristics of equity. However, it should be noted that the provision is not the exclusive means of limiting the deduction for interest paid on obligations used to acquire stock or assets of another corporation. *IRC Section 279(j)* prohibits one from drawing the inference that any instrument designated as a debt security by its issuer represents a debt of such issuer for the purpose of applying any other provision of the Code. Thus, the enactment of *IRC Section 279* does not prevent the disallowance of an interest deduction on the ground that the supposed debt is, in fact, equity and, therefore, that no indebtedness exists.ⁿ⁴⁰ Viewed in this perspective, *IRC Section 279* will most likely be invoked when the Service feels that it has a weak case on the issue of debt versus equity.

[5] Reorganizations Involving Two or More Investment Companies.

The Tax Reform Act of 1976 amended the reorganization provisions by adding a new subparagraph, *IRC Section 368(a)(2)(F)*, for the express purpose of requiring recognition of gain or loss on transactions which, from an investor's standpoint, resemble the formation of an exchange fund, a fund designed to attract low-basis, high-value investments by

giving the investor untaxed appreciation on the formation of the fund and tax-free diversification of his investment assets.ⁿ¹ The provision is designed to become operative if the reorganization involves an undiversified investment company and the result of the exchange is significantly greater diversification than existed before the transaction.ⁿ² Put more specifically, if the parties to a transaction which would normally meet the definition of reorganization contained in Section 368(a)(1) include two or more investment companies, the exchange will not qualify for nonrecognition treatment as to any of the investment companies and its shareholders if the company owned an undiversified portfolio of stock or securities before the exchange.ⁿ³

The new rule has no effect on reorganizations generally, nor does it render taxable reorganization exchanges between two or more diversified investment companies or between an undiversified company and a corporation which is not an investment company. Moreover, it is important to note that even if the transaction involves multiple investment companies, any party to the exchange which is not an undiversified investment company will continue to qualify for customary reorganization treatment. Finally, reorganizations of commonly controlled investment companies, those owned substantially by the same persons in the same proportions, continue to be tax-free.ⁿ⁴

The operation of the amendment can be illustrated by the case of the shareholder of an undiversified investment company who exchanges his stock solely for the voting stock of a diversified investment company in what would otherwise be a "B" reorganization. The shareholder will be treated as having sold his stock in a taxable transaction; the acquiring corporation, because diversified, continues to enjoy the benefits of the reorganization provision. If the shareholder of a diversified company exchanges his stock for the stock of another diversified company, the exchange will be tax-free.

For purposes of the reorganization provisions, a company is an investment company if it is a regulated investment company, a real estate investment trust, or a corporation with 50 percent or more of the value of its total assets consisting of stocks and securities and with 80 percent or more of the value of its total assets being assets held for investment.ⁿ⁵ (Investment assets in the 80 percent category include, but are not limited to stocks and securities.)ⁿ⁶ In making the 50 percent and 80 percent calculations, (1) stock and securities in any subsidiary corporation are to be disregarded and the parent corporation deemed to own its ratable share of the subsidiary's assets,ⁿ⁷ and (2) total assets are to be determined by excluding cash and cash items (including receivables), United States Government securities, and any assets acquired for the purpose of causing the corporation not to be an investment company.ⁿ⁸

A company meeting the definition of investment company is considered to be undiversified unless it is a regulated investment company, a real estate investment trust, or an investment company having not more than 25 percent of the value of its total assets invested in the stock or securities of any one nor more than 50 percent of the value of its total assets invested in the stock or securities of five or fewer issuers (other than a regulated investment company, a real estate investment trust, or an investment company of the type just described.)ⁿ⁹ A person holding stock in a regulated investment company, a real estate investment trust, or an investment company described in the previous sentence, is treated as holding a proportionate share of the assets held by the company or trust. In making these percentage determinations, authority is given to the Service to disregard active business assets and other property deliberately acquired before a planned reorganization for the purpose of qualifying the company as diversified.ⁿ¹⁰

The provision contains rules (the "reverse acquisition") to insure that regardless of whether, in form, the investment company is the acquired corporation or the acquiring corporation, nonrecognition treatment will be denied for the portion of the exchange involving the undiversified investment company and its shareholders. Thus, if an undiversified investment company acquires the assets of another investment company (diversified or undiversified) in a statutory merger or "C" reorganization, the tax consequences of the transaction to the investment company and its shareholders will be determined as though the undiversified investment company had been acquired by the other party to the transaction.ⁿ¹¹ In other words, the undiversified company is treated as if it had exchanged its assets for the stock of the other corporation and then had distributed the stock to its shareholders in exchange for their stock in the undiversified company. If the undiversified company acquires the stock of another investment company in a "B" reorganization, the

shareholders of the undiversified company will be treated as having exchanged their stock in the undiversified company for stock of the other corporation having a fair market value equal to the fair market value of the stock of the investment company owned by the shareholders immediately after the acquisition.ⁿ¹²

FOOTNOTES:

(n1)Footnote 1. *Helvering v Southwest Consol Corp*, 315 US 194 (1942) .

Rev Proc 81-60, 1981-2 CB 680 , reprinted in Appendix G, contains the checklist of information required in a request for a ruling under *IRC § 368(a)(1)(E)*.

A corporation involved in a recapitalization has certain reporting requirements. See § 8.03[3].

(n2)Footnote 2. *Bazley v Commr*, 331 US 737 (1947) ; see § 8.01.

A recapitalization does not have to meet the continuity of business or continuity of interest requirements. *Treas Reg § 1.368-1(b)*.

(n3)Footnote 3. *Treas Reg § 1.368-2(e)(1)*. The transaction should likewise be considered a recapitalization where the bondholder receives common stock as well as where the surrendered instruments are securities other than bonds.

(n4)Footnote 4. *Treas Reg § 1.368-2(e)(2), (3), (4)*.

(n5)Footnote 5. *Treas Reg § 1.368-2(e)(5)*; *Kaufman v Commr*, 55 TC 1046 (1971) , *acq 1971-2 CB 3* . The House version of the 1954 Code would have treated the distribution in lieu of dividends as income. The Senate eliminated the provision. S Rep No 1622, 83d Cong, 2d Sess 44 (1954).

(n6)Footnote 6. *Treas Reg § 1.368-2(e)(5)*. The exchange would be treated as a deemed distribution under *IRC § 305(c)*. See § 4.06[2][a][i][b].

(n7)Footnote 7. *Rev Rul 56-586, 1956-2 CB 214* (exchange of preferred for preferred); *Rev Rul 54-482, 1954-2 CB 148* (exchange of common for common). A conversion of a mutual insurance company into a stock company and an exchange by policyholders of their mutual proprietary interests for stock of the new company was held to be a recapitalization in *Ltr Rul 9142014* .

(n8)Footnote 8. The Service position came around to this after it had been singularly unsuccessful in arguing that a recapitalization contemplated a change in the authorized or outstanding capital stock of the corporation. See, eg, *Commr v Neustadt's Trust*, 131 F2d 528 (2d Cir 1942) ; *Mutual Fire, Marine & Inland Ins Co v Commr*, 12 TC 1057 (1949) , *acq 1951-2 CB 3* ; *Rev Rul 77-415, 1977-2 CB 311* .

(n9)Footnote 9. See § 8.03[1][c].

(n10)Footnote 10. 331 US 737 (1947) .

(n11)Footnote 11. 331 US at 741-742 (1947) . The regulations look upon a distribution of debentures made at the same time as a recapitalization as a distribution governed by *IRC § 301* whenever the distribution is in substance a separate transaction. *Treas Reg § 1.301-1(e)*.

(n12)Footnote 12. 205 F2d 798 (5th Cir 1953) , *aff'g 105 F Supp 292 (ND Ala 1952)* .

(n13)Footnote 13. This factor was also relied on in *Wolf Envelope Co v Commr*, 17 TC 471 (1951) , *nonacq 1952-1 CB 6* , *appeal dismissed 197 F2d 864 (6th Cir 1952)* .

(n14)Footnote 14. *18 TC 502 (1952)* .

(n15)Footnote 15. *Rev Rul 77-415, 1977-2 CB 311* .

(n16)Footnote 1. *Treas Reg § 1.1036-1(a)*; cf *Clark v Commr, 77 F2d 89 (3d Cir 1935)* (restricted stock exchanged for unrestricted stock); but see *Rev Rul 54-65, 1954-1 CB 101* , where a taxable exchange resulted from an exchange of special stock of a regulated investment company for special stock of a different series. One ground for the result was that each series was entirely dependent for its earnings and liquidation value on different underlying assets. A second ground was that the stock was neither preferred nor common.

(n17)Footnote 2. *Treas Reg § 1.1036-1(a)*.

(n18)Footnote 3. *IRC § 1031(b)*. Nonqualified preferred stock (as defined in *IRC § 351(g)(2)*) is treated as property other than stock for purposes of *IRC § 1036*. *IRC § 1036(b)*.

(n19)Footnote 4. *Treas Reg §§ 1.1031(b)-1(c), 1.1036-1(c)*.

(n20)Footnote 5. *IRC § 1031(c)*.

(n21)Footnote 6. *IRC § 1031(d)*.

(n22)Footnote 7. *IRC § 1031(d)*.

(n23)Footnote 8. *IRC § 1031(d)*.

(n24)Footnote 9. *IRC § 1223(1)*.

(n25)Footnote 1. *31 USC § 774(2)*.

(n26)Footnote 2. *Treas Reg § 1.1037-1(a)*.

(n27)Footnote 3. TIR No 292 (1961).

(n28)Footnote 4. A list of the various Revenue Rulings containing announcements as to offering circulars can be found in the loose-leaf tax services as part of their treatment of *IRC § 1037*.

(n29)Footnote 5. *Treas Reg § 1.1037-1(a)(1)*.

(n30)Footnote 6. *Id*; *Treas Reg § 1.1037-1(a)(3)*, Ex (1).

(n31)Footnote 7. *IRC § 1031(b)*; *Treas Reg § 1.1037-1(a)(1)*. If the cash received represents interest, it will be includable in gross income, even though the transaction produces a loss for the taxpayer. *Treas Reg § 1.1037-1(a)(3)*, Examples (3) and (4).

(n32)Footnote 8. *IRC § 1031(d)*.

(n33)Footnote 9. *Treas Reg § 1.1031(d)-1(a)*; *Treas Reg § 1.1037-1(a)(3)*, Ex (2).

(n34)Footnote 10. *IRC § 1031(d)*; *Treas Reg § 1.1037-1(a)(3)*, Ex (4).

(n35)Footnote 11. *Treas Reg § 1.1037-1(a)(2)*.

(n36)Footnote 12. The operation of *IRC § 1271(c)(2)* is discussed in Ch 17, *infra*.

(n37)Footnote 13. *IRC § 1037(b)*.

(n38)Footnote 14. *Treas Reg § 1.1037-1(b)(1)*.

(n39)Footnote 15. *IRC § 1037(b)(1)(A)*. The obligations covered by the provision are those described in *IRC § 454(a)* and *IRC § 454(c)*.

(n40)Footnote 16. The issue price of the obligation received on the earlier exchange will be equal to the stated redemption price of the surrendered obligation, increased by the amount of any additional consideration paid to the United States as part of the exchange. *IRC § 1037(b)(1)(B)*. Thus, the acquired obligation will, in most cases, be saddled with some original issue discount.

(n41)Footnote 17. This result assumes that the taxpayer was a cash basis taxpayer who did not elect, under *IRC § 454(a)*, to include the annual increase in stated redemption value in his gross income in the year of such increase. See § 17.02A[2][a], *infra*.

(n42)Footnote 1. See generally Fleischer & Cary, "The Taxation of Convertible Bonds and Stock," 74 *Harv L Rev* 473 (1961).

(n43)Footnote 2. *Treas Reg* 45, art 1563 (1920); *Rev Rul* 57-535, 1957-2 *CB* 513 ; *Rev Rul* 72-348, 1972-2 *CB* 97 ; *Rev Rul* 72-265, 1972-1 *CB* 222 .

The conversion of an installment obligation into stock accomplishes a satisfaction of the obligation at other than face value, requiring the recognition of gain or loss. *Rev Rul* 73-423, 1973-2 *CB* 161 ; *Rev Rul* 72-264, 1972-1 *CB* 131 .

(n44)Footnote 3. Because of this, the holding period of the stock or securities acquired on the conversion includes the period for which the taxpayer held the convertible stock or securities. *Rev Rul* 62-153, 1962-2 *CB* 186 .

(n45)Footnote 4. Special Ruling, Feb 23, 1945, 4 CCH 1945 Stand Fed Tax Rep P 6151.

(n46)Footnote 4.1. 1990-1 *CB* 153 .

(n47)Footnote 5. 1968-2 *CB* 329 . See also *Commr v Tew*, 108 *F2d* 570 (6th Cir 1940) ; *Young v Commr*, 34 *BTA* 648 (1936) , *acq* 1940-1 *CB* 5 ; *Rev Rul* 54-65 , See § 8.07[2] N 1, *supra*.

(n48)Footnote 6. 1956-1 *CB* 187 .

(n49)Footnote 7. See also *Sol Mem* 3710, IV-1 *CB* 4 (1925), where a similar result was reached on the ground that the exchange would produce a material change in the corporation's capital structure. *Sol Mem* 3710 was declared obsolete by *Rev Rul* 69-44, 1969-1 *CB* 312 . This does not indicate a change in the government's position.

(n50)Footnote 8. *Rev Rul* 57-535 , N 2, *supra*.

(n51)Footnote 9. *City Bank Farmers Trust Co v Hoey*, 52 *F Supp* 665 (SDNY 1942) , *affd per curiam* 138 *F2d* 1023 (2d Cir 1943) ; *West Mo Power Co*, 18 *TC* 105 (1952) , *acq* 1952-2 *CB* 3 ; *Motor Prods Corp*, 47 *BTA* 983 (1942) , *acq* 1943 *CB* 17, 1946-1 *CB* 3 , *affd per curiam* 142 *F2d* 449 (6th Cir 1944) ; *Rev Rul* 56-435, 1956-2 *CB* 506 .

(n52)Footnote 10. *Mutual Loan & Sav Co v Commr*, 184 *F2d* 161 (5th Cir 1950) .

(n53)Footnote 11. *Emery v Commr*, 166 *F2d* 27 (2d Cir 1948) ; *Girard Trust Co v US*, 69 *F Supp* 874 (ED Pa 1946) , *affd* 166 *F2d* 773 (3d Cir 1948) .

(n54)Footnote 12. *Rose v Trust Co of Ga*, 77 *F2d* 355 (5th Cir 1935) ; *Bancker v Commr*, 76 *F2d* 1 (5th Cir) , *cert*

denied 296 US 603 (1935) (parent's stock exchanged for subsidiary's; no conversion privilege in instrument); *Rev Rul 69-135, 1969-1 CB 198* (bonds of one corporation exchanged for stock of another pursuant to conversion privilege contained in bonds).

Pursuant to a merger agreement, the parent of the surviving corporation became jointly and severally liable for convertible securities of the merged corporation. A conversion into the stock of the parent did not result in the realization of gain or loss. *Rev Rul 79-155, 1979-1 CB 153*.

(n55)Footnote 13. See § 8.02, *supra*. Even if the transaction could be considered a reorganization, the exchange would not fit the nonrecognition provisions of *IRC § 354*.

(n56)Footnote 14. The installment method is discussed in § 1.06[2], *supra*.

(n57)Footnote 15. Query whether the conversion of the obligation would trigger gain under *IRC § 453(B)*.

(n58)Footnote 16. The provision, added by the Tax Reform Act of 1969 as *IRC § 453(b)(3)*, applies to dispositions made after May 27, 1969, unless made pursuant to a binding written contract entered into on or before that date.

The House Ways and Means Committee did not believe "that Congress originally intended the installment method to be available where the seller receives debentures or other marketable securities." It also found the use of the installment method in such transactions to be inconsistent with the purpose behind the installment reporting election. H Rep No 91-413 (Part 1), 91st Cong, 1st Sess, 107 (1969).

(n59)Footnote 17. Pub L No 96-471, enacted Oct 19, 1980.

(n60)Footnote 18. *IRC § 453(b)(1)*.

(n61)Footnote 19. Treas Reg § 1.453-2(b).

(n62)Footnote 20. *1969-2 CB 107*.

(n63)Footnote 21. *Id.*

(n64)Footnote 22. *22 BTA 1259 (1931)*.

(n65)Footnote 23. *30 BTA 1177 (1934)*.

(n66)Footnote 24. *XII-2 CB 57 (1933)*. *GCM 12148* has been declared obsolete. *Rev Rul 68-674, 1968-2 CB 609*.

(n67)Footnote 25. *Davis v US, 46 F2d 377 (Ct Cl 1931)*. There were payments in more than one year following the year of sale, in which there was no payment.

(n68)Footnote 26. *Gilbert v Commr, 241 F2d 491 (9th Cir 1957)* (no payment in year of sale; multiple payments thereafter).

(n69)Footnote 27. There seems no reason not to treat the obligations as evidences of indebtedness whenever they are not of the type described in *IRC § 453(f)(4)*. The fact that the debt will be paid in stock rather than cash should have no effect on the result.

(n70)Footnote 28. *Prop Treas Reg § 1.1273-2(e)*.

(n71)Footnote 29. The dollar amount that may be deducted must be reduced by the amount of interest paid or incurred by the corporation on obligations, issued in or after 1968 as consideration for the acquisition of stock or assets

of another corporation, but which do not meet the definition of "corporate acquisition indebtedness." *IRC § 279(a)(2)*.

(n72)Footnote 30. *IRC § 279(b)(1)*. A tax-free acquisition of stock of a corporation that the issuing corporation controls after the acquisition will be considered an acquisition under *IRC § 279(b)(1)* only if immediately before the transaction (a) the acquired corporation was in existence and (b) the issuing corporation was not in control of the acquired corporation. *IRC § 279(e)*. Control is present when the issuing corporation owns 80 percent of the voting stock and 80 percent of the total number of shares of all other classes of stock of the corporation. *IRC § 368(c)*.

Indebtedness issued to acquire the stock or assets of a foreign corporation will not be considered corporate acquisition indebtedness, if, for the three-year period ending with the date of acquisition, the acquired corporation received substantially all of its income from foreign sources. *IRC § 279(f)*.

If the stock of one corporation is acquired from another corporation and such stock constitutes at least two thirds of the assets of the latter corporation, the acquisition is treated as an asset acquisition. If the issuing corporation acquires less than two thirds of the assets of a corporation and those assets include the stock of a third corporation, the acquisition is a stock acquisition. *Treas Reg § 1.279-3(b)(3)*.

Obligations issued to provide indirect consideration for an acquisition of stock or assets comes within *IRC § 279*. An obligation is issued to provide such indirect consideration if (a) at the time of issuance the issuing corporation anticipated the acquisition and otherwise would not have issued the obligation, or (b) at the time of acquisition, the issuing corporation foresaw or reasonably should have foreseen that it would be required to issue obligations, which it would not have been required to issue if the acquisition had not occurred. *Treas Reg § 1.279-3(b)(2)*.

(n73)Footnote 31. *IRC § 279(b)(2)*. The term "substantial amount of unsecured indebtedness" is defined as an amount of unsecured indebtedness equal to 5 percent or more of the face amount of the obligations issued to finance the acquisition. *Treas Reg § 1.279-3(c)(2)*.

(n74)Footnote 32. *IRC § 279(b)(3)*. If the issuing corporation is a member of an affiliated group, the provisions of *IRC § 279(b)(3)* are deemed satisfied if the stock into which the obligation or option is convertible is the stock of any member of the group. *Treas Reg § 1.279-3(d)*.

(n75)Footnote 33. *IRC §§ 279(b)(4), 279(c)(1)(4)*. The term "projected earnings" means the average annual earnings and profits for the three-year period ending with the year of acquisition. In computing earnings and profits, no reduction can be made on account of interest paid or incurred, depreciation or amortization allowed as a deduction, income taxes paid to the United States, and dividend distributions (other than distributions made by the acquired corporation to the issuing corporation). *IRC § 279(c)(3)*.

An obligation, that is not corporate acquisition indebtedness in the year in which it is issued, will be subject to the test of *IRC § 279(b)(4)* in a subsequent year if the issuing corporation issues any obligation for an acquisition with respect to the same acquired corporation. The new test will be required whether or not the subsequent obligation is classified as corporate acquisition indebtedness. *Treas Reg § 1.279-5(b)(2)(i)*.

(n76)Footnote 34. *IRC § 279(d)(1)*.

(n77)Footnote 35. *IRC § 279(d)(2)*.

(n78)Footnote 36. *IRC § 279(d)(3)*.

(n79)Footnote 37. *IRC § 279(d)(4)*.

(n80)Footnote 38. *IRC § 279(d)(5)*. This provision is intended to eliminate de minimis stock acquisitions from the scope of the disallowance rule. S Rep No 91-552, 91st Cong, 1st Sess 143 (1969).

(n81)Footnote 39. *IRC § 279(h)(1); GCM 39618 ; Ltr Rul 8712059* . The protection granted by *IRC § 279(h)(1)* will not be honored if the refinancing was contemplated at the time of the stock or asset acquisition, and the refinancing did not have a valid business purpose.

(n82)Footnote 40. HR Rep No 91-413 (Pt 1), 91st Cong, 1st Sess 104-105 (1969).

(n83)Footnote 1. Because the loss is recognized, it becomes subject to the disallowance provisions of *IRC § 267(a)(1)*, if both corporations are members of the same controlled group. *IRC §§ 267(b)(3)*.

(n84)Footnote 2. S Rep No 94-938, Pt II, 94th Cong 2d Sess 49 (1976).

(n85)Footnote 3. Since recapitalizations involve a single corporation, they are not covered by the amendment.

The Service will issue advance rulings with respect to transactions covered by *IRC § 368(a)(2)(F)*. *Rev Proc 77-1, 1977-1 CB 534* .

(n86)Footnote 4. *IRC § 368(a)(2)(F)(v)*.

(n87)Footnote 5. *IRC § 368(a)(2)(F)(i),(iii)*.

(n88)Footnote 6. S Rep No 94-938, Pt II, 94th Cong, 2d Sess 50 (1976). The types of investment assets which should be treated as "securities" for purposes of *IRC § 368(a)(2)(F)* include obligations of state and local governments commodity futures contracts, shares of regulated investment companies and real estate investment trusts, and other investments constituting a security within the meaning of the Investment Company Act of 1940. *IRC § 368(a)(2)(F)(vii)*.

(n89)Footnote 7. *IRC § 368(a)(2)(F)(iii)*. A corporation is a subsidiary if the parent owns 50 percent or more of the combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock outstanding.

(n90)Footnote 8. *IRC § 368(a)(2)(F)(iv)*.

(n91)Footnote 9. *IRC § 368(a)(2)(F)(ii)*. All members of a controlled group, as defined in *IRC § 1563(a)* are treated as a single issuer.

(n92)Footnote 10. *IRC § 368(a)(2)(F)(iv)*.

(n93)Footnote 11. *IRC § 368(a)(2)(F)(iv)*. For purposes of *IRC § 1001*, the deemed acquisition and exchange is treated as a sale or exchange of property by the corporation and the shareholders.

(n94)Footnote 12. *IRC § 368(a)(2) ((F)(vi)*. The shareholders would be required to recognize gain in the difference between the basis of their stock in their own company and the value of the other company's stock deemed acquired in the deemed exchange.



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CHAPTER 8 Reorganizations and Other Exchanges

1-8 Taxation of Securities Transactions § 8.08

§ 8.08 Rollover of Publicly Traded Securities Gain into Specialized Small Business Investment Companies

Under *IRC Section 1044(a)*, added by the Omnibus Budget Reconciliation Act of 1993 and effective for taxable years ending on or after August 10, 1993, gain from the sale of publicly traded securities (securities traded on an established securities marketⁿ¹) will be recognized only to the extent that the amount realized on the sale exceeds (1) the cost of any common stock or partnership interest in a specialized small business investment company (SSBIC)ⁿ² purchased by the taxpayer during the 60-day period beginning on the date of sale, reduced by (2) any portion of the cost previously taken into account under *IRC Section 1044(a)*.ⁿ³ The provision is elective and applies only to gain that is otherwise treated as capital gain.ⁿ⁴ It may not be availed of by an estate, trust, partnership or S corporation.ⁿ⁵

The amount that can be excluded in any taxable year is limited. In the case of an individual, the maximum amount is the lesser of \$50,000, or \$500,000 reduced by the amount of gain excluded under *IRC Section 1044(a)* for all preceding taxable years.ⁿ⁶ The amounts are halved for a married person filing a separate return.ⁿ⁷

The amount that can be excluded by a C corporation for any taxable year cannot exceed the lesser of \$250,000, or \$1 million reduced by the amount of gain excluded under the provision for all prior taxable years.ⁿ⁸ All corporations that are members of the same controlled group of corporations are treated as one corporation, while any gain excluded by a predecessor of any C corporation is treated as having been excluded by that C corporation.ⁿ⁹

Gain that is not recognized because of the application of *IRC § 1044(a)* is applied to reduce (in the order acquired) the basis for determining gain or loss of any common stock or partnership interest in any SSBIC that is purchased by the taxpayer during the specified 60-day period.ⁿ¹⁰

FOOTNOTES:

(n1)Footnote 1. *IRC § 1044(c)(1)*.

(n2)Footnote 2. An SSBIC is any partnership or corporation that is licensed by the Small Business Administration under § 3(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993). *IRC § 1044(c)(3)*.

(n3)Footnote 3. For this purpose, a purchase occurs if the unadjusted basis of the common stock or partnership interest is its cost within the meaning of *IRC § 1012*. *IRC §§ 1043(b)(4), 1044(c)(2)*.

(n4)Footnote 4. The election must be made on or before the due date (including extensions) for the income tax

return for the year in which the publicly traded securities are sold. The election is to be made by reporting the entire gain from the sale of publicly traded securities on Schedule D, and by attaching a statement to the schedule showing (1) how the nonrecognized gain was calculated; (2) the SSBIC in which common stock or a partnership interest was purchased; (3) the date the SSBIC stock or partnership interest was purchased; and (4) the basis of the SSBIC stock or partnership interest. *Treas Reg § 1.1044(a)-1(b)*. The election is revocable with the consent of the Commissioner. *Treas Reg § 1.1044(a)-1(c)*.

(n5)Footnote 5. *IRC § 1044(c)(4)*.

(n6)Footnote 6. *IRC § 1044(b)(1)*. In the case of any joint return, the amount excluded under *IRC § 1044(a)* is allocated equally between the spouses for purposes of applying the limitation to subsequent taxable years. *IRC § 1044(b)(3)(B)*.

(n7)Footnote 7. *IRC § 1044(b)(3)(A)*.

(n8)Footnote 8. *IRC § 1044(b)(2)*.

(n9)Footnote 9. *IRC § 1044(b)(4)*. The term "controlled group of corporations" for purposes of *IRC § 1044(b)* has the same meaning given to it by *IRC § 1563(a)*, except that the requisite stock ownership level is reduced from 80 percent to 50 percent. *IRC § 52(a)*.

(n10)Footnote 10. *IRC § 1044(d)*. The provision does not apply for purposes of *IRC § 1202*, discussed in § 2.06[2][a][ii].



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CHAPTER 8 Reorganizations and Other Exchanges

1-8 Taxation of Securities Transactions § 8.09

§ 8.09 Reorganizations Involving Foreign Corporations

With the prevalence of a global economy, U.S. tax law in recent years has struggled to address issues related to reorganizations involving non-domestic corporations.

Even in one of the simplest situations, a merger between two foreign corporations, guidance has been relatively recent. It was not until 2005 that the Treasury Department acknowledged that such a merger should not have adverse effects on a U.S. shareholder of one of the corporations.ⁿ¹

Creating more significant problems are the "cross border" type of reorganizations, where U.S. assets are effectively transferred to foreign corporations and then retransferred to the U.S. The concern is that the deferral of gain associated with corporate reorganizations could end up permanent. This could result from the transfer of property with untaxed built-in gain to a tax jurisdiction outside of the United States. In some cases there could even be a repatriation of the assets after the imposition of taxation under a foreign jurisdiction.

IRC Section 367 is the primary means used to avoid such permanent deferral in situations of transfers to controlled corporations under *IRC Section 351*, and reorganizations under *IRC Section 361*. *IRC Section 367* is discussed at length at *Section 3.02[6]*, above, primarily in the context of forming a foreign corporation. The principles discussed in that context, however, will apply as well to a reorganization involving a transferor that is a U.S. person and a transferee that is a foreign corporation.

In particular, reorganizations involving a transferor domestic corporation and a transferee foreign corporation will be subject to *IRC Section 367(a)(5)*. That provision creates a requirement that there be at least 80 percent control of the transferor by five or fewer domestic corporations in order for the transfer to be eligible for tax-free reorganization treatment.

The function of the control requirement is to ensure that the tax-free treatment is in fact merely deferral. The control of the transferor corporation by domestic corporations will ensure that future taxation on the sale of the corporate stock received in the reorganization will be subject to U.S. taxing jurisdiction.

Where there is a minority shareholder (20 percent or less) of the transferor corporation that is not a domestic corporation, then that would trigger immediate gain to the extent that the U.S. would no longer have taxing jurisdiction.

Proposed regulations were issued on August 19, 2008ⁿ² under which domestic corporations in the control group would have the option of avoiding the immediate taxation by appropriate basis adjustments designed to preserve the deferred gain for ultimate U.S. taxation.

FOOTNOTES:

(n1)Footnote 1. *Notice 2005-6, 2005-5 IRB 448* .

(n2)Footnote 2. *73 FR 49278* .



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CHAPTER 9 Stock Options

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CHAPTER 9 Stock Options

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§ 9.01 Introduction

A stock option affords the holder of the option the ability to watch and capitalize on the market trend of the subject stock without incurring any cost other than the cost of acquiring the option. For example, if one acquires an option to purchase 100 shares of stock at \$50 a share and the price of the stock increases to \$75 a share, the optionee is in a position to make an advantageous purchase of the stock. But in addition, he holds a valuable asset--the option itself--and he can sell the option at a gain if he so desires. If the stock declines in price to, say, \$35 a share and the option holder still desires to purchase the stock, he will do so on the open market and permit the option to lapse. In the latter case, the option does not confer a tangible benefit on the holder. However, it does act as insurance against an unprecedented rise in the price of the stock.

A second type of option, the employee stock option, serves a different function. It provides the optionee with the opportunity of acquiring a proprietary stake in his employer's business. And if the option is a statutory stock option (an option granted under an employee stock purchase plan or an incentive stock option), any spread between the option price and the value of the stock at the time of exercise may not be taxed as compensation.

The first part of this chapter will focus upon the tax consequences which attach to the grant, exercise, lapse, and transfer of options which are not employee stock options. Following that, the discussion will turn to the employee stock option, both statutory and nonstatutory. The final portion will be devoted to consideration of the tax problems surrounding the acquisition of restricted stock other than by the exercise of an option, and to a brief discussion of phantom stock plans.



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CHAPTER 9 Stock Options

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§ 9.02 Options to Buy and Sell

[1] Definitions.

[a] "Puts" and "Calls." A "put" is an option that gives the holder (the optionee) the right to sell a given number of shares of a specified stock at a prescribed price within a certain period of time. The maker of the option (the optionor) is the person required to purchase the stock if the option is exercised. A "call" is the opposite of a "put"; it gives the optionee the right to buy a given amount of the optionor's stock at a certain price within a certain time.

[b] Combination Options--"Straddles," "Spreads," "Strips," and "Straps." "Puts" and "calls" may be issued in combination. When the option gives the holder both the right to buy and the right to sell the same stock at the same price during the same period of time, the option is called a "straddle." Where the combination option is issued with respect to the same stock, but the "put" price is below and the "call" price is above the then market price, the option becomes a "spread."¹ Adding a "put" to a "straddle" produces a "strip"; adding a "call" to a "straddle" creates a "strap."²

[2] Tax Treatment of "Puts."

[a] Grant of the Option. The grantor of a "put" option does not realize any gain or loss until the option is exercised or allowed to expire. The holder also has no gain or loss as a result of the granting of the option, but the transaction is not always without tax effect for him, since acquisition of a "put" may be treated as a short sale.¹

[b] Exercise of the Option. Gain realized on the exercise of a "put" will be short-term capital gain if (1) on the date the "put" is acquired, the grantee of the option has not held the stock covered by the option (or substantially identical stock) for more than one year, or (2) the stock covered by the option or substantially identical property is acquired after the acquisition of the option and before its exercise. This result is dictated by the special rule of *IRC Section 1233(b)(1)*;² acquisition of the "put" is treated as a short sale, and its exercise, the closing thereof. To illustrate:

Example:

Suppose that a taxpayer owns 100 shares of X Corp. stock that he purchased at \$10 a share on February 1, 1988 and 100 shares that he purchased at \$12 a share on March 1, 1989. Suppose further that an option to sell 100 shares of the stock at \$14 a share is acquired by the taxpayer on August 1, 1989, and exercised on October 1, 1989 by the delivery of the February shares. Application of *IRC Section*

1233(b)(1) makes the realized gain a short-term capital gain; the "put" was acquired at a time when stock substantially identical to that covered by the option had been held by the taxpayer for less than one year. The fact that the delivered stock had been held for more than one year prior to the acquisition and exercise of the option does not change the result. Furthermore, since the remaining 100 shares had been held for less than one year at the time that the taxpayer acquired the "put," *IRC Section 1233(b)(2)* would become operative and cause the holding period of such shares to begin on October 1, 1989 the date of closing of the short sale. Had the taxpayer delivered the March shares, the gain would still have been short-term, but the holding period of the remaining shares (the February, 1988 shares) would have been unaffected by *IRC Section 1233(b)(2)* since held for more than one year at the time the "put" was acquired.

Under *IRC Section 1233(c)*, the acquisition of an option to sell is not considered a short sale if the option and the stock that the taxpayer identifies as the stock he intends to use in exercising the option are acquired on the same day, and such stock is, in fact, sold under the exercise of the option. If identification of the stock intended to be used in exercising the option is not contained in the option itself, it must be made by appropriate entries in the taxpayer's records within fifteen days after the acquisition of the property.ⁿ³ Since the acquisition of an option covered by *IRC Section 1233(c)* is not treated as a short sale, gain realized on the exercise of the option is classified as long-term or short-term gain solely by reference to the length of time between acquisition and exercise. If held for more than one year, the gain will be long-term, otherwise it will be short-term.

Gain resulting from the exercise of a "put" will always be long term gain if the stock delivered on exercise is obtained more than one year prior to the acquisition of the option and the taxpayer does not acquire additional stock in the corporation (or substantially identical stock) within the period beginning one year before acquisition of the option and ending with its exercise. In such case, *IRC Section 1233(b)* is inapplicable and the acquisition of the "put" is not treated as a short sale.

The character of any loss resulting from the exercise of a "put" is dependent upon the taxpayer's holding period of the stock sold under the option. A holding period of more than one year will produce a long-term loss; one of one year or less, a short-term loss. The character of the loss is not affected by *IRC Section 1233(d)*, the provision that requires a loss realized on a short sale to be treated as a long-term loss whenever stock or securities substantially identical to those sold short have been held by the taxpayer on the date of the short sale for more than one year; the acquisition of the "put" is not a short sale for the purposes of *IRC Section 1233(d)*.ⁿ⁴ Nor is the character of the loss affected by *IRC Section 1233(b)(1)*, since that provision operates only when the short sale results in a gain. But although *IRC Section 1233(b)(1)* has no application, the special holding period rule of *IRC Section 1233(b)(2)* may become operative even though a loss is realized on the transaction. To illustrate:

Example:

A taxpayer purchased 100 shares of X Corp. stock on February 1, 1988 and an additional 100 shares on May 1, 1989. An option to sell 100 shares was acquired on September 1, 1989 and exercised on December 1, 1989 by the sale of the February shares at a loss, a long-term loss since the taxpayer had held the stock for more than one year prior to acquiring the option. A further consequence results from the operation of *IRC Section 1233(b)(2)*, made applicable by the fact that the "put" was acquired within one year of the purchase of the May shares. The holding period of those shares will commence on the date of exercise of the option (the closing of the short sale deemed to have been made when the "put" was acquired). Had the May shares been the ones sold on the exercise of the option, the loss would still have been long-term, but the holding period of the February shares would not have been subject to the rule of *IRC Section 1233(b)(2)*; those shares had been held for more than one year when the option was acquired.ⁿ⁵

The amount of gain or loss realized by an option holder on the exercise of a "put" is determined by first offsetting the

amount paid for the option against the option price and then subtracting therefrom the basis of the stock sold under the option.ⁿ⁶ For example, if a taxpayer paid \$500 for an option to sell stock for \$10,000, and he exercised the option by selling stock with a basis of \$8,000, his gain would be \$1,500 (\$10,000 option price, less \$500 option cost, less \$8,000 stock basis).

The maker of the option, the one required to purchase the stock if the option is exercised, realizes neither gain nor loss if the option is exercised. All he does is determine his basis for the stock by reducing the amount paid therefor by the amount received on the granting of the option.ⁿ⁷

[c] Lapse of the Option. As a general rule, loss attributable to the failure to exercise an option to sell "shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option ... relates as in the hands of the taxpayer. ..."n8 Thus, if the stock covered by the option is a capital asset in the hands of the optionee, his loss on lapse will be a capital loss, with the long-term or short-term nature of the loss depending on the length of time that the taxpayer held the option; the sale or exchange is deemed to take place on the day that the option expires.ⁿ⁹

The general rule will be inapplicable, and the loss on expiration treated as an ordinary loss, if the taxpayer is a dealer in options or a dealer in the property subject to the option.ⁿ¹⁰ The general rule is also inapplicable if the expired option and the stock intended to be used in exercising the option were acquired on the same day.ⁿ¹¹ In such case, the loss is not recognized, and the cost of the option is added to the basis of the stock with which it is identified.ⁿ¹²

We have seen that the purchase of a "put" is treated as a short sale if, at the time of acquisition, the taxpayer has held stock substantially identical to the stock covered by the option for less than one year. The lapse of the "put" marks the closing of that short sale. Although this will have no effect on the character of the loss, it does trigger the special holding period rule of *IRC Section 1223(b)(2)* and cause the holding period of as many shares of substantially identical stock held by the taxpayer as is equal to the number of shares covered by the option to commence on the date on which the option expires.ⁿ¹³ The last stated rule is again inapplicable if the "put" and the stock intended to be sold on its exercise were acquired on the same day.ⁿ¹⁴

Any gain realized by the grantor of the option on account of the failure of the holder to exercise it will be treated as short-term capital gain unless the option was granted by a dealer in options in the ordinary course of the dealer's business.ⁿ¹⁵ However, under *IRC Section 1032*, a corporation does not recognize any gain or loss resulting from the lapse of an option or with respect to a securities futures contract to buy or sell its stock (including Treasury stock).ⁿ¹⁶

[d] Sale or Exchange of the Option. Section 1234(a)(1) sets forth the general rule, in the case of the purchaser of the option, that gain or loss attributable to the sale or exchange of an option will be capital gain or loss, if the stock to which the option relates is, or would have been, a capital asset in the hands of the taxpayer. The period for which the taxpayer has held the option determines whether the gain or loss is long-term or short-term.ⁿ¹⁷

The general rule is inapplicable if the option is part of an option dealer's inventory or stock in trade, or if income derived in connection with the option would otherwise be treated as ordinary income.ⁿ¹⁸ For example, since some of the gain resulting from the sale of an option treated as Section 306 stock, or from the sale of a nonstatutory employee stock option, would be considered ordinary income apart from Section 1234(a)(1), the section will be inoperable, and the gain from such sale or exchange treated as ordinary income.ⁿ¹⁹

The character of any gain or loss realized on the sale or exchange of a "put" is unaffected by Section 1223(b); the language of that provision limits its application to instances in which a "put" constituting a short sale either is exercised or permitted to expire. Accordingly, the nature of the gain or loss resulting from the sale will be determined by the length of time that the option was held.ⁿ²⁰ Moreover, since the sale or exchange of the "put" is not the equivalent of the closing of a short sale, the holding period of so much of the substantially identical stock as is affected by *IRC Section*

1233(b)(2) will run from the date on which the stock was actually acquired and not from the date of sale of the option.

In the case of the grantor of the option, gain or loss from the sale or exchange of the option is treated as short-term capital gain or loss.ⁿ²¹

[e] Hedging Transactions. Gain or loss on an acquired or written "put" that is (or is identified as being) part of a hedging transaction is treated as ordinary gain or loss.ⁿ²²

[3] Tax Treatment of "Calls."

[a] Grant of the Option. As in the case of sell options, the grant of a "call" does not produce any gain or loss for either optionor or optionee.ⁿ¹ Tax consequences attach only upon the exercise of the option, its sale or exchange, or its expiration.

[b] Exercise of the Option. The exercise of a "call" requires the grantor of the option to sell the subject stock at the option price. To determine the gain or loss realized on the sale, the optionor must first add the option premium (the amount paid for the option) to the selling price of the stock, and then compare the resulting figure (the amount realized) with his basis for the stock.ⁿ² The gain or loss will be long-term or short-term depending on the length of time that the optionor has held the stock.

The optionee's basis for the acquired stock is the sum of the option price and the option premium. His holding period for the acquired stock commences on the day following acquisition; the period for which the optionee held the option cannot be "tacked."ⁿ³

[c] Lapse of the Option. Loss attributable to the expiration of a "call" is treated as loss arising from the sale or exchange (on the date of lapse) of property "which has the same character as the property to which the option ... relates ... would have in the hands of the taxpayer if acquired by him. ..." ⁿ⁴ Since, in the vast majority of cases, the stock covered by the option would be a capital asset in the optionee's hands, the loss sustained on the lapse of the "call" will be a capital loss. The period that the optionee held the option determines whether the loss is short-term or long-term.ⁿ⁵

The option premium received by the optionor at the time the "call" was granted becomes an item of short-term capital gain for the optionor on the date that the option expires.ⁿ⁶ However, any gain or loss realized by a corporation on the lapse or acquisition of an option to buy its stock (including treasury stock) is not recognized under *IRC Section 1032*.ⁿ⁷

[d] Sale or Exchange of the Option. Under *IRC Section 1234(a)*, the sale or exchange of an option to buy stock will ordinarily produce a capital gain or loss for the holder; the option takes its character as a capital or noncapital asset from the stock to which it relates.ⁿ⁸ Whether the gain or loss is long-term or short-term depends on the optionee's holding period for the option.ⁿ⁹

As in the case of the sale of a "put," *IRC Section 1234(a)(1)* will not apply to:

- (1) gain from the sale or exchange of an option constituting inventory or stock in trade of the optionor;ⁿ¹⁰ or
- (2) gain that is treated as ordinary income without regard to *IRC Section 1234(a)*, eg, gain from a nonstatutory stock option that is in the nature of compensation.ⁿ¹¹

The Service originally took the position that, where the purchaser of the option was the original seller of the "call," and the cost of repurchasing the option was greater than the premium received on the sale of the "call," the option or purchaser was not entitled to deduct the excess cost as a loss, but had to treat such excess as a capital expenditure and add it to the basis of the underlying stock.ⁿ¹²

However, in a private letter ruling issued to the Chicago Board Options Exchange,ⁿ¹³ the Service took the position that a loss incurred in a "closing transaction" (a cancellation of the option writer's obligation by the purchase of a call containing terms identical to the option previously written) constituted an ordinary loss. Congress changed that result by adding *IRC Section 1234(b)(1)*, which turns gain or loss from any closing transaction with respect to an option in property into a short-term capital loss.ⁿ¹⁴ Dealers in options continue to treat such gain or loss as ordinary income or loss provided the options are written in the ordinary course of their business.ⁿ¹⁵

[e] Hedging Transactions. Gain or loss on an acquired or written "call" that is (or is identified as being) part of a hedging transaction is treated as ordinary gain or loss.ⁿ¹⁶

[4] Tax Treatment of "Straddles."

Since a "straddle" is nothing more than a buy and sell option combined, the rules prescribed for "puts" and "calls" should apply with equal force to "straddles." However, the dual option nature of a "straddle" gives rise to some special rules applicable solely to such options.

[a] Allocation of Option Premium. The first problem relating specifically to "straddles" concerns the manner in which the premium received by the writer of the option should be allocated to the two component options. Prior to 1965, it was common practice to allocate the entire premium received to either the "put" or the "call" depending upon which one was exercised. This had the effect of reducing the writer's basis in stock sold to him under the optionee's exercise of the "put" side of the combination and increasing the gain realized if the "call" option were the only one exercised. Allocation of the entire premium to the exercised option is no longer permissible. Instead, the premium received for writing the "straddle" must be allocated to both the "put" and the "call" on the basis of the relative market values of the component options.ⁿ¹ As an alternative to an allocation based on relative fair market values, the Service permits the taxpayer to apportion 55 percent of the premium to the "call" option and 45 percent to the "put."ⁿ² An option writer who decides to use the 55-45 allocation method must indicate his election to do so in a statement attached to his income tax return.ⁿ³

[b] Lapse of a Component Option. Suppose that a taxpayer receives \$1,000 for writing a "straddle," and allocates 45 percent of the premium to the "put" component and 55 percent to the "call." If only the "put" side of the combination option is exercised, the expiration of the "call" would, without more, produce ordinary income of \$550 for the writer of the option. Conversely, the exercise of the "call" and the expiration of the "put" would give rise to ordinary income of \$450. If both options lapsed, the entire \$1,000 would constitute ordinary income to the writer.

Gain attributable to the lapse of a single component option of a straddle is now taxed as short-term capital gain, provided the option was not granted by a dealer in the ordinary course of his business as a dealer in options.ⁿ⁴ The original provision granting such treatment, *IRC Section 1234(c)(1)*, could apply to the lapse of an option granted as part of a multiple option, but only if (1) the lapsed option was part of the "straddle" portion of the multiple option, and (2) the grantor identified which two of the options in the multiple option constituted the straddle. The repeal of *IRC Section 1234(c)* and the addition of *IRC Section 1234(b)(1)* produces no change in the character of the gain realized on the lapse of a component option of a straddle. However, since *IRC Section 1234(b)(1)* applies to all options, not just straddles, it should apply to the lapse of a component option of a multiple option in all events.

[c] Exercise of a "Call" Option by a Holder of Both Components of a "Straddle." If the same person purchases both sides of a "straddle" and then exercises the "call" option first, his holding period for the acquired stock will not begin to run unless, at the time he purchased the option, he owned as many shares of the subject stock as are covered by the option. This results from the fact that, under *IRC Section 1233(b)*, the acquisition of the stock causes the "put" to be treated as an open short sale, in turn triggering the special holding period rule of *IRC Section 1233(b)(2)*. Thus, if the shares acquired by the exercise of the "call" constitute the taxpayer's only long position in the stock, the holding period of the stock cannot commence until the "put" is exercised or expires.

[d] Loss Deferral. *IRC Section 1092(a)(1)(A)* sets forth a general rule that losses realized on the disposition of one or more positions in a straddle are deductible in the loss year only to the extent of the losses over the unrecognized gains in offsetting positions.ⁿ⁵ The nondeductible portion is deferred and available for deduction in the first year in which there are no gains in offsetting positions.ⁿ⁶ If a taxpayer settles a position that is part of a straddle by delivering property to which the position relates (and the position, if terminated, would result in a realization of loss), the taxpayer is treated as if the taxpayer terminated the position for its fair market value immediately before the settlement, and sold the delivered property at its fair market value.^{n6.1}

For purposes of *IRC Section 1092*, a straddle must relate to offsetting positions in personal property that is actively traded.ⁿ⁷ "Actively traded" personal property includes any personal property for which there is an established financial market.ⁿ⁸ An established financial market includes:

- (i) a national securities exchange that is registered under Section 6 of the Securities Exchange Act of 1934;
- (ii) an interdealer quotation system sponsored by a national securities association registered under Section 15A of the Securities Exchange Act of 1934;
- (iii) a domestic board of trade designated as a contract market by the Commodities Future Trading Commission;
- (iv) a foreign securities exchange or board of trade that satisfies analogous regulatory requirements under the law of the jurisdiction in which it is organized (such as the London International Financial Futures Exchange, the *March 'e 'a Terme International de France*, the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited, the Frankfurt Stock Exchange, and the Tokyo Stock Exchange);
- (v) an interbank market;
- (vi) an interdealer market; and
- (vii) solely with respect to a debt instrument, a debt market.ⁿ⁹

An "interdealer market" is characterized by a system of general circulation (including a computer listing distributed to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine fair market value by disseminating price quotations (including rates, yields, or other pricing information) or actual prices of recent transactions.ⁿ¹⁰ An interdealer market does not include a directory or listing of brokers, dealers, or traders for specific contracts that provides neither price quotations nor actual prices of recent transactions.ⁿ¹¹

A "debt market" exists with respect to a debt instrument if price quotations for the instrument are readily available from brokers, dealers, or traders.ⁿ¹² A debt market does not exist with respect to a debt instrument if:

- (A) no other outstanding debt instrument of the issuer (or of any other person who guarantees the debt instrument) is traded on an established financial market;
- (B) the original stated principal amount of the issue that includes the debt instrument does not exceed \$25 million;
- (C) the conditions and covenants relating to the issuer's performance with respect to the debt instrument are materially less restrictive than the conditions and covenants included in all of the issuer's other traded

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debt (e.g., the debt instrument is subject to economically significant subordination provisions whereas the issuer's other traded debt is senior); or

(D) the maturity date of the debt instrument is more than three years after the latest maturity date of the issuer's other traded debt.ⁿ¹³

The regulations prescribe the manner in which the loss deferral rules are coordinated with the wash sale rules.ⁿ¹⁴ Any loss on the disposition of a position in a straddle is not taken into account if, within the period beginning 30 days before the disposition and ending 30 days thereafter, the taxpayer acquires (in a purchase or exchange in which the entire amount of gain is recognized), or enters into a contract to acquire, substantially identical stock or securities.ⁿ¹⁵ If the taxpayer disposes of less than all of the positions of a straddle, any loss sustained on the disposition of that position is not taken into account to the extent that the loss exceeds the unrecognized gain in successor positions,ⁿ¹⁶ offsetting positions to the loss position or offsetting positions to any successor position.ⁿ¹⁷ Any disallowed loss can be carried over to the succeeding taxable year, but if the disallowance was due to the acquisition of substantially identical stock or securities, the loss will not be allowed until there is a disposition of the stock or securities.ⁿ¹⁸

The general rule does not apply to losses on identified positions comprising an identified straddle.ⁿ¹⁹ If there is any loss with respect to any identified position of the identified straddle, the basis of each of the identified offsetting positions in the identified straddle is increased by an amount that bears the same ratio to the loss as the unrecognized gain with respect to the offsetting position bears to the unrecognized gain with respect to all of the offsetting positions; any such loss is not otherwise taken into account for federal income tax purposes.ⁿ²⁰ An identified straddle is defined as a straddle (i) that is clearly identified as such on the taxpayer's records before the earlier of the close of the day on which the straddle is acquired, or such time as the Service prescribes by regulation, (ii) to the extent provided by regulations, the value of each position of which (in the hands of the taxpayer immediately before the creation of the straddle) is not less than the basis of the position in the hands of the taxpayer at the time the straddle is created, and (iii) that is not part of a larger straddle.ⁿ²¹ The Code requires the promulgation of regulations that specify the proper methods for clearly identifying a straddle as an identified straddle (and the positions comprising that straddle), that specify the rules for the application of *IRC Section 1092(a)(2)(B)* for a taxpayer that fails to properly identify the positions of an identified straddle, and that specify rules in cases where a taxpayer disposes of less than an entire position that is part of an identified straddle.ⁿ²²

Hedging transactions are exempt from the loss deferral rule.ⁿ²³ To qualify for the exemption, the transaction must be entered into by the taxpayer in the normal course of the taxpayer's trade or business to reduce the risk of certain interest or price changes or currency fluctuations and result in ordinary income or loss.ⁿ²⁴ In addition, the taxpayer must identify the transaction as a hedging transaction before the close of the day on which it was entered.ⁿ²⁵

Straddles in which all of the offsetting positions consist of one or more qualified covered call options and the optioned stock and which are not part of a larger straddle are not covered by the loss deferral rule.ⁿ²⁶ The exception does not apply if the gain on the stock acquired by exercise of the qualified covered call options is realized in a taxable year later than the year of exercise, and the stock was not held by the taxpayer for at least 30 days after the closing of the options.ⁿ²⁷ The exception is also inapplicable if the stock is sold at a loss, the related option is not held for 30 days thereafter, and gain on the option is realized in a subsequent taxable year.ⁿ²⁸ An option can be a qualified covered call option only if it: (1) is traded on a national securities exchange that is registered with the Securities and Exchange Commission or other market designated by the Service; (2) is granted for a period of more than 30 days; (3) is not a deep-in-the-money option; (4) is not granted by an options dealer (a registered market maker or specialist in listed options) in connection with his activity in dealing in options; and (5) gain or loss produced by the option is not ordinary income or loss.ⁿ²⁹

A deep-in-the-money option is one having a strike price (exercise price) lower than the lowest qualified bench mark.ⁿ³⁰ The lowest qualified bench mark is the highest available strike price which is less than the applicable stock price (the

closing price of the stock on the most recent day on which it was traded before the date on which the option was granted, or the opening price on the day the option was granted if such price is greater than 110 percent of the closing price on the last previous trading date).ⁿ³¹ A number of special rules affect the determination of the lowest qualified bench mark. If the option is granted for more than 90 days with a strike price of more than \$50, the lowest qualified bench mark is the second highest available strike price which is less than the applicable stock price.ⁿ³² If the applicable stock price is \$25 or less, the lowest qualified bench mark can never be less than 85 percent of the applicable stock price.ⁿ³³ Finally, if the applicable stock price is \$150 or less, the lowest qualified bench mark must be at least the applicable stock price less \$10.ⁿ³⁴

Although the loss deferral rule extends beyond stock options to any situation in which the taxpayer holds offsetting positions with respect to personal property, the provisions of *IRC Section 1092* are inapplicable to any straddle involving the holding of stock (but not an interest in stock) unless (1) the stock is of a type that is actively traded and at least one of the positions offsetting the stock is a position with respect to the stock or substantially similar or related property, or (2) the stock is of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.ⁿ³⁵ A position is defined as an interest (including a futures or forward contract or option) in personal property.ⁿ³⁶

IRC Section 1092(b) requires the promulgation of "such regulations with respect to gain or loss on positions which are part of a straddle as may be appropriate to carry out the purposes of this section. ..." Consistent with such purposes, the regulations are to include rules applying wash sale principles and short sale gain, loss and holding period principles. In addition, the regulations must also prescribe the treatment of gain or losses from mixed straddles.

The holding period of any position in a straddle cannot begin earlier than the date the taxpayer no longer holds (directly or indirectly) an offsetting position with respect to that position, unless the position was held by the taxpayer for the long-term capital gain holding period or longer before a straddle that includes the position was established.ⁿ³⁷

Loss on the disposition of a loss position is treated as a long-term capital loss if (1) on the date the taxpayer entered into the loss position the taxpayer held, directly or indirectly, an offsetting position, and (2) all gain or loss with respect to a position in the straddle would be treated as long-term capital gain or loss if the position were disposed of on the day the loss position was entered into. Losses on non-Section 1256 positions in a mixed straddle are treated as 60 percent long-term and 40 percent short-term capital loss.ⁿ³⁸

The holding period and loss rules do not apply to positions that are part of a hedging transaction, to straddles that consist only of Section 1256 contracts, or to positions in a mixed straddle account.ⁿ³⁹

Gains and losses from the disposition of an identified mixed straddle are subject to a series of rules.ⁿ⁴⁰ If all positions in an identified mixed straddle are disposed of on the same day, gains and losses from Section 1256 contracts and gains and losses from non-Section 1256 contracts are netted, with the net gain or loss from the former being offset against the net gain or loss from the latter to determine the net gain or loss from the straddle. If the net gain or loss from the straddle is attributable to Section 1256 contracts, the gain or loss is 60 percent long-term and 40 percent short-term. If attributable to non-Section 1256 positions, the gain or loss is all short-term.ⁿ⁴¹

If all of the non-Section 1256 positions of an identified mixed straddle are disposed of on the same day, the gain and loss realized on such disposition is netted and then offset against the net *realized and unrealized* gain or loss with respect to non-Section 1256 positions of the straddle to determine the net gain or loss from the straddle. Net gain or loss from the straddle attributable to the non-Section 1256 positions must be realized and treated as short-term capital gain or loss, while net gain or loss from the straddle attributable to *realized* gain or loss attributable to Section 1256 contracts is treated as 60 percent long-term and 40 percent short-term. Any gain or loss subsequently realized on the Section 1256 contracts is adjusted to take into account the extent to which gain or loss was offset by unrealized gain on the Section 1256 contracts.ⁿ⁴²

If all of the Section 1256 contracts of an identified mixed straddle are disposed of on the same day, the gain and loss realized therefrom is netted and treated as short-term capital gain or loss to the extent of the net realized and unrealized gain or loss with respect to the non-Section 1256 positions of the straddle. Any excess gain or loss from the Section 1256 contracts is treated as 60 percent long-term and 40 percent short-term.ⁿ⁴³ Gain or loss on a non-Section 1256 position that is part of an identified mixed straddle and is held after all Section 1256 contracts in the straddle are disposed of is treated as short-term gain or loss to the extent attributable to the period when the positions were part of the straddle.ⁿ⁴⁴

If some, but not all, of the positions in an identified mixed straddle are disposed of on the same day, and the previous two paragraphs do not apply, the net gain or loss from the Section 1256 contracts disposed of on that day is offset against the net gain or loss from the disposition of non-Section 1256 positions. If the resulting net gain or loss is attributable to non-Section 1256 positions, the rules relating to the disposition of all of the non-Section 1256 positions in a mixed straddle apply. If the gain or loss is attributable to Section 1256 contracts, the applicable rules are those in the immediately preceding paragraph. If the netting process yields only gains or only losses, the gains or losses are treated separately under the rules described in the preceding two paragraphs.ⁿ⁴⁵

A taxpayer may elect to establish one or more mixed straddle accounts.ⁿ⁴⁶ Gains and losses in such an account are determined daily by netting gains and losses from Section 1256 contracts and from non-Section 1256 positions and then offsetting the net amounts against each other. The gain or loss is short-term to the extent attributable to non-Section 1256 positions, and 60 percent long-term and 40 percent short-term if attributable to Section 1256 contracts. An adjustment is made to any subsequent gain or loss to reflect any gain or loss taken into account for prior business days.ⁿ⁴⁷ At the end of each year, the daily account gains and losses are netted to arrive at any annual account gain or loss.ⁿ⁴⁸

Finally, if a taxpayer holds stock on which he has granted a qualified covered call option to purchase the stock at a strike price less than the applicable stock price, any loss on the call will be a long-term loss if the stock has been held for more than one year.ⁿ⁴⁹ That holding period is suspended during the option period.ⁿ⁵⁰

[e] Options Marked to Market. The Tax Reform Act of 1984 extended the mark-to-market rule that had applied only to regulated futures contracts and foreign currency contracts to nonequity options and dealer equity options and labeled all of such Section 1256 contracts.ⁿ⁵¹ The list was expanded in 2000 with the addition of dealer securities futures contracts.ⁿ⁵² Under *IRC Section 1256(a)(1)*, each Section 1256 contract held by a taxpayer at the close of the taxable year is treated as sold for its fair market value on the last business day of the year.ⁿ⁵³ The gain or loss so created is treated as 60 percent long-term and 40 percent short-term without regard to the actual holding period. (The wash sale rules of *IRC Section 1091* do not apply to any loss taken into account under *IRC Section 1256(a)(1)*).^{n53.1} The same treatment applies to a termination or transfer of the taxpayer's obligation or rights with respect to a Section 1256 contract.ⁿ⁵⁴ However, if two or more Section 1256 contracts are part of a straddle and the taxpayer takes delivery under or exercises any of such contracts, the other contracts are treated as terminated on the day of delivery instead of the last day of the year.ⁿ⁵⁵

A nonequity option is any option listed on a qualified board or exchangeⁿ⁵⁶ other than an equity option. An equity option is either an option to buy or sell stock or an option the value of which is determined directly or indirectly by reference to any stock, or any narrow-based security index (as defined in Section 3(a)(55) of the Securities Exchange Act of 1934).ⁿ⁵⁷ A dealer equity option is an equity option purchased or granted by an options dealer in the normal course of his activity of dealing in options and listed on the qualified board or exchange on which the option dealer is registered.ⁿ⁵⁸

A dealer securities futures contract is, with respect to any dealer, any securities future contract, and any option on such a contract, that (1) is entered into by the dealer (or, in the case of an option, is purchased or granted by the dealer) in the

normal course of the activity of dealing in such contracts (or options), and (2) is traded on a qualified board or exchange.ⁿ⁵⁹ A person will be treated as a dealer in securities futures contracts or options on such contracts if the Service determines that the person performs, with respect to such contracts or options, functions similar to those performed by an options dealer.ⁿ⁶⁰

The mark-to-market rules do not apply to hedging transactions (a transaction that a taxpayer enters into in the normal course of business primarily to reduce the risk or interest rate or price changes or currency fluctuations).ⁿ⁶¹ However, *IRC Section 1256(e)(4)* limits the deduction for hedging losses of limited partners and S corporation shareholders (if more than 35 percent of the losses for the year are allocable to the limited partners or shareholders) to the extent of the taxpayer's taxable income from the trade or business in which the hedging transactions were entered into. (Such taxable income is determined by not taking into account items attributable to hedging transactions.)ⁿ⁶² The disallowed portion of the loss is carried over and allowed as a deduction attributable to a hedging transaction in the succeeding taxable year. An economic loss exception makes the limitation inapplicable to any hedging loss to the extent it exceeds the unrecognized gains from hedging transactions at the close of the taxable year.ⁿ⁶³

Gain or loss resulting from the exercise of a Section 1256 contract must be recognized and, therefore, does not come within the 60-40 rule of *IRC Section 1256(a)*.ⁿ⁶⁴ Gain or loss attributable to the cancellation, lapse, expiration, or other termination of a Section 1256 contract (other than a securities futures contract) that is a capital asset in the hands of the taxpayer is treated as gain or loss from the sale of a capital asset.ⁿ⁶⁵ However, gain cannot be considered capital gain if the property involved was part of a hedging transaction.ⁿ⁶⁶

Traders in Section 1256 contracts realize capital gain or loss from trading in such contracts except to the extent the contract is used to hedge property that would produce ordinary loss.ⁿ⁶⁷ In determining the character of the gain or loss, the fact that the taxpayer is actually engaged in dealing in or trading Section 1256 contracts is not taken into account.ⁿ⁶⁸

The taxpayer can elect to have *IRC Section 1256* not apply to Section 1256 contracts that are part of a mixed straddle (a straddle where at least one but not all of the positions are Section 1256 contracts) in which the positions are clearly identified at the close of the day on which the first Section 1256 contract forming part of the straddle is acquired (or such earlier time as regulations prescribe).ⁿ⁶⁹ The election applies to the taxable year for which it is made and to all subsequent years unless the Service consents to its revocation.ⁿ⁷⁰

[5] Dividends Paid on Stock Subject to Options.

Under current practice, "put" and "call" options generally provide that the option price will be reduced by the amount of dividends received by the owner of the stock during the option period. Because of this adjustment, the seller of the subject stock receives less for his stock, thereby decreasing the amount of gain or increasing the amount of loss to be realized on the sale. The purchaser's basis for the stock will similarly be reduced, since the adjustment to the option price requires him to pay less for the stock.

The option may require the seller to deliver the amount of dividends received during the life of the option without any increase in the option price. The tax consequences here are no different from the instance in which the dividends work an adjustment to the option price; both the amount realized by the seller and the basis of the stock in the hands of the purchaser are reduced in an amount equal to the amount of delivered dividends.ⁿ¹

Whether the option calls for an adjustment of the option price or for the delivery of the amount of the dividends to the purchaser has no effect on the identity of the person who must include the dividends in gross income. The taxable person is still the one who owned the stock on the date that holders of the stock became entitled to receive the dividends.ⁿ²

[6] Tax Techniques Involving "Puts" and "Calls."

[a] Using "Puts" to Defer Gain Without Risk of Loss. A taxpayer holding stock which has appreciated in value can defer recognition of the gain while guarding against a reduction in the amount of gain by acquiring a "put." While the same result can be achieved through a short sale, the acquisition of a "put" allows the taxpayer to obtain the benefit of an increase in the price of the stock. The major disadvantage comes in the fact that the acquisition of the "put" will be considered a short sale if, on the date of acquisition, the taxpayer has held the subject stock for less than one year.ⁿ¹ There is, of course, the added cost of the option, but this should be viewed more as a necessary cost in obtaining the right to reap the benefit of a subsequent increase in the price of the stock than as an expense of guarding against a loss of the potential gain.

The following example illustrates the use of the technique described above:

Example:

A taxpayer purchases 100 shares of X Corp stock on August 15, 1990, at a cost of \$50 a share. On February 10, 1991, the taxpayer pays \$800 for a six-month option to sell the stock at \$80 a share. (The acquisition of the "put" would be considered a short sale since the stock had been held for less than one year.) On July 20, 1991, when the stock is selling at \$90 a share, the taxpayer decides to dispose of his stock. Since the stock is selling at a price in excess of the option price, the sale should be made without exercising the option, thereby giving rise to a gain of \$40 a share in 1991. The gain would be short-term capital gain since acquisition of the "put" made *IRC Section 1233(b)(2)* applicable, and caused the holding period of the stock to begin on the date of disposition. The taxpayer would then attempt to sell the option in order to realize a loss. A loss would result from the sale of the "put" as long as the price of the stock remained above \$80 a share, failing which he would allow the option to lapse. In either case, the loss would be a short-term capital loss.ⁿ² If the price of the stock plunged after the stock was sold, the "put" itself could be sold at a gain.ⁿ³

If the price of the stock dropped to \$60 a share after the "put" was acquired, the taxpayer would then sell the option at a price which approximates the difference between the option price and the price of the stock, a difference here of \$20 a share, realizing a gain of \$12 (\$20 less the \$8 cost of the option). The gain would be short-term; the length of time that the taxpayer held the option would always be less than one year. An immediate sale of the stock at \$60 a share would produce an additional short-term capital gain of \$10 a share. (The tainted holding period rule of *IRC Section 1233(b)(2)* would preclude long-term gain on the sale of the stock even if actually held for more than one year.)

[b] Using "Puts" to Achieve Gain in a Declining Market. An investor who believes that the market price of a particular stock will decline can attempt to secure a gain either by selling the stock short or by acquiring a "put" and then selling the option prior to its expiration. If the taxpayer does not own the stock subject to the short sale at the time that he makes the sale, any gain realized by him will be short-term capital gain; the later purchase of stock to cover the short sale will be the acquisition of substantially identical property, bringing into play the special gain rule of *IRC Section 1233(b)(1)*. On the other hand, if a "put" is acquired and the market price of the stock declines, the taxpayer can sell the option at a gain. If the taxpayer has not held the option for more than one year, the gain realized on the sale of the option will be short-term capital gain.ⁿ⁴ If the price of the stock increases, a sale or lapse of the option would result in a short-term capital loss.ⁿ⁵ If the stock were held for more than one year, its sale would give rise to a long-term gain.

[c] Using "Puts" to Limit Losses. We have seen that the simultaneous acquisition of an option to sell and the stock identified as the stock which the taxpayer intends to use in exercising the option will prevent the acquisition of the "put" from being treated as a short sale.ⁿ⁶ The practical effect of this rule is that, by acquiring stock and an option to sell the stock at a price equal to its purchase price, the taxpayer can limit his loss on the stock to the option premium (if the stock declined in value, he would exercise the option) without foregoing the opportunity to achieve long-term

capital gain treatment if the stock were to appreciate and be held for more than one year.

[d] Using "Calls" and Short Sales to Insure Gains. A "call" option and the stock subject to it are not considered substantially identical property.ⁿ⁷ Therefore, the holder of an appreciated "call" can enter into a short sale of the underlying property and not be concerned with the application of *IRC Section 1233(b)*. Why should he do so? The answer is simple--to protect himself against an economic loss produced by a decline in the market. To illustrate:

Example:

Assume that a taxpayer pays \$500 for a six-month option to purchase 100 shares of stock at \$50 a share. Assume further that when the stock increases to \$70 a share, the taxpayer makes a short sale of the stock at \$70 a share. By so doing, the taxpayer has insured a minimum gain of \$1,500 (\$7,000 realized on the short sale less the sum of \$5,000, the option price to be paid on the exercise of the option, and \$500, the option premium). If the value of the stock were to increase further, say, to \$85 a share, the "call" would be sold for approximately \$3,500, the difference between the option price and the market price of the stock. The short sale would be covered by purchasing stock on the open market at \$85 a share, producing a short-term capital loss of \$1,500. The net economic gain is still \$1,500, the difference between the \$3,500 gain realized on the sale of the "call" and the sum of the \$1,500 loss on the short sale and the \$500 option premium. If the value of the stock declined after the short sale, say, to \$55 a share, the short sale would be covered by a purchase of 100 shares at the market price, yielding a short-term gain of \$1,500. The "call" would be sold for \$500, but the amount would be offset by the cost of the option. The economic gain once again is \$1,500. If the market price of the stock fell below \$50 a share, the taxpayer would realize a gain by closing the short sale with shares purchased on the open market. If the price of the stock did not then increase above the option price, he would realize a loss by letting the option lapse or by selling it prior to expiration.

The combination of a "call" and a short sale can be used to advantage whenever the taxpayer anticipates a sudden, but short-lived increase in the value of a particular stock. The acquisition of an option to purchase at the present market price followed by a short sale when the price rise occurs will produce a gain equal to the difference between the short sale price and the sum of the option price and option premium. If the price of the stock continues to increase, the taxpayer will sell the "call" and close the short sale by purchasing shares on the open market. The gain on the sale of the option will be short-term since the option would not be held for more than one year prior to sale; the loss on the short sale will be a short-term loss. If the market price declines below the option price, the short sale will again be closed by stock purchased on the open market. Here the only gain will be on the closing of the short sale and it will be a short-term gain; the expiration of the option, or its sale prior to expiration, will produce a short-term loss.

FOOTNOTES:

(n1)Footnote 1. *Financial Handbook* 10-26 (4th ed 1964).

(n2)Footnote 2. *Id.* "Strips" and "straps" are purchased by option dealers who sell the three component options individually to traders and investors. Hariton, "Puts, Calls and Straddles," *NYU 18th Inst on Fed Tax* 357, 359 (1960).

(n3)Footnote 1. *IRC § 1233(b)*.

(n4)Footnote 2. See Ch 10.

(n5)Footnote 3. *Treas Reg § 1.1233-1(c)(3)*.

(n6)Footnote 4. *Treas Reg § 1.1233-1(c)(4)*.

(n7)Footnote 5. *Treas Reg § 1.1233-1(c)(6)*, Ex (5).

(n8)Footnote 6. *Rev Rul 71-521, 1971-2 CB 313 ; Rev Rul 58-234, 1958-2 CB 279 .*

(n9)Footnote 7. *Id.*

(n10)Footnote 8. *IRC § 1234(a)(1); Rev Rul 71-521, 1971-2 CB 313* . The reasons leading to the failure to exercise are immaterial. *Southern Coast Corp v Commr, 17 TC 824 (1951)* .

(n11)Footnote 9. *IRC § 1234(a)(2); Treas Reg § 1.1234-1(a)*.

(n12)Footnote 10. *IRC § 1234(a)(3)(A); Treas Reg §§ 1.1234-1(a)(3), 1.1234-1(d), 1.1234-1(g), Ex (3)*. An option dealer is a "merchant" of previously written options; the writer of the option is not necessarily a dealer. *Rev Rul 58-234, 1958-2 CB 279* .

(n13)Footnote 11. *IRC § 1234(a)(3)(C); Treas Reg § 1.1234-1(c)*.

(n14)Footnote 12. *IRC § 1233(c); Treas Reg § 1.1234-1(c)*.

(n15)Footnote 13. The rule will apply to substantially identical stock in the order of its acquisition. *IRC § 1233(b)(2)*.

(n16)Footnote 14. *IRC § 1233(c)*.

(n17)Footnote 15. *IRC § 1234(b)(1), (2), (3)*.

(n18)Footnote 16. The provision also governs acquisition by a corporation of an option to buy or sell its stock.

(n19)Footnote 17. *Treas Reg § 1.1234-1(a)(1)*.

(n20)Footnote 18. *IRC § 1234(a)(3)(A), (B). Broadwell v US, 30 AFTR2d 72-5500 (EDNC 1972) , affd per curiam 476 F2d 976 (4th Cir 1973)* .

(n21)Footnote 19. *Treas Reg § 1.1234-1(e)(1), (2)*.

(n22)Footnote 20. Ltr Rul, Sept. 7, 1973, 6 P.-H. 1974 Fed. Taxes P 55,130.

(n23)Footnote 21. *IRC § 1234(b)(1), (2)*.

(n24)Footnote 22. *Treas Reg §§ 1.1221-2(a)(2), 1.1234-4*.

(n25)Footnote 1. *Rev Rul 72-198, 1972-1 CB 223* (corporation does not recognize gain or loss when it issues warrants as consideration for the acquisition of another corporation); *Rev Rul 71-265, 1971-1 CB 223* (grant of option exercisable only after optionor's death not a sale, exchange, or other disposition of the subject property).

It is important that the transaction be the granting of an option. The taxpayer in *Holmes v Commr, TC Memo 1978-437* , realized ordinary income when he entered into an agreement granting a right of first refusal. He did not enter into an arrangement giving the other party the right to buy the property at a fixed price within a certain time.

(n26)Footnote 2. *Rev Rul 58-234, 1958-2 CB 279* .

(n27)Footnote 3. *Weir v Commr, 10 TC 996 (1948) , affd per curiam 173 F2d 222 (3rd Cir 1949) ; Rev Rul 72-198, 1972-1 CB 223* .

(n28)Footnote 4. *IRC § 1234(a)(1)*. A unilateral breach of a contract to purchase stock and the forfeiture of liquidated damages is not a loss governed by *IRC § 1234(a)*. *US Freight Co v US, 422 F2d 887 (Ct Cl 1970)* .

In *Dunlap v Commr, 670 F2d 785 (8th Cir 1982)* , no deduction was allowed on the lapse of the first of ten separately

purchased but consecutive annual options. The time to deduct the loss would be after the last option expired, because only then would the loss have been sustained.

(n29)Footnote 5. *Treas Reg § 1.1234-1(a)(1)*.

(n30)Footnote 6. *IRC § 1234(b)(1)*. Dealers in options treat the option premium as ordinary income. *IRC § 1234(b)(3)*.

The provisions of *IRC § 1234(b)(1)* apply to a cash settlement option, an option which on exercise is settled in or could be settled in cash or property other than the underlying property. *IRC § 1234(c)*.

A unilateral extension of the expiration date of a warrant has the effect of the grant of a new warrant. The issuer recognizes gain on the date the original unexercised warrant lapses. *Rev Rul 80-134, 1980-1 CB 187*.

The purchase of a call option by the writer of an option to close out the previously issued call option is subject to the provisions of *IRC § 1234(b)*. *Ltr Rul 8517029*.

(n31)Footnote 7. The Service had held that gain was recognized in such cases. *Rev Rul 72-198, 1972-1 CB 223*.

(n32)Footnote 8. The rule applies to cash settlement options as well.

(n33)Footnote 9. *Treas Reg § 1.1234(a)*.

(n34)Footnote 10. *IRC § 1234(a)(3)(A)*.

(n35)Footnote 11. *IRC § 1234(a)(3)(B)*. The sale of an employee stock option led to ordinary income in *Rank v US, 345 F2d 337 (5th Cir 1965)*; *Dugan v US, 234 F Supp 7 (SDNY 1964)*; and *Kunsman v Commr, 49 TC 62 (1967)*. The same result was reached in *Rev Rul 67-366, 1967-2 CB 165* and *Rev Rul 73-146, 1973-1 CB 61*. The transfer in *Rev Rul 73-146* took the form of a cancellation of the stock options in connection with a corporate acquisition. A similar transaction was involved in *TAM 9540003*.

In *Young v Commr, TC Memo 1961-33*, the taxpayer paid a minimal amount for an option to buy stock of a corporation. The option was in fact part of a device to disguise expected selling commissions due the taxpayer from the corporation. The gain from the sale of the option was taxed as ordinary income.

(n36)Footnote 12. *Rev Rul 70-205, 1970-1 CB 174*. The Service eventually revoked *Rev Rul 70-205*. *Rev Rul 78-181, 1978-1 CB 261*.

(n37)Footnote 13. *Ltr Rul Apr 8, 1974*.

(n38)Footnote 14. A closing transaction is any termination of the taxpayer's obligation under an option other than through exercise or lapse of the option. *IRC § 1234(b)(2)(A)*. Options fall within the provision if they are options in stocks or securities (including stocks or securities dealt with on a "when issued" basis), commodities, and commodities futures. *IRC § 1234(b)(2)(B)*.

(n39)Footnote 15. *IRC § 1234(b)(3)*.

(n40)Footnote 16. *Treas Reg §§ 1.1221-2(a)(2), 1.1234-4*.

(n41)Footnote 1. *Rev Rul 78-182, 1978-1 CB 265*.

(n42)Footnote 2. *Rev Proc 65-29, 1965-2 CB 1023*; *Treas Reg § 1.1234-2(f)*.

(n43)Footnote 3. *Rev Proc 65-29, 1965-2 CB 1023* .

(n44)Footnote 4. *IRC §§ 1234(b)(1), (3), 1234A*.

(n45)Footnote 5. A taxpayer has offsetting positions if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to the property by reason of his holding one or more other positions. *IRC § 1092(c)(2)*. A number of presumptions apply in determining whether two or more positions are offsetting. *IRC § 1092(c)(3)*. A position held by the taxpayer's spouse is treated as held by the taxpayer, while a corporation is deemed to hold any position held by any other corporation with which it files a consolidated return. *IRC § 1092(d)(4)(A),(B)*.

If part or all of the gain or loss with respect to a partnership, trust, or other entity is properly taken into account for income tax purposes by a taxpayer, the position is treated as held by the taxpayer. *IRC § 1092(d)(4)(C)*.

An obligor's interest in a nonfunctional currency denominated debt obligation is treated as a position in the nonfunctional currency. *IRC § 1092(d)(7)(A)*.

A corporation, whose stock is publicly traded, issued investment units consisting of one share of stock and one separately tradeable contingent payment right, the value of which varied inversely with the value of the stock. The Service has held that the holder of a right is in an economic position identical to the holder of a put with respect to the stock, and that the investment unit is a straddle because the right serves to diminish substantially a stockholder's risk of loss from a decline in value of the stock. *Rev Rul 88-31, 1988-1 CB 302* .

(n46)Footnote 6. *IRC § 1092(a)(1)(B)*.

(n47)Footnote 6.1. *IRC § 1092(d)(8)*.

(n48)Footnote 7. *IRC § 1092(c)(1), (d)(1)*. Foreign currency for which there is an active interbank market is presumed to be actively traded. *IRC § 1092(d)(7)(B)*.

A notional principal contract (a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for a specified consideration or a promise to pay similar amounts) constitutes personal property of a type that is actively traded if contracts based on the same or substantially similar specified indices are purchased, sold, or entered into on an established financial market. *Treas Reg § 1.1092(d)-1(c)*.

A proposed regulation would provide that an obligation under a debt instrument can be a position in personal property that forms part of a straddle. *Prop Treas Reg § 1.1092(d)-1(d)*.

(n49)Footnote 8. *Treas Reg § 1.1092(d)-1(a)*.

(n50)Footnote 9. *Treas Reg § 1.1092(d)-1(b)(1)*.

(n51)Footnote 10. *Treas Reg § 1.1092(d)-1(b)(2)(i)*.

(n52)Footnote 11. *Treas Reg § 1.1092(d)-1(b)(2)(i)*.

(n53)Footnote 12. *Treas Reg § 1.1092(d)-1(b)(2)(ii)*.

(n54)Footnote 13. *Treas Reg § 1.1092(d)-1(b)(2)(ii)*.

(n55)Footnote 14. The regulations apply to dispositions of loss positions on or after Jan 24, 1985. *Temp Treas Reg § 1.1092(b)-1T(f)*.

(n56)Footnote 15. *Temp Treas Reg § 1.1092(b)-1T (a)(1)*.

(n57)Footnote 16. A successor position is a position that is, or was at any time, offsetting to a second position if (a) the second position was offsetting to a loss position disposed of, and (b) the position was entered into within 30 days before or after the disposition of the loss position. *Temp Treas Reg § 1.1092(b)-5T(n)*.

(n58)Footnote 17. *Temp Treas Reg § 1.1092(b)-1T (a)(2)*.

(n59)Footnote 18. *Temp Treas Reg § 1.1092(b)-1T(b)*. If the disallowed loss would have been a capital loss when sustained, it will be treated as a capital loss when allowed. *Temp Treas Reg § 1.1092(b)-1T(c)*.

(n60)Footnote 19. *IRC § 1092(a)(2)(A)(i)*. Although the loss deferral rule applies to straddles having one or more positions in *IRC § 1256* contracts governed by the mark-to-market rules, the identified straddle exception applies to such contracts if all of the positions are identified straddles. *IRC § 1092(d)(5)*.

(n61)Footnote 20. *IRC § 1092(a)(2)(A)(ii), (iii)*. Unrecognized gain is (a) in the case of any position held by the taxpayer as of the close of the taxable year, the amount of gain that would be taken into account with respect to the position if it were sold on the last business day of the taxable year at fair market value, and (b) in the case of any position with respect to which, as of the close of the taxable year, gain has been realized by not recognized, the amount of such gain. *IRC § 1092(a)(3)(A)*.

The unrecognized gain with respect to any identified offsetting position is the excess of fair market value of the position at the time of determination over the fair market value of the position at the time the taxpayer identified the position as a position in an identified straddle. *IRC § 1092(a)(3)(B)*.

(n62)Footnote 21. *IRC § 1092(a)(2)(B)*.

(n63)Footnote 22. *IRC § 1092(a)(2)(B)*. The Code also calls for such regulations or guidance as may be necessary or appropriate to carry out the purposes of the special rule for identified straddles. *IRC § 1092(a)(2)(C)*.

(n64)Footnote 23. *IRC § 1092(e)*.

(n65)Footnote 24. *IRC § 1256(e)*.

(n66)Footnote 25. *IRC § 1256(e)(2)(C)*. The identification of a hedging transaction for purposes of *IRC § 1256(e)(2)(C)* must satisfy the requirements of *Treas Reg § 1.1221-2(f)(1)*, discussed in § 2.04(2)(a), *supra*. *Treas Reg § 1.1256(e)-1(b)*. However, solely for purposes of *IRC § 1256(f)(1)* (denying capital gain treatment to Section 1256 contracts involving property that is part of a hedging transaction), an identification that does not satisfy all of the requirements of *Treas Reg § 1.1221-2(f)(1)*, is nevertheless treated as an identification under *IRC § 1256(e)(2)*. Any identification for purposes of *Treas Reg § 1.1221-2(f)(1)* is also an identification for purposes of *Treas Reg § 1.1256(e)-1*. A transaction inadvertently identified as a hedging transaction and not treated as such pursuant to *Treas Reg § 1.1221-2(f)(1)(ii)* is not treated as a hedging transaction for purposes of *IRC § 1256(e)(2)*.

(n67)Footnote 26. *IRC § 1092(c)(4)(A)*. In Rev Rul 2002-66, 2002-2 CB 812, the Service ruled that if a grantor of a qualified covered call option held a put option on the same underlying equity, the straddle consisting of the underlying equity and the written call option was not excluded from straddle treatment by *IRC § 1092(c)(4)(A)*. In each of the three situations presented in the ruling, it was assumed that: (1) at the time the call option was written and at the time the put option was acquired, there was an inverse relationship between the value of the underlying equity and the value of each option position; (2) as a result of the magnitude of the inverse relationships, each option position substantially diminished the risk arising from holding the equity; (3) the acquisition of the put option substantially diminished the risk of loss with respect to the combined position consisting of the equity and the qualified covered call option on that equity; and (4) the call option was a qualified covered call option under *IRC § 1092(c)(4)(B)*.

(n68)Footnote 27. *IRC § 1092(c)(4)(E)*.

(n69)Footnote 28. *IRC § 1092(c)(4)(E)*.

(n70)Footnote 29. *IRC § 1092(c)(4)(B)*. An option is not a qualified covered call option unless it is granted not more than 12 months before the day on which the option expires or satisfies term limitation and qualified benchmark requirements established by the Service in guidance published in the Internal Revenue Bulletin. *Treas Reg § 1.1092(c)-1(b)(1)*. The 12-month period is extended to 33 months if the lowest qualified bench mark is determined using the adjusted applicable stock price, as defined in *Treas Reg § 1.1092(c)-4(e)*. *Treas Reg § 1.1092(c)-1(b)(2)*.

A qualifying over-the-counter option is a qualified covered call option if it meets the requirements of *Treas Reg §§ 1.1092(c)-1* and *1.1092(c)-2(c)*, after using the language "qualifying over-the-counter option" in place of "equity option with flexible terms." *Treas Reg § 1.1092(c)-3(b)*. A qualifying over-the-counter option is an equity option that (1) is not traded on a national securities exchange registered with the Securities and Exchange Commission; and (2) is entered into with (a) a registered broker-dealer, acting as principal or agent who must comply with the record-keeping requirements of *17 CFR § 240.17a3*, (b) an alternative trading system under *17 CFR § 242.300 through 17 CFR § 242.303*, or (c) a bank, acting as principal or agent, that must comply with record-keeping requirements for securities transactions described in *12 CFR §§ 12.3, 208.34, or 344.4*. *Treas Reg § 1.1092(c)-4(c)*.

(n71)Footnote 30. *IRC § 1092(c)(4)(C)*. An equity option with flexible terms is a qualified covered call option only if (i) the option meets the requirements of *IRC § 1092(c)(4)(B)* and *Treas Reg § 1.1092(c)-1*; (ii) the only payments permitted with respect to the option are a single fixed premium paid not later than five business days after the day the option is granted, and a single fixed strike price (as defined in *Treas Reg § 1.1092(c)-4(d)*) that is payable entirely at, or within five business days of, exercise; (iii) an equity option with standardized terms is outstanding for the underlying equity; and (iv) the underlying security is stock in a single corporation. *Treas Reg § 1.1092(c)-2(c)*. An equity option with standardized terms is an equity option that (a) is traded on a national securities exchange registered with the Securities and Exchange Commission; (b) on the date the option is written, expires on the Saturday following the third Friday of the month of expiration; (c) has a strike price that is not less than \$1 and is set at a minimum strike price interval that is established by the applicable national securities exchange registered with the Securities and Exchange Commission; and (d) has stock in a single corporation as its underlying security. *Treas Reg § 1.1092(c)-4(b)*.

(n72)Footnote 31. *IRC § 1092(c)(4)(D)(i), (G)*. The availability of a strike price for equity options with flexible terms does not affect the determination of the lowest qualified benchmark for an option that is not an equity option with flexible terms. *Treas Reg § 1.1092(c)-2(b)*. For purposes of determining whether an equity option with flexible terms is deep in the money, the lowest qualified bench mark is the same for an equity option with flexible terms as the lowest qualified bench mark for an equity option with standardized terms on the same stock having the same applicable stock price. *Treas Reg § 1.1092(c)-2(c)(2)*.

(n73)Footnote 32. *IRC § 1092(c)(4)(D)(ii)*.

(n74)Footnote 33. *IRC § 1092(c)(4)(D)(iii)*.

(n75)Footnote 34. *IRC § 1092(c)(4)(D)(iv)*.

(n76)Footnote 35. *IRC § 1092(d)(3)(A)*. For purposes of this rule, the term "substantially similar or related property" is defined in *Treas Reg § 1.246-5* (other than *Treas Reg § 1.246-5(b)(3)*). *Treas Reg § 1.1092(d)-2(a)*. See Ch 4 for a discussion of *Treas Reg § 1.246-5*.

Treas Reg § 1.1092(d)-2(b) applies to positions, if the taxpayer substantially diminishes its risk of loss by holding substantially similar or related property involving the following types of transactions: (1) holding offsetting positions consisting of stock and a convertible debenture of the same corporation where the price movements of the two positions

are related, or (2) holding a short position in a stock index regulated futures contract (or, alternatively, an option on such a regulated futures contract or an option on the stock index) and stock in an investment company whose principal holdings mimic the performance of the stocks included in the stock index (or, alternatively, a portfolio of stocks whose performance mimics the performance of the stocks included in the stock index). *Treas Reg § 1.1092(d)-2(b)*.

For the purpose of determining whether stock is of a corporation formed or availed of to take positions in personal property taken by any shareholder, all includable corporations of an affiliated group (within the meaning of *IRC § 1504(a)*) are treated as one taxpayer. *IRC § 1092(d)(3)(B)*.

(n77)Footnote 36. *IRC § 1092(d)(2)*.

(n78)Footnote 37. *Temp Treas Reg § 1.1092(b)-2T (a)(1), (2)*.

(n79)Footnote 38. *Temp Treas Reg § 1.1092(b)-2T(b)*.

(n80)Footnote 39. *Temp Treas Reg § 1.1092(b)-2T(c)*.

(n81)Footnote 40. The taxpayer must elect to have identified mixed straddles so treated. *Temp Treas Reg § 1.1092(b)-3T(d)*. The rules are applied prior to application of the loss deferral and wash sale rules. *Temp Treas Reg § 1.1092(b)-3T(c)*.

(n82)Footnote 41. *Temp Treas Reg § 1.1092(b)-3T(b)(2)*.

(n83)Footnote 42. *Temp Treas Reg § 1.1092(b)-3T(b)(3)*.

(n84)Footnote 43. *Temp Treas Reg § 1.1092(b)-3T(b)(4)*.

(n85)Footnote 44. *Temp Treas Reg § 1.1092(b)-3T(b)(7)*.

(n86)Footnote 45. *Temp Treas Reg § 1.1092(b)-3T(b)(5)*.

(n87)Footnote 46. A mixed straddle account is an account for determining gains and losses from all positions held as capital assets in a designated class of activities by the taxpayer at the time the taxpayer elects to establish a mixed straddle account. A separate mixed straddle account must be established for each separate designated class of activities. A taxpayer may designate as a class of activities the types of positions that a reasonable person, on the basis of all facts and circumstances, would ordinarily expect to be offsetting positions. *Temp Treas Reg § 1.1092(b)-4T(a),(b)(1), (2)*.

(n88)Footnote 47. *Temp Treas Reg § 1.1092(b)-4T(c)(1)*.

(n89)Footnote 48. *Temp Treas Reg § 1.1092(b)-4T(c)(2)*.

(n90)Footnote 49. *IRC § 1092(f)(1)*.

(n91)Footnote 50. *IRC § 1092(f)(2)*.

(n92)Footnote 51. *IRC § 1256(b)*.

(n93)Footnote 52. A securities futures contract or an option on such a contract is a Section 1256 contract only if it is a dealer securities futures contract.

(n94)Footnote 53. Proper adjustment is made in the gain or loss subsequently realized to adjust for the gain or loss taken into account on the deemed sale. *IRC § 1256(a)(2)*.

The taxpayer, in *Murphy v US*, 992 F2d 929 (9th Cir 1993) , challenged the constitutionality of IRC § 1256 on the ground that it taxed unrealized gains. The court noted that a taxpayer who trades in futures contracts receives, and is entitled to withdraw, profits as a matter of right each day. Since such a taxpayer is in constructive receipt of income on a daily basis, IRC § 1256 is not arbitrary, capricious, or confiscatory, and, therefore, is constitutional.

(n95)Footnote 53.1. IRC § 1256(f)(5).

(n96)Footnote 54. IRC § 1256(c)(1). The Second Circuit has held that futures contracts that are donated to charity must be marked to market. *Greene v US*, 79 F3d 1348 (2d Cir 1996) , *cert denied* 519 US 1028 . On remand, the taxpayers urged the trial court to make a proper adjustment under IRC § 1256(a)(2) to reflect that they realized no gain on the donation of the futures contracts, because they received no cash or property in exchange for the donations. However, the court held that statute forces the taxpayers, in effect, to treat their contributions as cash as opposed to contributions of investment contracts and does not accommodate the adjustment sought by the taxpayers. The opinion on remand is reported at 975 F Supp 273 (SDNY 1997) . The Second Circuit affirmed. 185 F3d 67 (2d Cir 1999) .

(n97)Footnote 55. IRC § 1256(c)(2).

(n98)Footnote 56. A qualified board or exchange is defined as a national securities exchange that is registered with the Securities Exchange Commission, a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or any other exchange, board of trade, or market that the Service determines has rules adequate to carry out the purposes of the mark-to-market rules. IRC § 1256(g)(7). For example, the Internal Revenue Service has determined that the London International Financial Futures and Options Exchange (LIFFE), a regulated exchange of the United Kingdom, is a qualified board or exchange within the meaning of IRC § 1256(g)(7)(C), effective January 1, 2010, and has granted consent to taxpayers to change to the section 1256 mark-to-market method for the first taxable year during which the taxpayer holds a LIFFE Contract entered into on or after January 1, 2010. Notice 2010-2, 2010-3 IRB 272 .

The statutory definition of an equity option is meant to exclude options on "broad-based" stock indices (such as the Standard & Poor's 500 index). Instead, these options are meant to qualify as nonequity options. HR Rep No 861, 98th Cong, 2d Sess 902 (1984).

(n99)Footnote 57. IRC § 1256(g)(6)(A), (B). The term "equity option" includes any option on a group of stocks only if such group meets the requirements for a narrow-based security index. The Service may prescribe regulations regarding the status of options the values of which are determined directly or indirectly by reference to any index that becomes (or ceases to be) a narrow-based security index.

(n100)Footnote 58. An options dealer is any person registered with an appropriate securities exchange as a market maker or specialist in listed options, or any person that the Service determines performs similar functions. IRC § 1256(g)(8).

(n101)Footnote 59. IRC § 1256(g)(9)(A). The term "securities futures contract" has the meaning given to the term by IRC § 1234B (see § 2.07[7]). IRC § 1256(g)(9)(C).

(n102)Footnote 60. IRC § 1256(g)(9)(B). Rev Proc 2002-11, 2002-1 CB 526 , provides guidelines for an exchange to follow in order to determine if certain persons trading in securities futures contracts qualify as dealers in such contracts. See Rev Rul 2004-94, 2004-2 CB 491 , and Rev Rul 2004-95, 2004-2 CB 493 , for determinations that Tier 1, Tier 2, and Tier 3 NQLX Market Makers, and Category 1 and 2 One Chicago Market Makers, respectively, are dealers in securities futures contracts.

(n103)Footnote 61. IRC § 1256(e)(1). The definition of hedging transaction can be found in the text dealing with loss deferral, § 9.02[4][d].

(n104)Footnote 62. *IRC § 1256(e)(3), (4)(A)*. The provisions apply to hedging transactions involving property other than stock or securities only if the taxpayer is subject to the at-risk rules of *IRC § 465(a)(1)*. *IRC § 1256(e)(4)(C)*.

(n105)Footnote 63. *IRC § 1256(e)(4)(B)*.

(n106)Footnote 64. *IRC § 1234(c)(1)*.

(n107)Footnote 65. *IRC § 1234A(2)*. The rule does not apply to the retirement of a debt instrument.

(n108)Footnote 66. *IRC § 1256(f)(1)*.

(n109)Footnote 67. *IRC § 1256(f)(3)(A), (B)*. Gains and losses on dealer equity options that are allocable to limited partners or S corporation shareholders are treated as short-term capital gains and losses. *IRC § 1256(f)(4)*.

(n110)Footnote 68. *IRC § 1256(f)(3)(C)*.

(n111)Footnote 69. *IRC § 1256(d)(1), (4)*.

(n112)Footnote 70. *IRC § 1256(d)(3)*.

(n113)Footnote 1. *Rev Rul 58-234, 1958-2 CB 279* .

(n114)Footnote 2. *Rev Rul 58-234, 1958-2 CB 279* .

(n115)Footnote 1. See § 9.02[2][a].

(n116)Footnote 2. *IRC § 1234(a)(1), (2)*; see § 9.02[2][c].

(n117)Footnote 3. The gain would be a short-term capital gain because the sale occurred less than one year after the date on which the option was purchased.

(n118)Footnote 4. *IRC §§ 1234(a)(1), 1222(2)*.

(n119)Footnote 5. *IRC § 1234(a)(1), (2)*.

(n120)Footnote 6. *IRC § 1233(c)*; see § 9.02[2][a].

(n121)Footnote 7. *Rev Rul 58-384, 1958-2 CB 410* .



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Taxation of Securities Transactions

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CHAPTER 9 Stock Options

1-9 Taxation of Securities Transactions § 9.03

§ 9.03 Statutory Stock Options--Options Granted Under Employee Stock Purchase Plans

[1] Requirements and Conditions of Employee Stock Purchase Plans.

No option granted as part of a stock purchase plan can qualify as a statutory stock option entitled to the special treatment afforded by *IRC Section 421(a)* unless (1) the plan provides that options can be granted only to employees of the employer corporation, or of a related (parent or subsidiary) corporation, to purchase stock in any of such corporations,ⁿ¹ and (2) the plan is approved by stockholders of the granting corporation within twelve months before or after the date on which the plan is adopted.ⁿ² In addition to these requirements, *IRC Section 423(b)* sets forth seven other conditions that must be satisfied before a plan can be considered an employee stock purchase plan and the options granted thereunder considered statutory stock options. However, as long as a plan satisfies the two requirements specified above, the remaining requirements can be satisfied by the terms of an offering made under the plan.ⁿ³ But in such case, only options granted as part of the offering will qualify as statutory stock options.ⁿ⁴

The determination of whether a particular option is an option granted under an employee stock purchase plan is made at the time such option is granted.ⁿ⁵ Here consideration must be given not only to the terms of the plan or offering under the plan but also to the terms of the option itself. If the terms of the option are inconsistent with the terms of the plan or the terms of the offering, the option will not be treated as an option granted under an employee stock purchase plan.ⁿ⁶

[a] Stock Ownership Limitation. The terms of the plan must provide that no employee can be granted an option if, immediately after the option is granted, the employee owns stock possessing 5 percent or more of the total combined voting power or value of all classes of stock of the employer corporation or of its parent or subsidiary corporation.ⁿ⁷ For this purpose, the employee is treated as the owner of all of the stock of the corporation, owned, directly or indirectly, by or for his brothers and sisters (of the whole and half-blood), spouse, ancestors, and lineal descendants, and the owner of a proportionate share of the stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust in which he is a shareholder, partner, or beneficiary.ⁿ⁸ In addition, the employee is deemed to be the owner of any stock that he can purchase under outstanding stock options, whether or not such options qualify for the special tax treatment provided by *IRC Section 421(a)*.ⁿ⁹

If an option is, in fact, granted to a person whose stock ownership exceeds the 5 percent limitation of *IRC Section 423(b)(3)*, no portion of the option will be treated as having been granted under an employee stock purchase plan.ⁿ¹⁰

[b] Eligible Employees. An employee stock purchase plan cannot be discriminatory; options must be granted to all

employees of the corporation except employees who have been employed for less than two years, part-time employees who customarily work no more than twenty hours a week, seasonal employees whose customary employment does not exceed five months a year, officers of the corporation, supervisory personnel, and highly compensated employees.ⁿ¹¹

Options granted in connection with an offering made after September 28, 1979, will not be statutory stock options if otherwise eligible employees are denied participation to any extent because of their continuing participation or eligibility for participation in a prior plan or offering of the employer corporation or related corporation.ⁿ¹² However, a plan which permits all eligible employees to participate, but which requires them to elect to do so, is not discriminatory if it grants options only to those who so elect.ⁿ¹³

[c] Equality of Rights Under Plan. An employee stock purchase plan must give all persons granted options under the plan the same rights and privileges.ⁿ¹⁴ Nevertheless, a plan will not fail to meet this requirement merely because the amount of stock that can be purchased by any employee under the plan is determined on the basis of a uniform relationship to the total compensation, or basic or regular compensation, of employees, or because the plan provides that no employee may purchase more than a maximum amount of stock fixed under the plan.ⁿ¹⁵ Thus, a plan can provide that an employee cannot purchase more than one share of stock for each \$200 of annual gross pay. But it cannot provide for the grant of options based on one share for each \$200 of annual gross pay in excess of \$5,000; such a provision may exclude some employees from participation under the plan.ⁿ¹⁶

A plan permitting any employee to apply sums withheld under an earlier plan towards the purchase of additional stock under the current plan will violate equal rights and privileges unless all eligible employees are permitted to make payments in an amount not less than that which any employee is allowed to carry over, to purchase shares under the current plan.ⁿ¹⁷ A plan will not fail to give equal rights and privileges merely because one or more employees are permitted to so apply sums withheld under an earlier plan if the applied amounts represent fractional shares in the earlier plan.ⁿ¹⁸

An example of the manner in which the equality requirement is applied can be found in the fact situation presented in *Revenue Ruling 69-218*,ⁿ¹⁹ where eligible employees could participate in an offering under the stock purchase plan only if they authorized payroll deductions based on a percentage of salary accumulated over a six-month period. Since all eligible employees could have elected to start payroll deductions at the beginning of the period, the plan satisfied the requirement that all employees granted options must have the same rights and privileges under the plan.

[d] Option Price. An employee stock purchase plan must provide that the option price of options issued under the plan will not be less than the lesser of:

- (1) an amount equal to 85 percent of the fair market value of the stock at the time the option is granted; or
- (2) an amount which, under the terms of the option, may not be less than 85 percent of the fair market value of the stock at the time of exercise.ⁿ²⁰

The option price can be stated either as a percentage or as a dollar amount. If the latter, then the price requirement can be met only by a plan or offering in which the fixed price is not less than 85 percent of the fair market value of the stock at the time of grant. This is required because, at the time of option grant, it is uncertain that the fixed price will not be less than 85 percent of the value of the stock at the time of exercise; the fact that a decline in the value of the stock results in the fixed price being not less than 85 percent of the value of the stock at the time of exercise will not save the option.ⁿ²¹

To illustrate, suppose that an option is granted when the value of the subject stock is \$100 a share. An option price set at 85 percent of the value of the stock at the time of exercise, but not less than \$80 a share, will satisfy the price

requirements; one fixed at 85 percent of value at exercise, but not more than \$80 a share will not. In the first instance, there is assurance that the price cannot be less than 85 percent of the value of the stock at the time of exercise; in the second, there is not.

Any option that does not meet this minimum pricing requirement will not be treated as granted under an employee stock purchase plan even though the terms of the plan or offering satisfy the requirement.ⁿ²² Thus, if such an option is the only one granted to an eligible employee, the offering will fail to meet the coverage requirement of *IRC Section 423(b)(4)*, namely, that all eligible employees receive options that qualify as options granted under an employee stock purchase plan, causing all of the options granted under the offering to be ineligible for the special tax treatment of *IRC Section 421(a)*.ⁿ²³

The grant of an option under an employee stock purchase plan does not constitute a deferral of compensation under *IRC Section 409A*.^{n23.1}

[e] Option Period. An employee stock purchase plan must provide that options granted under the plan cannot be exercised after the expiration of:

- (1) five years from the date of option grant, in which case the terms of the plan must provide that the option price cannot be less than 85 percent of the fair market value of the stock at the time of exercise; or
- (2) twenty-seven months from the date of grant, if the option price is otherwise determinable.ⁿ²⁴

Suppose an option, granted when the stock subject to the option has a value of \$100 a share, provides for an option price of 85 percent of the value of the stock at exercise, but not more than \$90 a share. Is the permissible option period five years or twenty-seven months? The Regulations prescribe the shorter period, irrespective of the price paid on exercise.ⁿ²⁵ This position accords with the statute, since there is no certainty that the option price will not be less than 85 percent of the value of the stock at the time the option is exercised. But the longer option period should be available where the fixed price acts as a floor and not as a ceiling; in such case, the option price could never be less than 85 percent of value at exercise.

Once a plan or offering fails to contain terms that meet the requirements relating to option period, no option granted under the plan or offering will be treated as an option granted under an employee stock purchase plan.ⁿ²⁶ Placing the proper terms in the option itself will not cure the defect.

[f] Purchase Limitation. A further condition, imposed by *IRC Section 423(b)(8)*, requires the plan to provide that no employee can be granted an option that permits his rights to purchase stock under employee stock purchase plans of his employer corporation or its related (parent and subsidiary) corporations "to accrue at a rate which exceeds \$25,000 of fair market value of the stock (determined at the time such option is granted) for each calendar year in which such option is outstanding at any time." In applying this limitation:

- (1) the right to purchase stock under an option is deemed to accrue when the option or any portion thereof first becomes exercisable during the calendar year;
- (2) the right to purchase stock under an option accrues at the rate provided in the option, but in no case can the rate exceed \$25,000 of fair market value of the subject stock (determined at the time the option is granted) for any calendar year; and
- (3) a right to purchase stock that has accrued under one option granted pursuant to the plan cannot be carried over to any other option.

The \$25,000 per year limitation is cumulative; to the extent the amount is not exhausted in one year, it will be added to the amount that can be purchased in a succeeding year in which the option is outstanding.ⁿ²⁷

Example:

Assume that a twenty-seven month option to purchase 750 shares at \$90 a share is granted to an employee on June 1, 1990, when the stock of the corporation has a value of \$100 a share. The employee can purchase up to 250 shares of stock in 1990;ⁿ²⁸ the value of the 250 shares at the time of option grant equals, but does not exceed, \$25,000. In 1991, the employee can purchase the difference between 500 shares and the number of shares purchased under the plan in 1990; in 1992, he is permitted to purchase the difference between 750 shares and the number of shares acquired by exercise of the option in the prior two years.

Suppose the employee does not exercise any portion of the option until 1992 when he purchases 700 shares of stock (\$70,000 in fair market value of stock determined as of the time of option grant). The purchase is applied first against the \$25,000 limitation for the earliest year in which the option was outstanding, and then against the limitation for each succeeding year, in order.ⁿ²⁹ Thus, \$25,000 of the purchase will be attributable to 1990, \$25,000 to 1991, and \$20,000 to 1992. If the optionee does not exercise the balance of the option, he may be granted another option that allows him to purchase up to \$5,000 more stock (based upon the value of the stock at the time of the grant of the new option) in 1992.ⁿ³⁰ But if he is not granted a new option until 1993, he may not carry over the unused portion of the prior option to increase the amount of stock which may be purchased under the second option.ⁿ³¹

The limitation of *IRC Section 423(b)(8)* applies only to options granted under employee stock purchase plans, and does not restrict the amount of stock an employee can purchase under restricted stock options, qualified stock options, or nonstatutory stock options.ⁿ³² Stock purchased under such other options will not limit the amount of stock which can be purchased under an employee stock purchase plan, except to the extent that such stock must be counted for purposes of the 5 percent stock ownership limitation of *IRC Section 423(b)(3)*.ⁿ³³

If the terms of the plan or offering satisfy the requirement of *IRC Section 423(b)(8)*, but the option gives the employee the right to purchase stock in excess of the prescribed limitation, no portion of the option will be considered as having been granted under an employee stock purchase plan.ⁿ³⁴ So, if the employee is not granted another option that does qualify as an option granted under an employee stock purchase plan, the offering under which the option was granted will not satisfy the coverage requirement of *IRC Section 423(b)(4)*, making all of the options granted under the offering ineligible for the special tax treatment afforded by *IRC Section 421*.ⁿ³⁵

[g] Transferability. The plan must prohibit the transfer of the option other than by will or the laws of descent and distribution, and must provide that the option is exercisable, during the lifetime of the employee, only by him.ⁿ³⁶ However, if the option or plan under which it was granted contains a provision allowing the employee to designate the person who may exercise the option after the employee's death, neither the provision, nor a designation pursuant to the provision, disqualifies the option as a statutory option.ⁿ³⁷

An employee can pledge stock purchasable under an option for a loan that is used to pay the option price.ⁿ³⁸ In addition, the employee can transfer the option to a trust if, under the grantor trust rules and applicable state law, the employee is considered the sole beneficial owner of the option while it is held in trust.ⁿ³⁹

[2] Modification, Extension, and Renewal of the Option.

IRC Section 424(h)(1) sets forth the general rule that a modification, extension, or renewal of the option will be considered the granting of a new option. Modification is defined as "any change in the terms of the option which gives the employee additional benefits under the option."ⁿ¹ Thus, a change in terms that shortens the option period is not a

modification; one that provides more favorable payment terms is.ⁿ² However, the term "modification" does not encompass (1) a change in terms attributable to the substitution of a new option or the assumption of the original option by reason of a corporate reorganization, separation, or liquidation, provided (a) the optionee does not receive any new or additional benefits, and (b) the excess of the aggregate fair market value over the aggregate option price of the subject shares immediately after the substitution is not greater than the excess of aggregate value over aggregate option price immediately before the substitution or assumption;ⁿ³ (2) a change in terms that makes the option nontransferable except by will or under the laws of intestacy, and exercisable during the life of the grantee of the option solely by him;ⁿ⁴ or (3) change in terms of an option not immediately exercisable in full to accelerate the time at which the option can be exercised.ⁿ⁵ A change in the number or price of the shares subject to the option merely to reflect a stock dividend or stock split is also not a modification of the option.ⁿ⁶ An amendment that increases the number of shares subject to an option is treated as the grant of a new option, but only to the extent of the increase; the original option is unaffected by the change.ⁿ⁷

An option is extended when the grantor corporation enlarges the time within which the option can be exercised.ⁿ⁸ It is renewed by the granting of the same rights or privileges contained in the original option on the same terms and conditions.ⁿ⁹

A change to an option providing that the optionee may receive an additional benefit under the option at the future discretion of the granting corporation is a modification of the option at the time the option is changed to provide the discretion.^{n9.1} Furthermore, the exercise of such discretion is a modification of the option.^{n9.2} However, it is not a modification for the grantor to exercise discretion specifically reserved under an option with respect to the payment of a cash bonus at the time of exercise, the availability of a loan at exercise, the right to tender previously acquired stock for the stock purchasable under the option, or the payment of employment taxes or required withholding taxes resulting from the exercise of the option.^{n9.3}

An offer to change the terms of an option that remains open less than 30 days is not a modification of the option.^{n9.4} However, if an offer to change the terms of an option remains outstanding for more than 30 days, there is a modification of the option as of the date the offer is made.^{n9.5}

Any inadvertent change to the terms of an option (or change in the terms of the plan under which the option was granted or in the terms of any other agreement governing the arrangement) that is treated as a modification is not considered a modification of the option to the extent the change in the terms of the option is removed by the earlier of the date the option is exercised or the last day of the calendar year in which the change occurred.^{n9.6}

Although the modification, extension, or renewal of a stock option is considered the granting of a new option, one looks to the highest of the following values, and not just to the value of the stock at the time of modification, to determine whether the option price meets the statutory requirement:

- (1) the fair market value of the stock at the time of original grant;
- (2) the fair market value of the stock at the time of modification, extension, or renewal; or
- (3) the fair market value of the stock at the time of any intervening modification, extension, or renewal.ⁿ¹⁰

We have seen that an employee stock purchase plan must meet the coverage requirement of *IRC Section 423(b)(4)*; the failure to grant an eligible employee an option that qualifies as an option granted under an employee stock purchase plan will not permit any of the options granted under the offering to be eligible for *IRC Section 421(a)* treatment. By modifying such an option to bring its terms into compliance with the requirements of *IRC Section 423(b)*, the offering may be "saved" and the options granted thereunder made eligible for the special treatment of *IRC Section 421*.

Conversely, an option granted to an eligible employee may be so modified that it can no longer be treated as an option granted under an employee stock purchase plan; in such case, the entire offering will fall unless the employee is also granted a qualifying option.

[3] Treatment of Options Granted Under Stock Purchase Plans.

[a] Exercise of the Option.

[i] By the Optionee. *IRC Section 423(a)* makes the rule of *IRC Section 421(a)* (no income on exercise) applicable to options granted under employee stock purchase plans meeting the requirements of *IRC Section 423(b)*, provided:

(1) no disposition of the stock acquired on exercise is made within two years after the granting of the option or within one year after the date on which the stock is acquired;ⁿ¹ and

(2) the optionee was an employee of the grantor corporation, a related corporation, a successor corporation (a corporation that issued a substitute option or assumed the original option as part of a corporate reorganization, separation or liquidation to which *IRC Section 424(a)* applies), or a corporation related to such corporation, at all times beginning with the date of the granting of the option and ending no earlier than three months before the date of exercise.

The exercise of an option granted under an employee stock purchase plan does not give rise to an item of tax preference under *IRC Section 57*.

[ii] By the Optionee's Estate. Where an employee dies holding an option with respect to which he could have made a qualifying exercise (one granted preferential treatment by *IRC Section 421(a)*), the exercise of the option by his estate, or by a person acquiring the right to exercise the option by bequest or inheritance or by reason of the employee's death, will not create any income for the exercising party.ⁿ² Moreover, the holding period and employment requirements that must be met by an optionee exercising an option during life need not be met when the option is exercised after his death.ⁿ³

[b] Dispositions of Stock Acquired Through Exercise of the Option.

[i] Effect of a Disqualifying Disposition. The employee who fails to meet the holding period requirement of *IRC Section 423(a)(1)*, realizes ordinary income (in the nature of compensation) in the year of disposition to the extent of the difference between the option price and the fair market value of the stock at the time of exercise of the option.ⁿ⁴ Selling the stock at a loss does not produce a contrary result; in such case, the taxpayer has ordinary income and a capital loss, the capital loss being equal to the difference between the selling price and the value of the stock at the time of exercise. (The basis of the stock is increased by the amount of compensation income.) If the sale is at a gain that exceeds the amount of ordinary income, the excess gain will normally be short-term capital gain. The gain will be long-term if the stock is held for more than one year from the date of exercise, but for less than two years from the date of the granting of the option.

Example:

An employee, granted an option to purchase stock, valued at \$100 a share, for \$90 a share, exercises the option at a time when the stock has a value of \$110 a share. Three months after exercise, the stock is sold for \$120 a share. The employee has ordinary income of \$20 a share, the difference between the \$110 value at the time of exercise and the \$90 option price, and a short-term capital gain of \$10, the difference between \$110 and the \$120 selling price. Had the selling price been \$100, the employee would still have had ordinary income of \$20; but, in addition, he would have realized a short-term capital loss of \$10, the difference will \$110 and \$100.

The term "disposition" is defined by *IRC Section 424(c)* to include "a sale, exchange, gift, or transfer of legal title," but does not encompass a transfer from a decedent to an estate, a transfer by bequest or inheritance, a mere pledge or hypothecation,ⁿ⁵ an exchange made pursuant to a corporate reorganization or separation to which *IRC Sections 354, 355, or 356*, apply, or an exchange governed by *IRC Section 1036* (an exchange of common stock for common stock or preferred stock for preferred stock in the same corporation). Also excluded from the scope of "disposition" is the initial acquisition of the stock in the name of the employee and another as joint tenants with right of survivorship, or a later transfer of stock into such ownership.ⁿ⁶ However, the termination of the joint tenancy (other than by reason of the death of a joint tenant) is a disposition except to the extent that the employee acquires ownership of the stock.ⁿ⁷

Since the holder of an option to sell specified stock need not exercise it, the acquisition of a "put" covering the stock acquired on the exercise of the option does not constitute a disposition, but exercise of the "put" does.ⁿ⁸ In a similar fashion, the Service has ruled that the mere delivery of shares endorsed in blank to a custodian for safekeeping is not a disposition where the optionee remains the registered owner of the stock.ⁿ⁹ Nor, says the Service, will there be a disposition if stock is delivered to a broker so that he may "lend" the shares to customers engaging in short sales, provided the broker satisfies his replacement obligation by delivering stock of the type that would have brought an exchange of the stock within *IRC Section 1036*.ⁿ¹⁰ Finally, no disposition is deemed to occur when the optionee exercises a conversion privilege contained in preferred stock acquired on the exercise of the option and exchanges the stock for common stock in the same corporation.ⁿ¹¹

Generally, a disposition takes place when legal title to the subject stock is actually transferred.ⁿ¹² This follows from the fact that, ordinarily, the obligations of buyer and seller remain executory until title is closed. But suppose they are not. In *Brown v. United States*,ⁿ¹³ the only case to really consider the question, a district court used the doctrine of constructive receipt to find that the disposition occurred when the corporation (whose stock the optionee owned) irrevocably deposited funds in escrow for distribution to shareholders under a plan of liquidation and not some months later when the shareholder delivered his stock to the corporation and received payment. The Ninth Circuit disagreed, and reversed, stating:

"The disqualifying event is not payment, actually or constructively received. The section 421 disposition is not just any disposition. ... We construe the terms' disposition * * * made by him' as manifesting Congress' intent that some affirmative, voluntary act of the option holder-taxpayer is required to constitute a disqualifying disposition."ⁿ¹⁴

The stock actually acquired on the exercise of the option is not the only stock that can form the subject of a disqualifying disposition. Under *IRC Section 425(b)*, stock distributed to the optionee, either in the form of a stock dividend on the acquired shares or as part of a reorganization or *IRC 1036* exchange, will be deemed to have been acquired on the exercise of the option. A sale of the later acquired shares within the prescribed period will be as much of a disqualifying disposition as a sale of the original shares.

[ii] Effect of the Option Price on the Character of Gain Realized in a Qualifying Disposition. Because stock acquired on the exercise of an option granted under an employee stock purchase plan must be retained for one year in order to satisfy the holding period requirement prescribed by *IRC Section 423(a)(1)*, any gain realized on a disposition of the stock after the expiration of the period will generally be treated as long-term capital gain. However, under *IRC Section 423(c)*, if the option price of the acquired stock was less than 100 percent of the value of the stock at the time the option was granted, a disposition of the stock after the required holding period (or the death of the taxpayer at any time while owning the acquired stock) will transform the gain into compensation income to the extent of the lesser of (1) the excess of the fair market value of the stock at the time of disposition (or death) over the amount paid for the stock, or (2) the excess of the fair market value of the stock at the time the option was granted over the option price.ⁿ¹⁵ If the option price is not fixed or determinable at the time the option is granted (eg, an option price of 90 percent of the fair market value of the stock on the day of exercise), then, for the purposes of *IRC Section 423(c)*, the option price is determined by considering the option as having been exercised on the date it was granted.ⁿ¹⁶

The basis of any share disposed of by an individual is increased by an amount equal to the amount of compensation that he is required to include in gross income.ⁿ¹⁷ The rule does not apply if the inclusion of compensation income is occasioned by the death of the owner of the stock; in such case, the fair market value of the share on the date of death (or applicable alternate valuation date) determines the basis of the share in the hands of the decedent's estate or the person who acquired the share by reason of the owner's death.ⁿ¹⁸

Example:

On June 1, 1990, X Corporation grants A, one of its employees, an option (under an employee stock purchase plan) to purchase stock of the corporation at \$90 a share. The stock had a fair market value of \$100 a share. A exercised the option on June 1, 1991, and sold the acquired stock on July 1, 1992, at its fair market value of \$120 a share. A's compensation income would be limited to \$10 a share, the difference between the value at the time of grant (\$100) and the option price (\$90). The basis of each share then would be increased by \$10 a share, the amount included in gross income as compensation, and the new basis of \$100 (\$90 + \$10) a share subtracted from the amount realized of \$120 a share to produce a long-term capital gain of \$20 a share. Had A died on July 1, 1992, still the owner of the acquired stock, the only amount includable in gross income for the taxable year ending with his death would have been the compensation income of \$10 a share. The basis of each share, in such case, would have been \$120, determined under *IRC Section 1014* without regard to the amount includable in gross income as compensation.

If the option had provided for an option price of 90 percent of the fair market value of the stock at the time of exercise, and the fair market value of the stock on June 1, 1991 had been \$110 a share, the following tax consequences would have flowed from the disposition:

- (1) Compensation income of \$10 a share (the difference between the \$100 value of the stock at the time of option grant and \$90, the option price that would have been paid had the option been exercised immediately following its grant);ⁿ¹⁹
- (2) An increase in the original cost basis of each share, \$99 (90 percent of \$110) by \$10, the amount per share includable in gross income as compensation;
- (3) Long-term capital gain of \$11 a share, the excess of the \$120 amount realized over the \$109 basis for the share.

[iii] Dispositions of Stock Acquired by an Estate's Exercise of the Option. Although an estate (or any person acquiring the right to exercise an option by bequest or inheritance or by reason of the death of the option holder) cannot make a disqualifying disposition of the stock acquired on the exercise of the option, any transfer of the stock by the estate or such person is considered a disposition for purposes of *IRC Section 423(c)*, thereby triggering the inclusion of compensation income to the extent required by that provision.ⁿ²⁰ However, the inclusion of compensation income in the gross income of the estate or other person gives rise to a deduction with respect to the estate tax attributable to the inclusion of the value of the option in the gross estate of the deceased employee.ⁿ²¹ The deduction is determined under *IRC Section 691(c)* by treating the option as an item of income in respect of a decedent and the amount of compensation income as an amount included in gross income in respect of such item of income in respect of a decedent.ⁿ²² The following example illustrates the manner in which the deduction is computed:

Example:

On December 31, 1990, an employee was granted an option under an employee stock purchase plan to purchase his employer's stock, then valued at \$100 a share, for \$85 a share. The employee died on May

1, 1993, without having exercised the option; the option was valued at \$45 a share for estate tax purposes. The employee's estate exercised the option on June 1, 1993, and sold the stock for \$150 a share on July 1, 1993. Application of the special rule of *IRC Section 423(c)* would require the estate to include \$15 in gross income as compensation. Assuming that the estate had no other items of income in respect of a decedent, that the estate tax attributable to the inclusion of the option in the gross estate was \$15, and that, during the taxable year of income inclusion, no amounts were paid, credited or distributable to beneficiaries of the estate, the estate's deduction would be \$5. The applicable formula for determining the amount of the deduction is:

$$\frac{\text{Amount included in gross income}}{\text{Items of income in respect of a decedent}} \times \text{Estate tax attributable to inclusion of items of income in respect of a decedent}$$

Substituting the given figures in the formula, we find that

$$\frac{\$15}{\$45} \times \$15 = \$5$$

[c] Special Basis Rules for Stock Acquired by an Estate on the Exercise of the Option. The basis of a share of stock acquired on the exercise of an option by a deceased employee's estate, or by a person acquiring the right to exercise the option, must include so much of the basis of the option as is attributable to such share.²³ To illustrate, if an employee dies holding an option to purchase 100 shares, and if the option had a date of death value of \$500, and the alternate valuation date was not elected, the cost basis of each share of stock acquired under the option will be increased by \$5. A reduction in basis is required if (1) *IRC Section 423(c)* applies because the option price is less than 100 percent of the value of the stock at the time of option grant, and (2) the amount of compensation income that would have been includable in gross income if the employee had exercised the option during life and died holding the acquired shares exceeds the amount that becomes includable on the disposition of the stock by the estate; the excess furnishes the amount of the downward adjustment in basis.²⁴ A final adjustment--an increase in basis--is mandated whenever the amount includable in gross income as compensation under *IRC Section 423(c)* exceeds the per share basis of the option; the increase is in the amount of such excess.²⁵

Example:

On December 31, 1990, when the stock of X Corp was valued at \$100 a share, an employee of the corporation was given an option to purchase 100 shares of stock at \$85 a share. The employee died on March 1, 1993. At that time the fair market value of the stock was \$105 a share and the value of the option, \$1,000 (or the equivalent of \$10 a share). The estate exercised the option and immediately sold the stock for \$98 a share. Applying the adjustment rules described above, we must:

(1) increase the basis of each share by \$10, the per share basis of the option; then

(2) decrease the basis of each share by \$2--the difference between \$15 and (\$100 stock value at grant less \$85 option price), the amount that the deceased employee would have included as compensation income had he exercised the option and died holding the shares, and \$13 (\$98 value at disposition less \$85 option price), the amount that the estate must include in income; and finally

(3) increase the basis of each share by \$3, the amount by which the estate's *IRC Section 423(c)* income (\$13) exceeds the per-share basis of the option (\$10).

The result is a basis of \$96 a share and a capital gain of \$2 a share.

[4] Effect on the Grantor Corporation.

A corporation is not allowed an ordinary and necessary business expense deduction under *IRC Section 162* when it transfers shares pursuant to an individual's exercise of an option granted under an employee stock purchase plan.ⁿ¹ A further consequence is that no amount other than the price paid under the option can be considered as received by the corporation for the transferred shares.ⁿ²

A deduction, equal to the amount of compensation income includable in the gross income of an individual making a disqualifying disposition of the stock acquired under the option, is allowable in the year of the disqualifying disposition.ⁿ³ And it is only a disqualifying disposition that can give rise to the deduction; the inclusion of an amount in gross income as compensation by reason of the application of *IRC Section 423(c)* does not create a deduction for the corporation.ⁿ⁴

FOOTNOTES:

(n1)Footnote 1. *IRC § 423(b)(1)*. The Service has ruled that American Depositary Shares (shares of a non-US company issued under a deposit agreement representing the underlying shares traded in the issuer's home country) qualify as stock for purposes of *IRC § 423*. *Ltr Rul 199931005*.

A partnership owned by an affiliated group parent qualifies as an employer and as a subsidiary corporation. *Ltr Rul 200017048*.

(n2)Footnote 2. *IRC § 423(b)(2)*; *Treas Reg § 1.423-2(c)*.

The degree of shareholder approval required is determined by reference to the applicable provisions of the corporation's charter and by-laws, and the law of the state of incorporation. If they are silent in this regard, the holders of a majority of the voting stock of the corporation must vote to approve the plan.

(n3)Footnote 3. *Treas Reg § 1.423-2(a)(1)*.

(n4)Footnote 4. *Treas Reg § 1.423-2(a)(1)*.

(n5)Footnote 5. *Treas Reg § 1.423-2(a)(2)*.

(n6)Footnote 6. *Id.*

(n7)Footnote 7. *IRC § 423(b)(3)*.

(n8)Footnote 8. *Id*; *IRC § 425(d)*.

(n9)Footnote 9. *IRC § 423(b)(3)*; *Treas Reg § 1.423-2(d)*. An option is outstanding for purposes of *IRC § 423(b)(3)* even though it is exercisable only in installments or after the expiration of a fixed period of time.

(n10)Footnote 10. *Treas Reg § 1.423-2(d)*.

(n11)Footnote 11. *IRC § 423(b)(4)*. In *Rev Rul 71-39, 1971-1 CB 134*, the plan subjected the corporation's obligation to grant options to the laws of a particular country that prohibited foreign corporations from granting options to any of its citizens regardless of their status as employees of the corporation. The plan further provided that, because of the prohibition, no stock options could be granted to any employee who was a citizen of that country. The Service held that the provision did not prevent the plan from meeting the requirement of *IRC § 423(b)(4)*.

(n12)Footnote 12. *Treas Reg § 1.423-2(e)(1)*.

(n13)Footnote 13. *Id.*

(n14)Footnote 14. *IRC § 423(b)(5)*. *IRC § 423(b)(5)* does not prohibit the delaying of the grant of an option to any employee who is barred from being granted an option solely by reason of having failed to meet a minimum service requirement until the employee meets the requirement. *Treas Reg § 1.423-2(f)(4)(i)*.

(n15)Footnote 15. *Id.*

(n16)Footnote 16. *Treas Reg § 1.423-2(f)(2)*.

(n17)Footnote 17. *Treas Reg § 1.423-2(f)(3)(i)*.

(n18)Footnote 18. *Treas Reg § 1.423-2(f)(3)(ii)*.

(n19)Footnote 19. *1969-1 CB 136*.

(n20)Footnote 20. *IRC § 423(b)(6)*.

(n21)Footnote 21. *Treas Reg § 1.423-2(g)(2)*.

(n22)Footnote 22. *Treas Reg § 1.423-2(g)(1)*.

(n23)Footnote 23. *Id.*

(n24)Footnote 23.1. *Notice 2005-1*, Q & A 4(d)(iii), *2005-1 CB 274*.

(n25)Footnote 24. *IRC § 423(b)(7)*. The date on which options are granted under employee stock purchase plans providing for the purchase of shares by accumulated payroll deductions is the first date of the purchase period, provided the maximum number of shares that an employee can purchase is fixed and determinable on that date. *Rev Rul 70-358, 1970-2 CB 96*. Where the number of shares that may be purchased is not fixed or determinable at the time an offer to purchase shares is made by the corporation to the shareholder, the date of grant is the date on which the number of shares the employee can purchase becomes fixed and determinable. *Rev Rul 68-317, 1968-1 CB 186*.

(n26)Footnote 25. *Treas Reg § 1.423-2(h)*.

(n27)Footnote 26. *Id.*

(n28)Footnote 27. *Treas Reg § 1.423-2(i)(3)*; *Treas Reg § 1.423-2(i)(4)*, Ex (1).

(n29)Footnote 28. The purchase of \$25,000 of stock in 1990 is permitted even though the option is outstanding for only a part of the year. *Treas Reg § 1.423-2(i)(4)*, Ex (1).

(n30)Footnote 29. *Treas Reg § 1.423-2(i)(3)*.

(n31)Footnote 30. *Id.* The new option could not be granted until the outstanding option expired.

(n32)Footnote 31. *IRC § 423(b)(8)(C)*.

(n33)Footnote 32. *Treas Reg § 1.423-2(i)(2)*.

(n34)Footnote 33. *Id.* The 5 percent stock ownership limitation is discussed in § 9.03[1][a], *supra*.

(n35)Footnote 34. *Treas Reg* § 1.423-2(i)(1).

(n36)Footnote 35. *Id.*

(n37)Footnote 36. *IRC* § 423(b)(9). The transfer of a statutory stock option to a spouse in connection with a divorce results in the disqualification of the option under *IRC* § 423(b)(9) and causes the option to be treated thereafter in the same manner as a nonstatutory stock option. *Rev Rul* 2002-22, 2002-1 CB 849 .

(n38)Footnote 37. *Treas Reg* § 1.421-1(b)(2).

(n39)Footnote 38. *Id.*

(n40)Footnote 39. *Id.*

(n41)Footnote 1. *IRC* § 424(h)(3). See, eg, *Rev Rul* 74-606, 1974-2 CB 141 , *Rev Rul* 74-546, 1974-2 CB 142 , and *Rev Rul* 72-351, 1972-2 CB 229 , for examples of modifications.

(n42)Footnote 2. *Treas Reg* § 1.424-1(e)(4)(i); *Rev Rul* 73-326, 1973-2 CB 149 .

(n43)Footnote 3. *IRC* §§ 424(a), 424(h)(3)(A); *Rev Rul* 71-385, 1971-2 CB 216 .

(n44)Footnote 4. *IRC* § 424(h)(3)(B). An amendment to permit the optionee to designate other than by will the person who could exercise the option was held not to be a modification in *Rev Rul* 69-648, 1969-2 CB 103 .

(n45)Footnote 5. *IRC* § 424(h)(3)(C); *Rev Rul* 74-504, 1974-2 CB 141 . An amendment to an option, exercisable in installments while the optionee is living, to permit its exercise in full after death is not a modification. *Rev Rul* 70-94, 1970-1 CB 112 .

(n46)Footnote 6. *Treas Reg* § 1.424-1(e)(4)(v). However a change in the option price and number of shares subject to the option to offset a decline in market price caused by an exercise of stock rights is a modification. *Rev Rul* 69-335, 1969-1 CB 137 . See also *Ltr Rul* 9129048 , relating to a similar change made with respect to incentive stock options.

(n47)Footnote 7. *Treas Reg* § 1.424-1(e)(4)(iv).

(n48)Footnote 8. *Treas Reg* § 1.424-1(e)(4)(vii).

(n49)Footnote 9. *Id.*

(n50)Footnote 9.1. *Treas Reg* § 1.424-1(e)(4)(iii).

(n51)Footnote 9.2. *Id.*

(n52)Footnote 9.3. *Id.*

(n53)Footnote 9.4. *Id.*

(n54)Footnote 9.5. *Id.*

(n55)Footnote 9.6. *Treas Reg* § 1.424-1(e)(4)(viii).

(n56)Footnote 10. *IRC* § 424(h)(2)(A).

(n57)Footnote 1. The stock is deemed to be acquired on the date of exercise of the option. *Swenson v Commr*, 309 F2d 672 (8th Cir 1962) ; *Rev Rul* 70-335, 1970-1 CB 111 .

Remuneration received on account of a transfer of stock to any individual under an employee stock purchase plan, or because of a disposition of that stock, is excluded from the definition of wages for employment tax and unemployment purposes. *IRC* § 3121(a)(22); § 3306(b)(19).

(n58)Footnote 2. *IRC* § 421(c)(1).

(n59)Footnote 3. *IRC* § 421(c)(1)(A).

(n60)Footnote 4. *IRC* § 421(b); *Treas Reg* § 1.421-2(b)(1).

A disposition of stock pursuant to a certificate of divestiture to comply with conflict-of-interest requirements that meets the requirements of *IRC* § 1043 is not a disqualifying disposition.

No wage withholding is required because of a disqualifying disposition. *IRC* § 421(b).

(n61)Footnote 5. A disposition of the stock pursuant to the pledge is a disposition even though the pledge itself is not. *Treas Reg* § 1.424-1(c)(1)(iii).

(n62)Footnote 6. *IRC* § 424(c)(2). A transfer of shares acquired under a statutory stock option to a revocable trust created by a husband and wife for their benefit was held not to be a disposition in *Ltr Rul* 9136006 .

(n63)Footnote 7. *IRC* § 424(c)(2); *Treas Reg* § 1.424-1(c)(2).

(n64)Footnote 8. *Rev Rul* 59-242, 1959-2 CB 125 .

(n65)Footnote 9. *Rev Rul* 57-451, 1957-2 CB 295 .

(n66)Footnote 10. *Id.* For example, if common stock of X Corp is given up, common stock of X Corp must be received.

(n67)Footnote 11. *Rev Rul* 68-162, 1968-1 CB 188 .

(n68)Footnote 12. *First Am Natl Bank v US*, 209 F Supp 902 (MD Tenn 1962) .

(n69)Footnote 13. 292 F Supp 527 (D Ore 1968) , *revd* 427 F2d 57 (9th Cir 1970) .

(n70)Footnote 14. 427 F2d at 60 . For the view that a disqualifying disposition need not be a voluntary affirmative act of the shareholder, see *Bayer v Commr*, 382 F Supp 576 (ND Ohio 1974) , *Rev Rul* 74-267, 1974-1 CB 102 , and *Ltr Rul* 9849001 .

(n71)Footnote 15. However, no wage withholding is required. There is no compensation income if the stock is sold at a loss. *Treas Reg* § 1.423-2(k)(3), Ex (2).

(n72)Footnote 16. *IRC* § 423(c).

(n73)Footnote 17. *Id.*

(n74)Footnote 18. *IRC* § 1014(a); *Treas Reg* § 1.423-2(k)(2).

(n75)Footnote 19. This difference is less than the difference between the value of the stock at the time of disposition, \$120, and the amount paid for the stock, \$99 (90 percent of \$110).

(n76)Footnote 20. *IRC* § 421(c)(1)(B). The rules governing the determination of the amount of compensation

income are discussed in the preceding section.

(n77)Footnote 21. *IRC § 421(c)(2)*.

(n78)Footnote 22. *Id.*

(n79)Footnote 23. *IRC § 421(c)(3)(A)*.

(n80)Footnote 24. *Id.*

(n81)Footnote 25. *IRC § 421(c)(3)(B)*.

(n82)Footnote 1. *IRC § 421(a)(2)*.

(n83)Footnote 2. *IRC § 421(a)(3)*.

(n84)Footnote 3. *IRC § 421(b)*.

(n85)Footnote 4. *Treas Reg § 1.423-2(k)(1)(ii)*.



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Taxation of Securities Transactions

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CHAPTER 9 Stock Options

1-9 Taxation of Securities Transactions § 9.04

§ 9.04 Statutory Stock Options--The Incentive Stock Option

[1] Requirements and Conditions--The Definition of an Incentive Stock Option.

[a] Employment. To qualify as an incentive stock option, the option must be granted to an individual for a reason connected with his employment by the granting corporation, its parent or subsidiary.ⁿ¹ In addition, to obtain favorable tax treatment at the time of exercise the optionee must continue as an employee of either the corporation granting the option, a parent or subsidiary of such corporation, or a corporation substituting a new option or assuming the old option as part of a corporate reorganization or liquidation, at all times beginning with the date of the granting of the option and ending no earlier than three months before the date of exercise.ⁿ²

The employment relationship is treated as continuing intact while the employee is on military leave, sick leave, or other bona fide leave of absence (such as temporary government service) if the period of the leave does not exceed three months, or if longer, so long as the employee's right to reemployment with the granting corporation (or a related corporation) or a corporation assuming or substituting an option as part of a corporate transaction is guaranteed either by statute or by contract.^{n2.1} If the period of leave exceeds three months and the employee's right to reemployment is not guaranteed, the employment relationship is deemed to terminate on the first day of the month immediately following the three-month period.^{n2.2}

[b] Stock Option Plan. An incentive stock option must be granted under a plan that specifies the maximum aggregate number of shares of stock that can be issued as incentive stock options under the plan and the employees or class of employees eligible to receive options.ⁿ³ The plan must be approved by the stockholders of the granting corporation within twelve months before or after the plan is adopted.ⁿ⁴ Stockholder approval is not required for amendments to an incentive stock option plan that do not increase the aggregate number of shares that can be issued under the plan or change the eligibility of employees who are to receive them.ⁿ⁵

[c] Time Periods for Granting and Exercising the Option. An incentive stock option must be granted within ten years from the date the plan is adopted, or the date the plan is approved by the shareholders, whichever is earlier.ⁿ⁶ It can not be exercised later than ten years after the date it is granted.ⁿ⁷

[d] Option Price. *IRC Section 422(b)(4)* mandates that the option price be not less than the fair market value of the stock on the date the option is granted. (For purposes of the incentive stock option provisions, the fair market value of stock is determined without regard to any restriction other than a restriction which, by its terms, will never lapse.)ⁿ⁸

However, an option which has a price less than value will not be disqualified if there was a good faith attempt to meet the requirement of *IRC Section 422(b)(4)*.ⁿ⁹

The grant of an option under an employee stock purchase plan does not constitute a deferral of compensation under *IRC Section 409A*.^{n9.1}

[e] Stock Ownership and Value Limitations. At the time the option is granted, the grantee cannot own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation, or of its parent or subsidiary corporation.ⁿ¹⁰ This condition does not apply if, at the time the option is granted, the option price is at least 110 percent of the fair market value of the stock subject to the option, and the option by its terms is not exercisable after the expiration of five year from the date the option is granted.ⁿ¹¹

In addition, the aggregate fair market value (determined at the time that the option is granted) of the stock with respect to which incentive stock options are first exercisable by the employee in any calendar year under all plans of the employer corporation, or parent or subsidiary corporation, or in any predecessor corporation, cannot exceed \$100,000.ⁿ¹² The aggregate fair market value limit is deemed to have been met if there is a good faith attempt to do so.ⁿ¹³

If the aggregate fair market value of stock with respect to which options are exercisable for the first time by an employee in any calendar year exceeds \$100,000, the options relating to stock in excess of the value limitation are nonqualified stock options.ⁿ¹⁴ In determining which of a series of options qualify as incentive stock options, the rule is applied by taking options into account in the order in which they were granted.

If a single, otherwise qualifying option is granted for stock in excess of \$100,000, the option will be treated in part as an incentive stock option and in part as a nonqualified stock option.ⁿ¹⁵ For example, if the single option for \$150,000 of stock first becomes exercisable in a taxable year, the option is treated as an incentive stock option for \$100,000 of stock and a nonqualifying option for \$50,000 of stock. Pursuant to the exercise of an incentive stock option, the corporation can designate the stock that is treated as acquired by issuing a separate certificate (or certificates) for \$100,000 of stock and identifying the certificate as incentive stock option stock in its stock transfer records. In the absence of such a designation, two-thirds (\$100,000/\$150,000) of each share of stock will be treated as stock acquired pursuant to the exercise of an incentive stock option and one-third as stock acquired pursuant to the exercise of a nonqualifying option.

[f] Transferability of the Option. An incentive stock option cannot, by its terms, be transferable by the optionee other than by will or the laws of descent and distribution, nor can it be exercised during life by anyone other than him.ⁿ¹⁶ If the transfer of an incentive stock option contravenes the prohibition against transfer, the grantees are required to include in gross income, in the taxable year of the transfer, the excess of the amount received upon the transfer over the amount, if any, paid for the option.ⁿ¹⁷

An employee can pledge stock purchasable under an option for a loan that is used to pay the option price.ⁿ¹⁸ In addition, the employee can transfer the option to a trust if, under the grantor trust rules and applicable state law, the employee is considered the sole beneficial owner of the option while it is held in trust.ⁿ¹⁹

[g] Permissible Provisions. An incentive stock option that meets the requirements described above can contain further conditions provided they are not inconsistent with the qualification standards.ⁿ²⁰ In addition, the Code permits the employee to pay for stock acquired on exercise with other stock of the granting corporation, and even to receive cash or property at the time of exercise.ⁿ²¹

[2] Modification, Extension and Renewal of the Option.

The earlier discussion of modificationsⁿ¹ is relevant here as well. *IRC Section 424*, in general, and *IRC Section 424(h)*, in particular, apply with equal force to all statutory options. As before, the crucial feature of any modification,

extension, or renewal of the option is its treatment as a new option.

[3] Treatment of Incentive Stock Option.

[a] Exercise of the Option. The holder of an incentive stock option does not realize any income upon the exercise of the option if there is no disposition of the shares within the prescribed holding period, namely, two years from the date of the granting of the option and one year from the date of acquisition.ⁿ¹ The no-income-on-exercise rule extends to the situation in which the option is exercised after the death of the employee by the estate of the decedent or by a person who acquired the right to exercise the option by reason of the death of the employee. In such case, the holding period and employment requirements imposed on lifetime exercise are waived.ⁿ² Numerous AMT relief provisions, including relief targeted to AMT triggered by exercise of incentive stock options, were included in Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (part of Pub L No 110-343, October 3, 2008). ^{n2.1}

The spread between the option price and the fair market value of the stock at the time of exercise is an item of tax preference for purposes of the alternative minimum tax. The basis of stock acquired by exercise of the option is increased by the amount treated as an item of tax preference.^{n2.2} A disqualifying disposition in a taxable year subsequent to the year of exercise does not permit the taxpayer to avoid the tax preference in the year of exercise. There is no tax preference if exercise and disqualifying disposition occur in the same taxable year.^{n2.3}

The Tax Court has held that a taxpayer's election under *IRC Section 83(b)* with respect to vested and nonvested stock acquired on the exercise of an incentive stock option was valid and required him to treat the spread between the option price and the fair market value of both the vested and nonvested stock as income for alternative minimum tax purposes.^{n2.4}

[b] Dispositions of Stock Acquired Through Exercise of the Option. The combination of the requirement that the stock be held one year after exercise and the fact that the stock is, most likely, a capital asset in the hands of the employee insures that any gain realized on a disposition of the stock will be treated as long-term capital gain.ⁿ³

An early and disqualifying disposition of the stock acquired by exercise of the option produces ordinary income for the employee in the year of disposition.ⁿ⁴ If the amount realized on the disqualifying disposition is less than the fair market value of the stock at the time of exercise, the amount of such income is limited to the gain, if any, realized on the disposition.ⁿ⁵ The treatment of any additional gain is unaffected by the rules governing statutory stock options.

[4] Effect on the Grantor Corporation.

The corporation granting the option is not allowed any deduction for compensation paid if the employee follows the rules prescribed for favored tax treatment.ⁿ¹ If the employee fails to do so and makes a disqualifying disposition, the corporation is entitled to a deduction in the year of disposition, in an amount equal to the compensation income includable in gross income by the employee.ⁿ²

FOOTNOTES:

(n1)Footnote 1. *IRC § 422(b)*. A partnership owned by an affiliated group parent qualifies as an employer and as a subsidiary corporation. *Ltr Rul 200017048* .

(n2)Footnote 2. *IRC §§ 422(a)(2), 424(a)*. Employees who become disabled have one year to exercise the option after leaving employment. *IRC § 422(c)(6)*.

(n3)Footnote 2.1. *Treas Reg § 1.421-1(h)(2)*. A corporate transaction includes (i) a merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation; (ii) a distribution (excluding an ordinary dividend or stock split or pro rata stock dividend) or change in terms or number of outstanding shares of the corporation; and (iii) any other corporate events prescribed by the Commissioner in published guidance. *Treas Reg §*

1.424-1(a)(3).

(n4)Footnote 2.2. *Treas Reg § 1.421-1(h)(2)*.

(n5)Footnote 3. *IRC § 422(b)(1)*. If a corporation maintains an omnibus plan under which incentive stock options, nonstatutory stock options, and other stock-based awards may be made, the plan must contain a maximum number of shares that may be issued as incentive stock options, but need not state the maximum number of shares that may be issued to nonstatutory options or other stock-based awards. *Treas Reg § 1.422-2(b)(3)(i)*.

(n6)Footnote 4. *IRC § 422(b)(1)*.

(n7)Footnote 5. *Notice 87-49, 1987-2 CB 355 ; Treas Reg § 1.422-2(b)(2)(iii)*. An amendment that increases the maximum aggregate number of shares is considered the adoption of a new plan, requiring shareholder approval. The plan is considered adopted when the shareholders approve the amendment.

(n8)Footnote 6. *IRC § 422(b)(2)*.

Options issued at any time during the 10-year period following adoption of an amendment to the plan that increases the maximum aggregate number of shares that can be issued under the plan satisfy the 10-year period limitation of *IRC § 422(b)(2)*. *Ltr Rul 200519026* .

(n9)Footnote 7. *IRC § 422(b)(3)*. The exercise period is shortened to five years in certain circumstances. See § 9.03[1][e].

(n10)Footnote 8. *IRC § 422(c)(7)*. The option price may be determined in any reasonable manner, including valuation methods prescribed in the estate tax regulations, so long as the minimum price possible under the terms of the option is not less than the fair market value of the stock on the date of grant. *Treas Reg § 1.422-2(e)(1)*.

(n11)Footnote 9. *IRC § 422(c)(1)*. Whether there was a good-faith attempt to set the option price at not less than the fair market value of the stock on the date of grant depends on the relevant facts and circumstances, including whether the stock is publicly traded or not. *Treas Reg § 1.422-2(e)(2)*.

(n12)Footnote 9.1. *Notice 2005-1 , Q & A 4(d)(iii), 2005-1 CB 274* .

(n13)Footnote 10. *IRC § 422(b)(6)*. An individual is considered as owning the stock owned, directly or indirectly, by or for his brothers and sisters, spouse, ancestors, and lineal descendants. *IRC § 424(d)(1)*. Stock owned, directly or indirectly, by a corporation, partnership, or trust, is deemed to be owned proportionately by or for its shareholders, partners, or beneficiaries. *IRC § 424(d)(2)*.

(n14)Footnote 11. *IRC § 422(c)(5)*.

(n15)Footnote 12. *IRC § 422(d)*. The taxpayers in *Montgomery v Commissioner, 127 TC No 3 (2006)* , contended that the \$100,000 limitation is only applied to shares that are not subject to a subsequent disqualifying disposition during the same taxable year in which the shares are acquired. The Tax Court held that the limitation does not exclude shares that are later the subject of a disqualifying distribution.

A disqualifying disposition has no effect on the determination of whether an option exceeds the \$100,000 limitation. *Treas Reg § 1.422-4(b)(6)*.

(n16)Footnote 13. *IRC § 422(c)(1)*.

(n17)Footnote 14. *IRS Notice 87-49, 1987-2 CB 355* .

(n18)Footnote 15. *IRS Notice 87-49, 1987-2 CB 355* .

(n19)Footnote 16. *IRC § 422(b)(5)*. The cancellation of a stock option is not a permissible transfer under *IRC § 422(b)(5)*. See, eg, *TAM 9540003* .

The transfer of a statutory stock option to a spouse in connection with a divorce results in the disqualification of the option under *IRC § 422(b)(5)* and causes the option to be treated thereafter in the same manner as a nonstatutory stock option. *Rev Rul 2002-22, 2002-1 CB 849* . However, the provisions of *IRC § 422(b)(5)* were not violated when a divorce court (1) recognized the spouse's community property interest in incentive stock options, (2) required the employee to exercise the spouse's options only in accordance with the spouse's instructions, and (3) required the employee to designate the spouse as the beneficiary of the spouse's share of the option. *Ltr Rul 200519011* .

(n20)Footnote 17. *Treas Reg § 1.83-7(a)*. However, if the option or plan under which it was granted contains a provision allowing the employee to designate the person who may exercise the option after the employee's death, neither the provision, nor a designation pursuant to the provision, disqualifies the option as a statutory option. *Treas Reg § 1.421-1(b)(2)*.

(n21)Footnote 18. *Id.*

(n22)Footnote 19. *Id.*

(n23)Footnote 20. *IRC § 422(c)(4)(C)*. However, an option will not be an incentive stock option if its terms state that it is not to be treated as such. *IRC § 422(b)*.

(n24)Footnote 21. *IRC § 422(c)(4)(A), (B)*. The receipt of property is allowed only if the employee is subject to the provisions of *IRC § 83* because of the receipt of the property. The operation of *IRC § 83* is discussed at § 9.06[2][d].

(n25)Footnote 1. See § 9.03[2], *supra*. The Service will not rule whether the substitution of a new incentive stock option for an old incentive stock option, or the assumption of an old incentive stock option, by an employer by reason of a corporate transaction constitutes a new option by reason of failing to satisfy the spread test requirement of *IRC § 424(a)(1)* or the ratio test of *Treas Reg § 1.425-1(a)(4)*. The Service will continue to rule on the issue of whether the new incentive stock option or the assumption of the old gives the employee additional benefits not present under the old option within the meaning of *IRC § 424(a)(2)*. *Rev Proc 2010-3, 2010-1 IRB 110, 113-114* (§ 3.01(44)).

(n26)Footnote 1. *IRC §§ 421(a)(1), 422(a)(1)*. The employment requirement mentioned earlier must also be met. *IRC § 422(a)(2)*.

Remuneration received on account of a transfer of stock to any individual pursuant to the exercise of an incentive stock option is excluded from the definition of wages for employment and unemployment tax purposes. *IRC §§ 3121(a)(22), 3306(b)(19)*.

A transfer of stock acquired on the exercise of a statutory stock option (an incentive stock option or an option granted under an employee stock purchase plan) to purchase stock pursuant to the exercise of an incentive stock option will be taxable if the holding period applicable to the transferred stock has not been met. *IRC § 424(c)(3)*.

(n27)Footnote 2. *IRC § 421(c)(1)*. Gain realized on a disposition within one year will be treated as short-term capital gain.

Although the employee's estate can exercise the option more than three months after the termination of the employment relationship, death must occur within three months of such termination if the decedent is not an employee at the time of death. *Treas Reg § 1.421-8(c)(1)*.

(n28)Footnote 2.1. See § 2A.03[1], above.

(n29)Footnote 2.2. *IRC § 57(a)(3)(B)*.

(n30)Footnote 2.3. *Ltr Rul 8821076* .

(n31)Footnote 2.4. *Kadillak v Commr, 127 TC 184 (2006)* , *aff'd 534 F3d 1197 (3d Cir 2008)* .

(n32)Footnote 3. This assumes that there is no disposition within two years from the granting of the option. The taxpayer in *Svoboda v Commr, TC Memo 2006-235* , argued that a taxpayer could comply with the holding period for capital gain treatment either by holding the option for two years after its grant or by holding the stock acquired on exercise of the option for one year after its acquisition. The Tax Court rejected this alternative test.

The transfer of legal title to stock acquired on the exercise of an incentive stock option to a broker as collateral for a margin account is not a disposition where the broker is required to replace the transferred stock with new stock of the corporation of the same kind and amount. *Ltr Rul 8636055* .

Remuneration received on account of a transfer of stock acquired pursuant to the exercise of an incentive stock option is excluded from the definition of wages for employment tax purposes. *IRC § 3121(a)(22)*.

(n33)Footnote 4. *IRC § 421(b)*. A transfer of acquired stock by an insolvent person to a trustee, receiver, or similar fiduciary in an insolvency proceeding is not a disqualifying disposition. *IRC § 422(c)(3)*. Neither is a transfer to a spouse or former spouse that falls within the terms of *IRC § 1041*. *IRC § 424(c)(4)*.

A disposition of stock pursuant to a certificate of divestiture to comply with conflict-of-interest requirements that meets the requirements of *IRC § 1043* is not a disqualifying disposition. *IRC § 421(d)*.

(n34)Footnote 5. *IRC § 422(c)(2)*; S Rep No 97-144, 97th Cong, 1st Sess, 99 note 1 (1981).

The limitation contained in *IRC § 422(c)(2)* does not apply when the disqualifying disposition is a wash sale, a gift, or a sale to a related party governed by *IRC § 267(a)(1)*. *Prop Treas Reg § 1.422A-1(b)(2)*. Thus, the Service has ruled that a transfer of stock to a charitable remainder trust prior to the end of the one-year holding period results in includable gain equal to the difference between the fair market value of the stock at the time of exercise and the option price. *Ltr Rul 9308021* .

(n35)Footnote 1. *IRC § 421(a)(2)*.

(n36)Footnote 2. *IRC § 421(b)*. A payment to the holder of an employee stock option to cancel the option yields a deduction for the corporation under *IRC § 162(a)*; the payment is controlled by *IRC § 83* and not *IRC § 421*. *Ltr Rul 9206004* .

Income realized from disqualifying dispositions of stock acquired pursuant to an incentive stockoption plan constitutes wages for purposes of the *IRC § 41* credit for increasing research activities. *Sun Microsystems, Inc v Commr, TC Memo 1995-69* , *acq, 1997-2 CB 1* .



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CHAPTER 9 Stock Options

1-9 Taxation of Securities Transactions § 9.05

§ 9.05 Reporting Requirements With Respect to Statutory Stock Options

A corporation must file an information return for any calendar year in which it transfers a share of stock to any person pursuant to such person's exercise of an incentive stock option.ⁿ¹ A return is required for any calendar year in which the corporation or its agent records the first transfer of legal title of a share of stock acquired by the transferor pursuant to his exercise of an option granted under an employee stock purchase plan with an option price between 85 percent and 100 percent of the value of the subject stock at the time of option grant.ⁿ² In addition, every corporation that is required to file one of the prescribed information returns is also required to furnish a written statement containing the information shown on the return to each person whose name is set forth in the return; this statement must be furnished no later than January 31 of the year following the calendar year for which the return is made.ⁿ³

FOOTNOTES:

(n1)Footnote 1. *IRC § 6039(a)(1)*.

(n2)Footnote 2. *IRC § 6039(a)(2)*.

(n3)Footnote 3. *IRC § 6039(b)*. The statement can consist of a copy of the appropriate return. *Treas Reg § 1.6039-2(a)*. The statement must be furnished upon the transfer of legal title of the stock to the employee who exercises an incentive stock option. When stock is acquired pursuant to an employee stock purchase plan, the statement must be provided for the first transfer of legal title to the stock to the employee. Chief Counsel Advice 200114001.



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CHAPTER 9 Stock Options

1-9 Taxation of Securities Transactions § 9.06

§ 9.06 Nonstatutory Stock Options

Where an option is granted for any reason connected with the employment of an individual, and the terms of the option fail to satisfy the requirements prescribed for statutory stock options, the rules governing the tax treatment of nonstatutory stock options apply even though (1) the option is granted by someone other than the employer corporation or a related corporation (eg, by a stockholder); (2) it is granted to someone other than the employee, perhaps a member of his family; and (3) it covers stock in a corporation other than the employer corporation or a related corporation.ⁿ¹ But the applicable rules are not limited to options granted to employees; options granted to independent contractors as payment for services are subject to the same treatment.ⁿ² However, the rules regarding nonstatutory options have no application when the option is acquired solely as an investment and is in no way compensatory.ⁿ³ For example, the regulations permit a person to establish that an option having a readily ascertainable fair market value was not acquired as payment of an amount constituting compensation by showing that the amount paid for the option equalled its value.ⁿ⁴ To prove that an option without a readily ascertainable value was not compensatory, the taxpayer must show that, from an examination of all of the surrounding circumstances, there was no reason for the option to have been granted as payment of an amount constituting compensation. This he does by showing that he had neither rendered, nor was obligated to render, substantial services in consideration for the granting of the option.ⁿ⁵

[1] Treatment of Options Having a Readily Ascertainable Value.

[a] Determination of a Readily Ascertainable Value. According to the Regulations, options may have a value when granted,ⁿ¹ but that value is generally not readily ascertainable unless the option is actively traded on an established market.ⁿ² An option not actively traded on an established market can have a readily ascertainable fair market value only if all of the following conditions exist:

- (1) the option is freely transferable by the optionee;
- (2) the option is exercisable immediately in full by the optionee;ⁿ³
- (3) the option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure payment of the purchase price) which has a significant effect on the fair market value of the option or the subject property; and
- (4) the fair market value of the option privilege is readily ascertainable.ⁿ⁴ The fair market value of the

option is not merely the spread between the option price and the value of the stock subject to the option; it also includes the value of the option privilege--the opportunity to benefit from any appreciation in the subject property without risking any capital.ⁿ⁵ In determining whether an option privilege has a readily ascertainable value and the amount of such value, it becomes necessary to consider:

- (a) whether the value of the property subject to the option can be ascertained,
- (b) the probability of an increase or decrease in the ascertainable value of the subject property, and
- (c) the length of the option period.ⁿ⁶

An interesting comment on the problem of determining whether an option has a readily ascertainable value is provided by *Union Chem. & Materials Corp. v. United States*.ⁿ⁷ Evidence to the effect that the options were worth around \$30,000 to \$35,000 had been introduced in a companion case. The Court of Claims found this insufficient, stating:

"Is this what is meant by a readily ascertainable market value? On the day that the warrants were issued the stock was selling for approximately \$19.75 per share. The option price was \$21 per share ... How valuable then was [the option]? Certainly it was worth something, but exactly how much no one could ascertain."ⁿ⁸

The breadth of opinion that a particular fact situation can engender is shown by *LeVant v. Commissioner*,ⁿ⁹ where each of three judges reached a different conclusion as to the nature of the acquired interest and its value. One judge found that the employee had acquired only a conditional privilege to obtain an option or, at most, a personal, nonassignable option that had no value when granted. The second found the option to be assignable, but held that the taxpayer had failed to sustain his burden of proving a readily ascertainable value. The third judge agreed that the employee had received an assignable option, but dissented on the ground that the option had an ascertainable fair market value.

[b] Grant of the Option. The employee to whom a nonstatutory option with a readily ascertainable fair market value is granted realizes compensation income, at the time of option grant, in an amount equal to the difference between the fair market value of the option and the amount paid therefor.ⁿ¹⁰ The amount includable in gross income increases the basis of the option in the hands of the employee.

[c] Transfer or Exercise of the Option. No amount is includable in gross income as compensation by reason of the transfer or exercise of an option that had a readily ascertainable fair market value when granted.ⁿ¹¹ This rule applies even though the optionee failed to return an amount as compensation in the year of grant and the assessment of a deficiency for that year is barred by the statute of limitations.ⁿ¹²

[d] Disposition of Stock Acquired on the Exercise of the Option. No special tax problems are created by the disposition of stock acquired on the exercise of a nonstatutory stock option having a readily ascertainable fair market value at the time of option grant. The amount of realized gain or loss is computed in the ordinary manner--by comparing the amount realized and the basis of the stock.ⁿ¹³ (The basis of the stock will be the sum of the option price and the taxpayer's basis for the option. In the case in which the employee receives the option without cost to him, the basis of the stock will be the sum of the option price and the amount included in gross income as compensation.) The recognition of gain or loss and its character is likewise determined in accordance with the general rules governing the disposition of property.

[2] Treatment of Options Without a Readily Ascertainable Value.

[a] Grant of the Option. Compensation income is not realized when a nonstatutory stock option without a readily ascertainable fair market value is granted to an employee in connection with his employment.ⁿ¹ Some further action or

event is required before income results.

The grant of a nonstatutory stock option provides for a deferral of compensation subject to *IRC Section 409A*.^{n1.1} However, a nonstatutory stock option does not provide for a deferral of compensation if (1) the exercise price of the option may never be less than the fair market value of the underlying stock on the date the option is granted, (2) the receipt, transfer, or exercise of the stock is subject to taxation under *IRC Section 83*, and (3) the option does not include any feature for deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of the option.^{n1.2}

[b] Transfer of the Option. If the optionee does not exercise the option, but instead transfers it to another in an arm's-length transaction, he is required to return any gain resulting from the transfer as compensation income.ⁿ² If the transfer is not an arm's-length transaction, the employee still realizes compensation equal in amount to the sum of any money and the fair market value of substantially vested property received in the disposition of the option.ⁿ³ But in the latter instance, the employee will realize additional compensation when the transferee takes action with respect to the option which, if taken by the employee while holding the option, would have resulted in the realization of income by him; the compensation income realized at such later date is reduced by the amount realized on the earlier transfer.ⁿ⁴

Example:

If an employee is granted an option not having a readily ascertainable fair market value which he then transfers to another for \$10 in a transaction not at arm's-length, he realizes \$10 of compensation on account of such transfer. If the transferee then sells the option for \$25 in an arm's length transaction, thereby realizing a \$15 gain (\$25, amount realized, less \$10, cost basis for the option), the employee has additional compensation income of \$5 (\$15, the transferee's gain, less \$10, the prior amount of compensation income).

A different rule applies when the transfer of the option is incident to a divorce. The Service has ruled that *IRC Section 1041* confers nonrecognition treatment on any gain that the transferor might otherwise realize when the options were transferred to the former spouse.^{n4.1} Moreover, the transferor is not required to include in gross income any income resulting from the transferee's exercise of the option; the income must be reported by the transferee.^{n4.2} The ruling does not apply to transfers between spouses that are not incident to a divorce even though *IRC Section 1041* applies to such transfers. It also does not apply to transfers of options that are unvested at the time of transfer. Even though the transferee spouse is the one who must take into account the income generated by the exercise, that income is still treated as wages earned by the transferor for purposes of FICA and FUTA taxes.^{n4.3}

[c] Exercise of the Option. Under *IRC Section 83*, an employee receiving restricted stock on the exercise of an option has compensation income to the extent of the difference between the amount paid for the stock and its fair market value (determined without regard to any restriction other than one which, by its terms, will never lapse) at the time that his rights in the stock are transferable or are not subject to a substantial risk of forfeiture.ⁿ⁵ Thus, only after compensation-income is realized can any appreciation in value be treated as capital gain. And since the holding period for the stock does not begin to run until compensation is realized, the taxpayer must hold the stock for another one year in order to have any additional gain taxed as long-term capital gain.ⁿ⁶

A person's interest in property will always be considered subject to a substantial risk of forfeiture if his right to full enjoyment of the property is conditioned upon his future performance of substantial services.ⁿ⁷ A substantial risk of forfeiture may exist even if the condition does not exist.ⁿ⁸ However, in such case, the question of whether or not the property is subject to a substantial risk of forfeiture depends upon all the facts and circumstances of the particular case.ⁿ⁹ An interest is transferable only if the rights of any transferee are not subject to any substantial risk of forfeiture.ⁿ¹⁰ So, as one can see, in the absence of a substantial risk of forfeiture, compensation income will be realized when the option is exercised.

Ordinarily, the amount of compensation income is the difference between the fair market value of the stock without restrictions and the option price.ⁿ¹¹ But where the stock is subject to a restriction which, by its terms, will never lapse, and which allows the employee to sell the stock only at a price determined under a formula, the price so determined will be considered as the fair market value of the property, unless a different price is established to the contrary by the Commissioner (the burden of proof being on the Commissioner).ⁿ¹² The nonlapsing restriction is viewed as an inherent limitation on the employee's property rights; the employee's income should be determined accordingly.ⁿ¹³ A later cancellation of the restriction will produce additional compensation for the employee in the year of cancellation. The amount then includable is the excess of the fair market value of the stock (without regard to the restriction) at the time of cancellation over the sum of (1) the fair market value of the stock taking the restriction into account immediately prior to the cancellation and (2) the amount, if any, paid for the cancellation.ⁿ¹⁴ This last stated rule will not apply if the taxpayer can establish that the cancellation is not compensatory and that the person who would be entitled to a deduction if it were compensatory will not treat the cancellation as a compensatory transaction.ⁿ¹⁵

Example:

An employee is granted a nonstatutory stock option to purchase shares of his employer's stock for \$80 a share. The option, which had no readily ascertainable fair market value when granted, is exercised at a time when the fair market value of the acquired stock (without regard to any restrictions) is \$110 a share. However, the stock is subject to a restriction that calls for a resale of the stock to the corporation at the price paid by the employee if he fails to remain in the employ of the corporation for a period of two years from the date of exercise. The stock is subject to a further restriction requiring any sale after two-year period to be made only to the corporation at a price equal to the book value of the stock at the time of sale. Since the employee's full enjoyment of the stock is conditioned upon continued performance of substantial services, the rights in the property are subject to a substantial risk of forfeiture, and the employee will not realize any compensation income when the option is exercised. Such income will be realized at the end of the two-year period when the substantial risk of forfeiture terminates, and the amount of income will be the excess of the book value of the stock at that time over the option price. The book value of the stock is considered to be the fair market value of the stock, unless the Commissioner can prove a higher value. Were there no requirement of a resale at book value, the difference between the fair market value of the stock at the end of the two-year period and the option price would provide the measure of compensation includable in the employee's gross income.

A different type of cancellation can also produce income for the employee. If an indebtedness that has been treated as an "amount paid" for purposes of *IRC Section 83* is subsequently canceled, forgiven, or satisfied for an amount less than the amount of the debt, the amount of the debt that is not paid is includable in the income of the employee in the taxable year in which the cancellation, forgiveness, or satisfaction occurs.ⁿ¹⁶

A sale or disposition of the stock in an arm's-length transaction before the employee's rights become transferable or not subject to a substantial risk of forfeiture creates compensation income for the employee in the year that the transaction occurs.ⁿ¹⁷ On the other hand, a gift of the forfeitable property is not a taxable event, but the employee (and not the donee) will be the one taxable on the compensation income realized when the rights in the stock become nonforfeitable.ⁿ¹⁸

The holder of the restricted stock does not realize income if the stock is exchanged for other stock or property subject to substantially the same restrictions and (1) the exchange is made tax-free by the application of *IRC Section 354, 355, 356, or 1036*, or (2) the exchange is pursuant to the exercise of a conversion privilege.ⁿ¹⁹ The stock acquired on the exchange becomes the restricted property subject to *IRC Section 83(a)*, so that the exchange transaction merely defers the realization of compensation until the holder's rights in the new stock become transferable or not subject to a substantial risk of forfeiture.ⁿ²⁰

The employee receiving restricted stock on the exercise of her option may elect (the election to be made not later than

thirty days after the date of acquisition) to realize compensation income in the year of exercise to the extent of the spread between the value of the stock at the time of acquisition (determined without regard to any restriction other than a restriction which, by its terms, will never lapse) and the amount paid for the stock.ⁿ²¹ By so doing, the taxpayer will not be saddled with any additional compensation income and will be able to treat all further appreciation in the value of the stock as capital gain.

The election described in the preceding paragraph is made by filing one copy of a statement containing (a) the name, address, taxpayer identification number, and taxable year of the optionee; (b) a description of the property with respect to which the election is being made; (c) the date of transfer of the property; (d) the restrictions to which the property is subject; (e) the fair market value of the property if unrestricted; (f) the amount paid for the property;ⁿ²² and (g) a statement to the effect that copies have been furnished to the optionee and to any transferee of the property, if the transferee is not the person furnishing the services. An additional copy of the statement must be submitted with the taxpayer's income tax return for the taxable year in which the property was transferred.ⁿ²³

[d] Death of the Optionee Prior to Realizing Compensation Income.ⁿ²⁴ If an option not having a readily ascertainable fair market value is granted to an employee who dies before transferring or exercising the option, income having the character of compensation will be realized by the estate or beneficiary of the person who performed the services.ⁿ²⁵ If an employee dies holding stock that was acquired pursuant to the exercise of an option and the employee's rights in the stock were subject to a substantial risk of forfeiture from the time of acquisition until the time of death, compensation income is properly includable in the gross income of the employee for the taxable year which closes with his death, provided that death eliminates the risk of forfeiture. But if the substantial risk of forfeiture is based on facts and circumstances other than the future performance of substantial services, so that the risk of forfeiture continues after the employee's death, the person receiving the stock will be the one to report income having the character of compensation.

[e] Basis of Stock Acquired on the Exercise of the Option. If a nonstatutory option lacking a readily ascertainable value when granted is exercised by the employee to whom it was granted, his basis for the acquired stock is increased by the amount of compensation includable in his gross income, whether such income is realized at the time of exercise or at some later date.ⁿ²⁶ The stock will continue to reflect that adjustment if transferred to a person whose basis for the stock is the same as the transferor's.ⁿ²⁷ But if the transfer came at death, the basis of the stock is its fair market value on the date of death or applicable alternate valuation date (as determined under *IRC Section 1014*) without any increase whatsoever.

If the option is transferred by the employee in a transaction that is not at arm's length, and the transferee exercises the option, the transferee's basis for the acquired stock is increased by the amount of compensation includable in the gross income of the employee at the time of exercise of the option and acquisition of the property.ⁿ²⁸ However, there is no increase in the basis of the acquired stock where the exercise of the option follows an arm's-length transfer of the option.ⁿ²⁹ The basis of the stock in such case is the sum of the amount paid for the stock and the amount paid for the option.

[3] Effect on the Grantor of the Option.

When the application of *IRC Section 83* produces compensation income for an employee acquiring stock on the exercise of an option granted by his employer after April 22, 1969, *IRC Section 83(h)* allows "as a deduction under section 162, to the [employer], an amount equal to the amount included under [*IRC Section 83(a), (b) or (d)(2)*] in the gross income of the [employee]." ⁿ¹ The provision is far from a model of clarity. Does it stand for the proposition that the employer must be allowed a deduction in an amount equal to the compensation realized by the employee, or does it mean only that the employer is deemed to have paid compensation to the employee, with the availability of a deduction to be determined under the reasonableness criterion of *IRC Section 162*? The latter position appears to be more in keeping with the statutory language.ⁿ² Although *IRC Section 83(h)* states that a deduction "shall be allowed," it makes it

allowable "as a deduction under section 162." By interpreting the provision as one which requires that the compensation meet the test of deductibility imposed by *IRC Section 162*, the reference to that section is given meaning; to hold otherwise would cause the reference to be mere surplusage.ⁿ³

The deduction is allowed in the taxable year of the employer that includes the close of the employee's taxable year in which the compensation is realized.ⁿ⁴ But since *IRC Section 83(h)* applies only when *IRC Section 83* governs the realization of compensation, the employer is entitled to a deduction in the year in which the compensation is deemed to be paid by the employer whenever the employee's compensation results from grant of an option having a readily ascertainable fair market value or from the transfer of an option without a readily ascertainable fair market value.ⁿ⁵

The employer corporation is entitled to a deduction in accordance with the foregoing rules even though the stock transferred to the employee comes from a shareholder of the employer; the transfer by the shareholder is treated as a contribution to the capital of the employer.ⁿ⁶

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.421-6(a)(1)*. *Rev Proc 2002-13*, 2002-1 CB 549 , provides guidance for valuing compensatory stock options for purposes of the golden parachute provisions of *IRC § 280G*. The procedure includes a safe-harbor valuation method that takes into account the volatility of the underlying stock, the exercise price of the option, the value of the stock at the time of valuation, and the term of the option. *Rev Proc 2002-13* , modified, *Rev Proc 2002-45*, 2002-2 CB 40 . *Rev Proc 2003-68*, 2003-2 CB 398 , restates and modifies *Rev Proc 2002-13* , as modified by *Rev Proc 2002-45* .

(n2)Footnote 2. *Treas Reg § 1.61-15(a)*.

(n3)Footnote 3. *Treas Reg § 1.61-15(b)(1)(ii)*. See, eg, *Sun Microsystems, Inc v Commr*, *TC Memo 1993-467* , where warrants were issued to a customer as a sales incentive. The difference between the fair market value of the stock and the option price was deemed to be a sales allowance. The same result was reached in *Convergent Technologies, Inc v Commr*, *TC Memo 1995-320* .

The tax consequences to the recipient of the Sun Microsystems warrants came before the Tax Court in *Sun Computervision International Corp v Commr*, *TC Memo 1996-131* . The court concluded that the approach taken in *Sun Microsystems* was appropriate in resolving the issue, and held that the warrant constituted a trade discount and not a capital asset. Thus, the entire net proceeds of a sale of one of the warrants was properly treated as a reduction in the cost of goods sold.

(n4)Footnote 4. *Treas Reg § 1.61-15(b)(2)*.

(n5)Footnote 5. *Treas Reg § 1.61-15(b)(2)*. This requirement generally prevents an employee from claiming that an option was not granted as payment of an amount constituting compensation.

(n6)Footnote 1. This was recognized by the Supreme Court in *Commr v LoBue*, 351 US 243 (1956) , and in *Commr v Smith*, 324 US 177 (1945) . The *Smith* case held that an option with an option price less than market value at the time of grant could not then have a fair market value.

For purposes of *IRC § 280G* (denying a deduction for an excess "golden parachute" payment), a nonqualified stock option with an ascertainable fair market value at the time the option becomes substantially vested is treated as property that is transferred no later than the time of vesting. Any money or property that is transferred upon the sale or other disposition of the option is not treated as a payment in the nature of compensation. *Prop Treas Reg § 1.280G-1*, Q&A 13.

(n7)Footnote 2. *Treas Reg §§ 1.83-7(b)(1)*; *Wanvig v US*, 295 F Supp 882 (ED Wis 1969) , *affd on other grounds*,

423 F2d 769 (7th Cir 1970) . Warrants issued to an underwriter as compensation for services rendered were found not to have a readily ascertainable value. In so holding in *Weigl v Commr*, 84 TC 1192 (1985) , the Tax Court rejected the taxpayer's contention that the regulations were invalid as applied to independent contractors.

(n8)Footnote 3. *Treas Reg* § 1.83-7(b)(2)(ii). The validity of the "immediately exercisable" requirement was upheld in *Cramer v Commr*, 101 TC 225 (1993) , *affd* 64 F3d 1406 (9th Cir 1995) , *cert denied*, 116 S Ct 2499 (1996) .

(n9)Footnote 4. *Treas Reg* § 1.83-7(b)(2).

(n10)Footnote 5. *Treas Reg* § 1.83-7(b)(3).

(n11)Footnote 6. *Treas Reg* § 1.83-7(b)(3).

(n12)Footnote 7. 296 F2d 221 (Ct Cl 1961) .

(n13)Footnote 8. 296 F2d 225 (Ct Cl 1961) . In *Colton v Williams*, 209 F Supp 381 (ND Ohio 1962) , the court found a readily ascertainable value, although the option price was \$3.25 and a practically contemporaneous public offering had a price of \$3.00 per share. However, the offering was oversubscribed, and there was competent testimony that the stock had a value of \$3.75 per share and that the option had a value of \$1.00 per share based on the market spread and the value of the option privilege.

(n14)Footnote 9. 376 F2d 434 (7th Cir 1967) .

(n15)Footnote 10. *Treas Reg* § 1.83-7(a).

(n16)Footnote 11. Any gain realized on the transfer of the option will ordinarily be capital gain.

(n17)Footnote 12. *Colton v Williams*, 209 F Supp 381 (ND Ohio 1962) . Query whether the basis of the option can be increased by the amount which should have been included in gross income.

(n18)Footnote 13. *IRC* § 1001(a).

(n19)Footnote 1. The Service will not ordinarily rule when compensation is realized by a person who, in connection with the performances of services, is granted a nonstatutory stock option without a readily ascertainable fair market value to purchase stock at a price that is less than the fair market value of the stock on the date the option is granted. *Rev Proc* 2008-3, 2008-1 IRB 110

(n20)Footnote 1.1. *Notice* 2005-1, Q & A 4(d)(i), 2005-1 CB 274 .

(n21)Footnote 1.2. *Notice* 2005-1 , Q & A 4(d)(ii). The right to receive substantially nonvested stock upon the exercise of the option does not constitute a feature for the deferral of income.

With respect to options issued before Jan 1, 2005, the failure to meet the option price requirement will not create a deferral of income if there was a good faith attempt to set the option price at not less than the fair market value of the stock subject to the option at the time the option was granted. *Notice* 2006-4, 2006-3 IRB 307 .

(n22)Footnote 2. *Treas Reg* §§ 1.83-1(b), 1.83-7(a). The same rule has been applied to a situation in which an option that did not have a readily ascertainable fair market value at grant was exchanged for an option that also lacked such a readily ascertainable fair market value. *Ltr Rul* 200418017 .

Regulations except a transfer of the option to a person related to the service provider. For this purpose, a person is related to the service provider if (1) the person and the service provider bear a relationship to each other that is specified in *IRC* §§ 267(b) or 707(b)(1) (substituting 20% for 50% each place it appears), and *IRC* § 267(c)(4) is applied as if the

family of an individual includes the spouse of any member of the family; or (2) the person and the service provider are engaged in trades or businesses under common control (within the meaning of *IRC* § 52(a) and (b)). However, a person is not related to the service provider if the person is the service recipient with respect to the option or the grantor of the option. *Treas Reg* § 1.83-7(a).

Payment received by an employee from his employer on the termination of a qualified stock option was held to be governed by *IRC* § 83 and constituted compensation income. The provisions governing statutory stock options did not apply because the option was never exercised. In addition, the option did not have a readily ascertainable fair market value when granted. *Bagley v Commr*, 85 TC 663 (1965). The same rule has been applied to a situation in which an option that did not have a readily ascertainable fair market value at grant was exchanged for an option that also lacked such a readily ascertainable fair market value. *Ltr Rul* 200418017.

A transfer to a family member, for no consideration, of a nonstatutory stock option, is a completed gift for gift tax purposes on the later of (1) the transfer, or (2) the time when the transferee's right to exercise the option is no longer conditioned on the performance of services by the transferor. *Rev Rul* 98-21, 1998-1 CB 975.

(n23)Footnote 3. *Treas Reg* § 1.83-1(c). No income will be realized if options that are community property are divided as part of a property settlement agreement pursuant to a divorce. *Ltr Rul* 9433010.

A gift of a nonstatutory stock option is a completed gift under *IRC* § 2511 on the later of (i) the transfer, or (ii) the time when the donee's right to exercise the option is no longer conditioned on the performance of services by the transferor. *Rev Rul* 98-21, 1998-1 CB 975.

The methodology for valuing nonpublicly traded compensatory stock options is set forth in *Rev Proc* 98-34, 1998-1 CB 983.

(n24)Footnote 4. *Treas Reg* § 1.83-1(c). The transferee's basis for the property acquired on the exercise of the option will reflect the amount paid for the option and any amount included in the income of the person who performed the services. *Treas Reg* § 1.83-4; *Ltr Rul* 9421013.

No amount is includable in income of the employee if the option is exercised by a former spouse who received the option as part of a division of community property pursuant to a settlement agreement incident to a divorce. *Ltr Rul* 9433010.

For gift tax purposes, a donative transfer of an option is a completed gift on the date the option is transferred rather than on the date the option is exercised. *Rev Rul* 98-21, 1998-1 CB 975; *Ltr Rul* 9722022; see also *Rev Rul* 80-186, 1980-2 CB 280.

(n25)Footnote 4.1. *Rev Rul* 2002-22, 2002-1 CB 849. Under the facts of the ruling, the options were considered marital property subject to equitable distribution in the state in which the parties resided. The same rules will apply if the options are considered to be community property.

(n26)Footnote 4.2. The Service has taken the position that applying the assignment of income doctrine in divorce cases to tax the transferor spouse when the transferee spouse ultimately receives the income from the property transferred in the divorce would frustrate the purpose of *IRC* § 1041 with respect to divorcing spouses.

The Service will apply assignment of income principles to treat income as gross income of the transferor and not the transferee if: (1) the income is attributable to an interest in nonstatutory stock options, (2) the options were transferred incident to a divorce, (3) the transfer was required by a provision of an agreement entered into, or court order issued, before Nov 22, 2002, and (4) the agreement or order specifically provides that the transferor must report gross income attributable to the transferred interest.

(n27)Footnote 4.3. *Rev Rul 2004-60, 2004-1 CB 1051* .

(n28)Footnote 5. *IRC § 83* is inapplicable to the transfer of any option to which *IRC § 421* applies, to the transfer of an option without readily ascertainable fair market value, and to the transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value on the date of grant. *IRC § 83(e)(1), (3), (4)*. Payment received by an employee in exchange for termination of a statutory stock option does not fit within the exception and is governed by *IRC § 83*. *Bagley v Commr, 806 F2d 169 (8th Cir 1986)* . The same holds true for nonqualified options that did not have a readily ascertainable fair market value. *Rupprecht v US, 59 AFTR2d P 87-648 (Cl Ct 1987)* .

The Sixth and Ninth Circuits have held that *IRC § 83* is not limited to stock transfers that are compensatory in nature. It is sufficient that the stock be transferred in connection with the performance of services. *MacNaughton v US, 888 F2d 418 (6th Cir 1989)* ; *Alves v Commr, 734 F2d 478 (9th Cir 1984)* . However, *IRC § 83* was held inapplicable to gain realized on the exercise of warrants issued to nonemployee stockholders who merely guaranteed loans of the issuing corporation; no services were involved. *Centel Communications Co v Commr, 920 F2d 1335 (7th Cir 1990)* .

So long as the sale of stock at a profit within six months after the purchase of the property could subject a person to suit under Section 16(b) of the Securities Exchange Act of 1934, the person's rights in the property are treated as subject to a substantial risk of forfeiture and as not transferable until the earlier of (i) the expiration of the six-month period, or (ii) the first day on which the sale of the property at a profit will not subject the person to such a suit. *IRC § 83(c)(3), Treas Reg § 1.83-3(j)*. The First Circuit is of the opinion that *IRC § 83(c)(3)* lends support to its opinion that a contractual provision calling for a resale to the corporation at original cost if the shareholder wants to dispose of the acquired shares in less than one year from the date of acquisition should be considered substantial as well. *Robinson v Commr, 805 F2d 38 (1st Cir 1986)* , *rev'g 82 TC 444 (1984)* . In *Tanner v Commr, 117 TC 237 (2001)* , *aff'd, 91 AFTR2d 2003-1842 (5th Cir 2003)* , the Tax Court held that a taxpayer and the corporation granting the option could not contractually extend the 6-month period of Section 16(b) of the Securities Exchange Act of 1934 for purposes of *IRC § 83(c)(3)*.

An employee was required to participate in a dividend reinvestment plan as a condition of receiving restricted stock. The dividend stock was subject to the same substantial risk of forfeiture as the nonvested original stock. As a result, the employee was not in constructive receipt of income when the dividends were reinvested. The tax will be due when the stock vests. *GCM 39520* .

An unsuccessful assault on the constitutionality of *IRC § 83* was mounted in *Sakol v Commr, 67 TC 986 (1977)* , *aff'd 574 F2d 694 (2d Cir 1978)* , *cert denied, 439 US 859* . The taxpayer contended, first, that the provision taxed income which was not realized and, second, that the conclusivemeasurement of income without regard to restrictions on transferability was so unreasonable and arbitrary as to amount to a denial of due process. The court dismissed the first argument on the ground that formalistic realization was no longer a requirement for inclusion in income. As to the second, the court said merely that it was unable to conclude that Congress acted arbitrarily in responding to an area of tax avoidance created by the use of restrictions in stock purchase agreements.

The restriction in *Pledger v Commr, 71 TC 618 (1979)* , *aff'd 641 F2d 287 (5th Cir 1981)* , *cert denied, 454 US 964* , was the law-imposed bar on the sale to the public of stock that had not been registered under the Securities Act of 1933. The stock would have been sold in a private placement, but the price would have been subject to a significant discount from the publicly traded price. But see *Grant v US, 62 AFTR2d P 88-5058 (Cl Ct 1988)* , where the taxpayer was required to recognize compensation income under the general rule when half of the unregistered stock was sold in a private placement on the date of exercise at a price less than market value.

Property is transferable for purposes of *IRC § 83* even if there is only one permissible transferee. *Schulman v Commr, 93 TC 623 (1989)* .

The Service will not rule whether a restriction constitutes a substantial risk of forfeiture if the employee is a controlling shareholder. It will also refuse to rule whether a transfer has occurred if the amount of the property involves a nonrecourse obligation. It will ordinarily not rule when compensation is realized by a person who, in connection with the performance of services, is granted a nonstatutory option without a readily ascertainable fair market value to purchase stock at a price that is less than the fair market value of the stock of the date the option is granted. *Rev Proc 2010-3, 2010-1 IRB 110, 111, 115* (§§ 3.01(5); 4.01(4)).

In *Theophilus v Commr*, 85 F3d 440 (9th Cir 1996), the Ninth Circuit held that a corporate officer's contractual obligation to acquire stock in the corporation was property taxable under *IRC* § 83, so that appreciated stock acquired pursuant to the agreement in a later year was not taxable at the time of receipt.

The regulations provide that, if the amount paid for the transfer of property is a nonrecourse loan secured by the property, the transaction may be in substance the same as the grant of an option. *Treas Reg* § 1.83-3(a)(2). The taxpayer in *Hilen v Commr*, *TC Memo 2005-226*, paid for stock acquired on the exercise of the option with a nonrecourse loan from a commercial lender. He argued that he should not have to recognize gain until he made a substantial payment on the debt. The Tax Court held that, because he had paid for the stock in cash, the regulation did not apply and, therefore, he had to recognize gain on the exercise of the option. The Court of Federal Claims reached the same result in *Palahnuk v US*, 97 AFTR2d 1433 (*Fed Cl* 2006), as did the Ninth Circuit in *US v Tuff*, 469 F3d 1249 (9th Cir 2006), the Fifth Circuit in *Cidale v US*, 475 F3d 685 (5th Cir 2007), and the Seventh Circuit in *Racine v Commr*, 493 F3d 777 (7th Cir 2007).

(n29)Footnote 6. *IRC* § 83(f).

(n30)Footnote 7. *Treas Reg* § 1.83-3(c)(1).

(n31)Footnote 8. *IRC* § 83(c)(1). *Treas Reg* § 1.83-3(c)(2), (3).

(n32)Footnote 9. S Rep No 91-552, 91st Cong, 1st Sess, 121 (1969).

(n33)Footnote 10. *IRC* § 83(c)(2).

(n34)Footnote 11. Blockage, a concept that determines the value of traded shares other than by market quotations because of the size of the block of shares involved, is not a restriction within the meaning of *IRC* § 83 and may be taken into account in determining the value of the stock and the amount of compensation income. *Robinson v Commr*, 82 TC 467 (1984). The Tax Court's application of the blockage discount concept to determine the value of the shares involved in *Robinson* can be found at *TC Memo 1985-275*.

The exercise of a nonstatutory stock option by, and the distribution of stock to, an employee on disability leave was a taxable transfer of property under *IRC* § 83, and not the receipt of tax-free disability income. *Fisher v Commr*, 2 F3d 1148 (Table), 72 AFTR2d 93-5914 (1st Cir 1993).

(n35)Footnote 12. *IRC* § 83(d)(1). Congress did not consider restrictions that never lapse to be tax-motivated, i.e., designated to achieve deferral for tax saving purposes. S Rep No 91-552, 91st Cong, 1st Sess, 121 (1969).

A recipient of restricted stock was required to give the issuing corporation a right of first refusal to purchase the stock at a formula price. The corporation had five days to accept the offer, after which the shareholder would be free to sell the shares. Subsequent holders of the stock were not subject to any restrictions. The right of first refusal was held not to be a nonlapse restriction, but merely an arbitrary reduction in price. Thus, the fair market value of the stock as determined on the exchange on which it was traded was the price to be used in determining the fair market value of the stock. In fact, it appears that the Service takes the position that the nonlapse restriction rule should never apply when the fair market value of the stock is easily determined by reference to stock exchange prices. *GCM 39535*.

An employee who received unregistered stock on the exercise of nonstatutory stock options immediately sold half of the acquired shares in a private placement at a price greater than the option price, but less than the price at which publicly held shares of the corporation were traded on the same day. The fact that the shares were not registered did not constitute a nonlapsing restriction. Thus, the taxpayer was required to recognize compensation income equal to the difference between the option price and the mean trading price on the day of exercise. *Grant v US*, 62 AFTR2d P 88-5058 (Cl Ct 1988) .

(n36)Footnote 13. IRC § 83(d)(1).

(n37)Footnote 14. IRC § 83(d)(2).

(n38)Footnote 15. IRC § 83(d)(2).

(n39)Footnote 16. *Treas Reg § 1.83-4(c)*. See, eg, *Ltr Rul 9444003* , where the employee's debt was discharged through full offset of its principal amount against performance bonuses.

In addition to a cancellation of the principal amount of the indebtedness, the employee will realize compensation income if the interest rate is reduced or the debt is changed from recourse to nonrecourse. *Rev Rul 2004-37, 2004-1 CB 583* .

(n40)Footnote 17. IRC § 83(a).

A sale of nonvested property at a loss produces a capital loss, not an ordinary loss. *Wright v Commr, TC Memo 1983-707* , *aff'd*, 756 F2d 1039 (4th Cir 1985) .

Unexercised nonqualified stock options formed part of community assets divided between a husband and wife as part of a divorce settlement. The Service held that the husband would not recognize income as a result of the community property division or upon the wife's exercise of the options transferred to her. The wife would recognize income when she exercised her options. The husband would recognize income when the stock acquired upon the exercise of his options was no longer subject to the transfer restrictions of § 16(b) of the Securities Exchange Act of 1934. *Ltr Rul 8751029* .

(n41)Footnote 18. S Rep No 91-552, 91 Cong, 1st Sess, 122-23 (1969).

(n42)Footnote 19. IRC § 83(g)(1); *Rev Rul 71-80, 1971-1 CB 132* .

(n43)Footnote 20. IRC § 83(g)(2).

(n44)Footnote 21. IRC § 83(b)(1), (2). The election can be revoked only with the consent of the Commissioner. *Treas Reg § 1.83-2(f)*. *Rev Proc 2006-31, 2006-27 IRB 32* , provides guidance concerning the factors that must be present for a taxpayer to receive consent to revoke a ruling previously filed under IRC § 83(b). The revenue procedure also sets out procedures for submitting a request for consent to revoke.

In determining whether a corporation has experienced a change in ownership or control under the golden parachute rules of IRC § 280G, unvested shares of restricted stock for which an election under IRC § 83(b) has been made are treated as outstanding stock. *Rev Rul 2005-39, 2005-2 CB 1* .

In *Ltr Rul 9104039* , the Service ruled that elections made under IRC § 83(b) were of no effect where, pursuant to a rescission of the agreement under which the restricted stock was issued to the employees, the stock was returned to the corporation in the same year that it was issued.

Shares purchased by an employee at fair market value on the date of purchase were subject to restrictions as to their sale. The shares were worth more when the restrictions lapsed, producing ordinary income for the taxpayer. Had he elected the provisions of *IRC § 83(b)*, he could have avoided the effect of *IRC § 83(a)*. *Alves v Commr*, 79 TC 864 (1982), *aff'd*, 734 F2d 478 (9th Cir 1984).

A taxpayer, who received nonstatutory stock options that were deemed not to have a readily ascertainable fair market value under the criteria set forth in *Treas Reg § 1.83-7(b)(2)*, contended that he was unfairly excluded from the application of *IRC § 83* and the ability to make the election to realize compensation upon the receipt of the restricted property. The Claims Court found it unnecessary to reach the question because the taxpayer failed to make the election within the prescribed 30-day period. *Welsh v US*, 52 AFTR2d 83-5113 (Cl Ct 1983).

Dividends received on restricted stock that is not substantially vested but for which an election under *IRC § 83(b)* has been made, are reportable as dividend income and not as compensation. *Rev Proc 83-38*, 1983-1 CB 773. Such payments will be treated as additional compensations absent the election. *Rev Proc 80-11*, 1980-1 CB 616.

A busy executive signed an election that covered three blocks of stock although he believed it applied to only one of the blocks. The Service ruled that the taxpayer's failure to apprise himself of the contents of the election was not a ground for relief under *Treas Reg § 1.83-2(f)*, making the election irrevocable. *Ltr Rul 8511065*.

(n45)Footnote 22. *Treas Reg § 1.83-2(c), (e)*.

(n46)Footnote 23. *Treas Reg § 1.83-2(d)*. The *IRC § 83(b)* election must be made within 30 days after the transfer of the property to the optionee. The period cannot be extended.

(n47)Footnote 24. The methodology to value nonpublicly traded compensatory stock options for estate tax and generation-skipping transfer tax purposes is set forth in *Rev Proc 98-34*, 1998-1 CB 983.

(n48)Footnote 25. *Treas Reg § 1.83-1(d)*. The option will be a right to receive an item of income in respect of a decedent subject to the rules of *IRC § 691*. The income will be includable by the estate or beneficiary of the person who performed the services. See, eg, *Ltr Rul 200012076*, involving the bequest of nonstatutory stock options to a charity.

(n49)Footnote 26. *Treas Reg § 1.83-4(b)(1)*.

(n50)Footnote 27. *Treas Reg § 1.83-4(b)(1)*.

(n51)Footnote 28. *Treas Reg § 1.83-4(b)(1)*.

(n52)Footnote 29. *Treas Reg § 1.83-4(b)(2)*.

(n53)Footnote 1. Income resulting from the exercise of nonstatutory stock options qualifies as wages for purposes of the credit now allowed by *IRC § 41* for increasing research activities. *Apple Computer, Inc & Cons Subs v Commr*, 98 TC 232 (1992), *acq*, 1992-2 CB 1.

The issue in *Venture Funding, Ltd v Commr*, 110 TC 236 (1998), *aff'd in an unpublished opinion* (6th Cir 1999), *cert denied* 530 US 1205, was whether the employer could claim a deduction under *IRC § 83(h)* when the employees failed to include the value of the stock in income. The taxpayer argued that such a deduction should be allowed in the year in which the income was includable. The court looked at the plain language of the provision and held that a deduction was permitted only in the year in which the compensation income was actually reported by the employees.

The Court of Appeals for the Federal Circuit reached a different conclusion and held that the deduction is allowed to the employer in the year that the income must be included by the employee as a matter of law. *Robinson v US*, 335 F3d 1365 (Fed Cir 2003), *cert denied*, 124 S Ct 1044.

(n54)Footnote 2. For purposes of whether a deduction is allowed under *IRC* § 162(m), the grant of a nonstatutory stock option is performance-based compensation governed by *IRC* § 162(m)(4)(C). *Ltr Rul* 200027012 . However, a nonstatutory option will not qualify as performance-based compensation for purposes of *IRC* § 162(m)(4)(C) if the price at which the stock is offered is discounted below the fair market value of the stock on the grant date. See *Treas Reg* § 1.162-27(e)(2)(vi)(A). Furthermore, any attempt to reprice a discounted option grant retroactively, whether before or after its exercise, will be disregarded by the Internal Revenue Service; the requirement that the stock be offered at its fair market value must be met on the date of the grant. Generic Legal Advice Memoranda (GLAM) 2009-006, 2009 *GLAM LEXIS* 6 (July 6, 2009) .

(n55)Footnote 3. The deduction will be allowed if the requirements of either *IRC* § 162 or *IRC* § 212 are met. *Treas Reg* § 1.83-6(a)(1). The regulations impose another condition on the employer's right to deduct, namely, that the employer deduct and withhold the tax due on the amount includable in income.

A corporation sold shares at a discount as part of a loan transaction. Because the purchaser provided no services in consideration for the transfer of the stock, *IRC* § 83 was inapplicable. Therefore, *IRC* § 83(h) posed no additional independent requirement to the deductibility of the discount. *Duncan Inds, Inc v Commr*, 73 TC 266 (1979) .

A corporation that donates an option to purchase shares of its common stock to a charitable organization is entitled to a charitable contributions deduction, in the taxable year the option is exercised, for the excess of the fair market value of the stock on the date of exercise over the exercise price. *Rev Rul* 75-348, 1975-2 CB 75 .

If a majority shareholder of a corporation transfers shares of stock in the corporation to a key employee of a controlled subsidiary as compensation, no gain or loss is recognized by the transferor-shareholder, who is required to allocate his basis in the transferred shares to his remaining shares in the parent. The transfer of the shares is considered to be a contribution of the property to the capital of the corporation by the shareholder and immediately thereafter a transfer of the property by the corporation to the employee. No gain or loss is recognized by the subsidiary on the deemed disposition of the parent's stock. *Treas Reg* §§ 1.83-6(d)(1), 1.1032-3(e), Ex 9. See also *Ltr Rul* 9351029 .

Any consideration paid by the transferee-employee to the transferor-shareholder is deemed to be paid, first, to the corporation, and, then, to the shareholder as a distribution in redemption to which *IRC* § 302 applies. If a portion of the consideration is represented by a promissory note, only the note is part of the distribution; payments of principal and interest under the note are considered to be paid directly by the employee to the shareholder. *Ltr Rul* 9525035 .

A corporation's attempt to deduct the value of stock, transferred as payment for arranging for a public offering of the corporation's stock, was denied to the extent that it represented a capital expenditure incurred in raising capital. *IRC* § 83(h) allows a deduction only when the property is transferred as compensation to the recipient. *Steinberg v Commr*, *TC Memo* 1983-534 .

Where a parent corporation is divided into separate corporations and options in the new corporations are issued to predistribution parent employees in order to provide them with the same value, the new corporations are entitled to a deduction under *IRC* § 83(h) because they were service recipients when part of the parent. *Ltr Rul* 199927004 .

(n56)Footnote 4. *IRC* § 83(h). However, when property is substantially vested on transfer, the deduction is allowed in accordance with the employer's method of accounting. *Treas Reg* § 1.83-6(a)(3).

(n57)Footnote 5. S Rep No 91-552, 91st Cong, 1st Sess, 122 (1969); *IRC* § 83(e)(3).

(n58)Footnote 6. S Rep No 91-552, 91st Cong, 1st Sess, 123-24 (1969).

In *Tilford v Commr*, 75 TC 134 (1980) , the Tax Court held that the principal shareholder of a corporation was entitled to a capital loss deduction for stock sold to employees as inducements to work for the corporation. The court held that

Treas Reg § 1.83-6(d), which requires the shareholder to treat the transfer as a contribution to capital, was invalid as exceeding the statutory authority conferred by *IRC § 83*. The Sixth Circuit reversed the Tax Court decision as erroneous as a matter of law and held the regulation to be consistent with the legislative history and statutory intent of *IRC § 83(h)*. The later opinion is reported at 705 F2d 828 (6th Cir 1983) .



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Taxation of Securities Transactions

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CHAPTER 9 Stock Options

1-9 Taxation of Securities Transactions § 9.07

§ 9.07 Restricted Stock Plans

Part of the discussion in the previous section concerned the tax consequences of the acquisition of restricted stock pursuant to the exercise of a nonstatutory stock option that did not have a readily ascertainable fair market value when granted. The same rules govern the tax effect of a direct transfer of restricted stock from employer to employee or from a recipient of services to an independent contractor furnishing such services.ⁿ¹

Under *IRC Section 83* (discussed in the previous section),ⁿ² the employee can defer the realization of compensation income beyond the time of receipt of the stock only in the event the employee's interest in the acquired stock is subject to a substantial risk of forfeiture. If it is, no amount will be includable in gross income until the property becomes transferable or no longer is subject to a substantial risk of forfeiture, unless the employee elects to realize compensation in the year he acquires the property.

The realization of compensation by the employee gives rise to a potential deduction for the employer corporation.ⁿ³ The availability of the deduction is controlled by the criterion of *IRC Section 162*, to wit, the total compensation paid to the employee during the taxable year (including the amount of compensation produced by the restricted stock) must be reasonable in amount.ⁿ⁴ In cases covered by *IRC Section 83*, the year of deduction is the taxable year of the employer that includes the close of the taxable year of the employee in which she realizes her compensation;ⁿ⁵ in cases that are not, the deduction is allowed for the taxable year in which compensation is deemed to be paid.ⁿ⁶

An additional tax consequence can arise when the restricted stock transferred to the employee is not the employer's own stock. If the deduction taken by the employer exceeds its basis in the transferred stock, the employer must recognize income in the amount of such excess. Conversely, if the basis of the stock is greater than the compensation deduction, the employer is entitled to a loss deduction to the extent of the difference. The legislative history makes it clear that Congress did not intend any change in these rules when it enacted *IRC Section 83*.ⁿ⁷

FOOTNOTES:

(n1)Footnote 1. The stock transferred to the employee is often the stock in an unrelated company, generally a company with good growth potential. See *Cohn v Commr*, 73 TC 443 (1979) (*IRC § 83* applied to receipt of stock by independent contractor).

(n2)Footnote 2. See § 9.06[2][d], *supra*.

(n3)Footnote 3. A parent corporation issued restricted stock to its employees as well as employees of a subsidiary. After a spin-off of the subsidiary, the employees received equal amounts of subsidiary stock with restrictions identical to those on the parent stock in order to preserve their pre-spin-off economic interest in the parent stock. In Rev Rul 2002-1, 2002-1 CB 268, the Service held that both the parent and subsidiary were entitled to claim deductions when the restrictions lapsed for amounts that the employees were required to include in income in the year of lapse.

The Service will not issue a ruling as to which corporation is entitled to the deduction under *IRC § 83(h)* in cases where the corporation undergoes a corporate division if the facts are not similar to those described in *Rev Rul 2002-1*. *Rev Proc 2010-3, 2010-1 IRB 110, 111* (§ 3.01(6)).

(n4)Footnote 4. *IRC § 83(h)*, applicable for any case to which *IRC § 83* is applicable; Treas Reg § 1.421-6(f) governing non-*IRC § 83* cases; see also the discussion in § 9.06[3], *supra*.

(n5)Footnote 5. *IRC § 83(h)*.

(n6)Footnote 6. Treas Reg § 1.421-6(f).

(n7)Footnote 7. S Rep No 91-552, 91st Cong, 1st Sess, 124 (1969).



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CHAPTER 9 Stock Options

1-9 Taxation of Securities Transactions § 9.08

§ 9.08 Phantom Stock Plans

An increasingly popular method of compensating key employees is the phantom stock plan--a plan that does not give the employee any interest in the real stock of the corporation, but which does award her the unit equivalent of shares of the real stock of the corporation. Thereafter, the employee occupies the same financial position as a real shareholder. The phantom stock account is credited with the per-unit equivalent of dividends declared on the corporation's real stock. When a stock split or stock dividend works a change in the real stock, it works a corresponding change in the number of phantom stock units credited to the employee's account. And when the price of real stock changes, the price of phantom stock changes.

The employee is taxed at ordinary income rates when the phantom stock benefits are received--the appreciation in the value of the units and the dividend equivalents; the corporation gets its deduction in the same year and in the same amount.ⁿ¹ Thus, it should be apparent that a phantom stock plan provides the employee with much the same benefits to be derived from actual ownership of the corporation's stock. But the one major advantage of the phantom stock plan is that the employee incurs no out-of-pocket cost other than the payment of income taxes.

FOOTNOTES:

(n1)Footnote 1. A stock appreciation right (a form of phantom stock), issued by a corporation entitled the grantee employee to a cash payment equal to the excess of the fair market value of one share of the common stock of the corporation on the date of exercise of the right over the value of the stock on the day of the grant. No right could be exercised before one year nor after five years, the right being deemed exercised on the fifth anniversary of the grant if not previously exercised. Once the right was exercised, the employee lost all chance of further appreciation in the stock. Held, this was the loss of a valuable right that precluded application of the constructive receipt of income doctrine. No amount had to be reported in income until the right was exercised. *Rev Rul 80-300, 1980-2 CB 165* . A similar result was reached in *Rev Rul 82-121, 1982-1 CB 79* , where an employee was granted nonqualified stock options with related stock appreciation rights. In order to exercise the stock appreciation right, the employee had to surrender the related options and forfeit the right to benefit from any appreciation in stock in excess of the price at which the related option could have been exercised.



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CHAPTER 9 Stock Options

1-9 Taxation of Securities Transactions § 9.09

§ 9.09 Stock Compensation of Insiders in Expatriated Corporations

A domestic corporation becomes an expatriated corporation if, pursuant to a plan (or series of related events), (i) the foreign corporation completes after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation, (ii) after the acquisition at least 60 percent of the stock (by vote or value) of the foreign corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation, and (iii) after the acquisition, the expanded affiliated group that includes the foreign corporation does not have substantial business activities in the foreign country in which the corporation is organized, when compared with the total business activities of the expanded affiliated group.ⁿ¹ Certain individuals ("disqualified individuals") are subject to a tax of 15 percent of the value of the "specified stock compensation" held (directly or indirectly) by or for the benefit of the individual or a member of the individual's family (as defined in *IRC Section 267*) at any time during the 12-month period beginning on the date that is six months before the expatriation date.ⁿ² A disqualified individual with respect to a corporation is an individual who, at any time during the 12-month period beginning on the date that is six months before the expatriation date is subject to the insider provisions of *Section 16(a)* of the Securities Exchange Act of 1934 with respect to the corporation or any member of the expanded affiliated group that includes the corporation, or would be subject to the insider provisions if the corporation or member were an issuer of equity securities referred to in that section.ⁿ³

Specified stock compensation is defined as payment (or right to payment) granted by the expatriated corporation (or by any member of the expanded affiliated group that includes the corporation) to any person in connection with the performance of services by a disqualified individual for the corporation or member if the value of the payment or right is based on (or determined by reference to) the value or change in value of stock in the corporation or member.ⁿ⁴ However, specified stock compensation does not include any statutory stock option, or any payment or right to payment from a qualified plan that is excluded from the definition of parachute payment under *IRC Section 280G(b)(6)*.ⁿ⁵

The value of specified stock compensation in the case of a stock option (or similar right) or stock appreciation right is the fair value of the option or right.ⁿ⁶ In any other case, the value of the compensation is its fair market value.ⁿ⁷ There are three possible dates on which the determination of value is made: (1) if the specified stock compensation is held on the expatriation date, the value is determined on that date; (2) if the compensation is canceled during the six months before the expatriation date, the value is determined on the day before the cancellation; (3) if the compensation is granted after the expatriation date, the value is determined on the date the compensation is granted.ⁿ⁸ Whether there is specified stock compensation, and the value thereof, is determined without regard to any restriction other than a

restriction that by its terms will never lapse.ⁿ⁹

The tax imposed by *IRC Section 4985(a)* applies to a disqualified individual only if gain (if any) on any stock in the expatriated corporation is recognized in whole or in part by any shareholder because of the acquisition of the property of the expatriated corporation.ⁿ¹⁰ The tax does not apply to any stock option that is exercised on the expatriation date or during the six-month period before that date and to the stock acquired in such exercise, if income is recognized under *IRC Section 83* on or before the expatriation date with respect to the stock acquired by the exercise, or to any other specified stock compensation that is sold, exchanged, distributed, cashed-out, or otherwise paid during the six-month period in a transaction in which income, gain, or loss is recognized in full.ⁿ¹¹

FOOTNOTES:

(n1)Footnote 1. *IRC §§ 4985(e)(2)(A), 7874(a)(2)(A), (B)*.

(n2)Footnote 2. *IRC § 4985(a)*. The expatriation date is the date on which the corporation first becomes an expatriated corporation. *IRC § 4985(e)(2)(B)*.

(n3)Footnote 3. *IRC § 4985(e)(1)*. An expanded affiliated group is an affiliated group (as defined in *IRC § 1504(a)* without regard to *IRC § 1504(b)(3)* (excluding a foreign corporation from the scope of corporations that can be part of an affiliated group); except that *IRC § 1504(a)* is applied by applying a more than 50% vote and value ownership test in lieu of the 80% test normally applied. *IRC § 4985(e)(4)*.

(n4)Footnote 4. *IRC § 4985(e)(3)(A)*. Any payment of the tax imposed by *IRC § 4985(a)* directly or indirectly by the expatriated corporation or any member of the expanded affiliated group is treated as specified stock compensation and is not allowed as a deduction for federal income tax purposes. *IRC § 4985(f)(2)*.

Any transfer of property is treated as a payment and any right to a transfer of property is treated as a right to a payment. *IRC § 4985(f)(4)*.

(n5)Footnote 5. *IRC § 4985(e)(3)(B)*.

(n6)Footnote 6. *IRC § 4985(b)(1)(A)*.

(n7)Footnote 7. *IRC § 4985(b)(1)(B)*.

(n8)Footnote 8. *IRC § 4985(b)(2)*.

(n9)Footnote 9. *IRC § 4985(f)(3)*. The cancellation of a restriction that by its terms will never lapse is treated as a grant. *IRC § 4985(f)(1)*.

(n10)Footnote 10. *IRC § 4985(d)(1)*.

(n11)Footnote 11. *IRC § 4985(d)(2)*.



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CHAPTER 9A Notional Principal Contracts--Financial Derivatives

1-9A Taxation of Securities Transactions 9A.syn

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CHAPTER 9A Notional Principal Contracts--Financial Derivatives

1-9A Taxation of Securities Transactions § 9A.01

§ 9A.01 Introduction

The 1980s and early 1990s have brought forth myriad new financial products. The most prevalent are referred to as notional principal contracts, common examples of which include: interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, and similar arrangements.ⁿ¹ The term "notional" is attached to these transactions because the payments under the contract are computed with reference to a principal amount that never changes hands but serves solely as a conceptual benchmark. Businesses use notional principal contracts: (1) to attempt to reduce exposure to adverse changes in interest rates, commodity prices, and currency exchange rates; (2) to obtain access to new capital at better rates than otherwise might be available; and (3) to speculate in interest rate movements for the purpose of asset/liability management.

This chapter examines notional principal contract transactions and the tax consequences that attend such transactions.ⁿ² The Service issued final regulations on October 8, 1993ⁿ³ that govern the tax accounting treatment of notional principal contracts.

Possibly because of recent financial problems resulting from these types of financial products, increasing attention is being given to their tax consequences. The IRS has announced as a priority the finalizing of proposed regulations under *Notice 2004-52*, related to credit default swaps, and *Notice 2008-2*, related to prepaid forward contracts.

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.446-3(c)(1)(i)*.

(n2)Footnote 2. See also *§ 2.07[6]* for a discussion of constructive ownership transactions.

(n3)Footnote 3. *Treas Reg § 1.446-3; TD 8491* (Oct 8, 1993).



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CHAPTER 9A Notional Principal Contracts--Financial Derivatives

1-9A Taxation of Securities Transactions § 9A.02

§ 9A.02 Notional Principal Contract Defined

A notional principal contract is a financial instrument that provides for the payment of amounts by one party to another (i.e., a counterparty) at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.ⁿ¹ A notional principal amount is any specified amount of money or property that when multiplied by a specific index measures the parties' rights and obligations under a contract.ⁿ² The notional principal amount may vary over the term of the contract, provided that it is set in advance or varies based on objective financial information (as defined by *Regulations Section 1.446-3(c)(4)(ii)*).ⁿ³ The notional principal amount serves only as a reference for determining the amount of payments under the contract and, except in the case of certain currency swaps, is not actually borrowed or loaned between the parties.ⁿ⁴ In other words, notional principal contracts do not involve the actual exchange of debt principal. Rather, the parties use an agreed-upon amount (perhaps representing a desired percentage of their underlying debt) to calculate the exchange payments.

Example:

D and *C* agree that *D* will pay *C* annually for a period of five years an amount equal to the product of \$100 million and the London Interbank Offered Rate (LIBOR) on the date that the payment is due, while *C* will pay *D* on the same dates amounts equal to \$100 million multiplied by 8 percent. This agreement is a type of notional principal contract called an interest rate swap. (See § 9A.04, below.)

In this example, *D* and *C* do not actually exchange the underlying principal amount of indebtedness. They simply calculate their payments based on the agreed-upon and identified notional principal amount (\$100 million). As a result, the swap concerns only *D* and *C*, not their respective creditors. *D* remains legally liable to her original lender for the floating-rate payments, while *C* remains liable to his original lender for the fixed-rate payments. The swap changes the effective nature of *D*'s and *C*'s loan payments without altering the underlying agreements with their original creditors.

The specified index used to determine the amount of payment due under a notional principal contract can be based on the following:ⁿ⁵

- (1) any fixed interest rate, price, or amount;

(2) a fixed rate, price, or amount applicable in one or more specified periods followed by one or more different fixed rates, prices, or amounts applicable in other periods;

(3) objective financial or economic information; or

(4) an interest rate index that is regularly used in normal lending transactions between a party to the contract and unrelated persons.

Examples of specific indices include the prime rate, the London Interbank Offering Rate (LIBOR), the consumer price index, a broad-based equity index (e.g., Standard & Poor's 500), and the outstanding balance of a pool of mortgages. Objective financial information is any current, objectively determinable financial information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances (such as one party's dividends, profits, or the value of its stock). An example of objectively determinable financial information is a broadly based equity index or the outstanding balance of a pool of mortgages, but not the value of a party's stock.ⁿ⁶

Any contract described in *IRC Section 1256(b)* (i.e., any regulated futures contract, any foreign currency contract, any nonequity option, any dealer equity option, and any dealer securities futures contract); any futures contract; any forward contract; and any option are *not* notional principal contracts. Any financial instrument or contract that constitutes indebtedness under the general principles of the Internal Revenue Code is also *not* a notional principal contract.^{n6.1} Further, an option or forward contract that entitles or obligates a person to enter into a notional principal contract is not a notional principal contract. However, payments made under such an option or forward contract may be governed by *Regulations Section 1.446-3(g)(3)*.ⁿ⁷

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.446-3(c)(1)*.

(n2)Footnote 2. *Treas Reg § 1.446-3(c)(3)*.

(n3)Footnote 3. *Treas Reg § 1.446-3(c)(3)*.

(n4)Footnote 4. *Treas Reg § 1.446-3(c)(3)*.

(n5)Footnote 5. *Treas Reg § 1.446-3(e)(2)*.

(n6)Footnote 6. *Treas Reg § 1.446-3(c)(4)(ii)*.

(n7)Footnote 6.1. A notional principal contract may be disregarded for federal income tax purposes when it is part of a series of transactions designed to repatriate the earnings of a controlled foreign corporation to its US parent and has no independent economic significance. See *Schering-Plough Corp v US*, 2009 US Dist LEXIS 77467 (DNJ August 28, 2009), discussed at § 20.04[2][d], below.

(n8)Footnote 7. *Treas Reg § 1.446-3(c)(1)(ii)*.



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CHAPTER 9A Notional Principal Contracts--Financial Derivatives

1-9A Taxation of Securities Transactions § 9A.03

§ 9A.03 Accounting for Notional Principal Contracts

The net income or net deduction from a notional principal contract for a taxable year is included in or deducted from gross income for that taxable year.ⁿ¹ The net income or net deduction from a notional principal contract for a taxable year equals the total of all periodic and nonperiodic payments that are recognized from that contract for the taxable year.ⁿ² For contracts entered into before December 13, 1993, the preceding rule does not apply. For those contracts, the Service will generally treat a method of accounting for notional principal contracts as clearly reflecting income if it takes payments into account over the life of the contract under a reasonable method, whether or not that method satisfies the rules in the final regulations or in the proposed version of those regulations.ⁿ³

[1] Payments--Basic Netting Rule

Payments made or received with regard to notional principal contracts are classified as:

- (1) periodic;
- (2) nonperiodic;
- (3) termination; or
- (4) embedded loan.

Regulations Section 1.446-3(d) adopts a "netting" approach that requires a taxpayer to take into account its share of ongoing periodic payments and nonperiodic payments and termination payments to determine its gain or loss for the year from its notional principal contract.

Example:

On January 1, *D* and *C*, cash basis, calendar-year taxpayers, enter into a notional principal contract calling for payments on December 31. *D* agrees to make payments to *C* of 7 percent on a notional principal amount of \$10 million, and *C* agrees to make payments to *D* based on the average specified LIBOR multiplied by the \$10 million notional principal amount. In this example, *D* is called the "fixed-rate payor," and *C* is called the "floating-rate payor." The average specified LIBOR for the first year of the contract is 5 percent. If the contract provided for payments on a gross basis, *D*, the fixed

payor, would pay *C*, the floating-rate payor, \$700,000 (.07 x \$10 million), and *C* would be required to pay *D* \$500,000 (.05 x \$10 million). If the payments were made on a net basis, only one payment would be made. *D*, the fixed-rate payor, would pay *C*, the floating-rate payor, \$200,000. Accordingly, *D* would realize a loss of \$200,000, and *C* would have a gain in that amount. However, the amounts they would recognize on their tax returns might differ from these amounts, depending on other factors, such as the time periods covered by the payments, as explained below.

[2] Periodic Payments

With the exception of payments made to purchase or sell a cap or floor (see § 9A.08, below), periodic payments are payments made or received pursuant to a notional principal contract that:

- (1) are payable at intervals of one year or less during the term of the contract;
- (2) are based on a specified index; and
- (3) are based on either a single notional principal amount or a notional principal amount that varies over the term of the contract in the same proportion as the notional principal amount that measures the other party's payments.ⁿ¹

The intervals between payments need not be the same.

All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a periodic payment for the taxable year to which that portion relates.ⁿ² The ratable daily portion of a payment attributable to a taxable year is determined by multiplying the amount of the payment by the ratio of the number of days in the period covered by the payment that falls within the taxpayer's taxable year to the number of days in the period covered by the payment.

The amount of a periodic payment may not be readily ascertainable at the end of a taxable year because the value of the specified index will not be fixed until a date that occurs after the end of the taxable year. In that case, the ratable daily portion of a periodic payment that relates to that taxable year is generally based on the specified index that would have applied if the specified index were fixed as of the last day of the taxable year.ⁿ³ If a taxpayer determines that the value of the specified index as of the last day of the taxable year does not provide a reasonable estimate of the specified index that will apply when the payment is fixed, the taxpayer may use a reasonable estimate of the specified index each year. This can only be done, however, if the taxpayer (and any related person that is a party to the contract):ⁿ⁴ (1) uses the same method to make the estimate consistently from year to year, and (2) uses the same estimate for purposes of all financial reports to equity holders and creditors. The taxpayer's treatment of notional principal contracts with substantially similar specified indices will be considered in determining whether the taxpayer's estimate is reasonable. Any difference between the amount that is recognized pursuant to the foregoing rules and the corresponding portion of the actual payment that becomes fixed under the contract is taken into account as an adjustment to the net income or net deduction from the notional principal contract for the taxable year during which the payment becomes fixed.ⁿ⁵

Rules similar to those set forth in the preceding paragraph apply if the amount of a periodic payment is not determinable at the end of a taxable year because the notional principal amount is not fixed until a date that occurs after the end of the taxable year.ⁿ⁶

Example:

Assume the same facts as in the prior example except that (1) the notional principal contract is entered into on July 1, (2) the payment date is the following June 30, (3) the floating rate is LIBOR on the date of payment, (4) *C* and *D* use a 30-day month, 360-day year counting convention, (5) LIBOR on December 31 is 6.8 percent, and the two parties reasonably estimate that LIBOR on June 30 of the following year

will be 6.8 percent, but (6) LIBOR on June 30 of the following year turns out to be 6.9 percent. On December 31, the amount that *D* and *C* are obligated to pay to each other on June 30 is not determinable, but, based on the reasonable estimate that LIBOR will be 6.8 percent on June 30, *D* will be obligated to make a net payment to *C* of \$10,000 (.2 percent x \$10 million x 180/360) on June 30. *C* has net income of \$10,000 for the taxable year; *D* has a net deduction of \$10,000 for the year. On June 30 of the succeeding year when LIBOR is determined to be 6.9 percent, the net payment that the agreement actually requires *D* to make to *C* is only \$5,000 (.1 percent x \$10 million x 180/360). *C* and *D* must, in the second taxable year, adjust the net income and net deduction they recognized in the first year by \$5,000.

[3] Nonperiodic Payments

A nonperiodic payment is any payment made or received with respect to a notional principal contract that is not a periodic payment or termination payment.ⁿ¹ Examples of nonperiodic payments are the premium for a cap or floor agreement (even if paid in installments), the payment for an off-market swap agreement, the prepayment or part or all of one leg of a swap, and the premium for an option to enter into a swap if and when the option is exercised.ⁿ² All taxpayers, regardless of their method of accounting must recognize the ratable daily portion of a nonperiodic payment for the taxable year to which that portion relates.ⁿ³ Generally, a nonperiodic payment must be recognized over the term of a notional principal contract in a manner that reflects the economic substance of the contract.ⁿ⁴

The timing of income recognition and the taking of deductions with respect to nonperiodic payments under the contract must be determined in accordance with the values of the financial instruments that the swap and cap and floor agreements resemble.ⁿ⁵ An option or forward contract that entitles or obligates a person to enter into a notional principal contract is subject to the general rules of taxation for options or forward contracts.ⁿ⁶ Any payment with respect to the option or forward contract is treated as a nonperiodic payment for the underlying notional principal contract. These rules apply regardless of the regular method of accounting used by the parties to the notional principal contract.ⁿ⁷

For contracts entered into before January 14, 1994, the Service will generally treat a method of accounting as clearly reflecting income if it takes payments into account over the life of the contract under a reasonable amortization method.ⁿ⁸ This position supports the Service's premise that either including the entire amount of nonperiodic payments in income in the year of receipt, or deferring it until the termination of the contract, does not clearly reflect income, and, therefore, is an impermissible method of accounting for these payments.ⁿ⁹ In other words, the Service does not want taxpayers to include all of the nonperiodic payment in the year received, but to spread the recognition of income (or deductions) over the life of the contract. This precludes the use of notional principal contracts as a way to accelerate income or to use net operating losses about to expire.

The Service has ruled on the appropriate method for the inclusion as income or as a deduction a nonperiodic payment made pursuant to a notional principal contract where the payment is comprised of noncontingent and contingent components.ⁿ¹⁰ The ruling contains the following example:

Example:

The taxpayer (*T*) enters into a notional principal contract with a counterparty (*CP*) on October 1, 2002, for a term of 18 months. Pursuant to the terms of the contract, *T* agrees to make quarterly payments to *CP* based on three-month LIBOR multiplied by a notional principal amount of \$100 million. In exchange, *CP* agrees that upon expiration of the notional principal contract on March 31, 2004, *CP* will pay *T* 6 percent per year multiplied by a notional principal amount of \$92 million (the fixed payment amount). In addition, the *CP* or *T* will make a payment upon expiration equal to the percentage change in the value of the S&P 500 stock index multiplied by a notional principal amount of \$8 million. If the change is positive (an appreciation amount), *CP* will make a payment to *T*; if the change is negative (a

depreciation amount), T will make a payment to CP. Any depreciation amount payable by T will be netted against the fixed payment amount payable by CP.

The amounts that T pays to CP are periodic payments. T and CP must recognize the ratable daily portion of each periodic payment for the taxable year to which that portion relates.

The amount payable on March 31, 2004, is a nonperiodic payment that T and CP are required to recognize over the term of the notional principal contract in a manner that reflects the economic substance of the contract. In substance, the nonperiodic payment that CP must pay T on expiration equals the sum of a noncontingent component and a contingent component. The noncontingent component is the fixed amount payment or \$8.28 million (the product of 6 percent per year for 18 months and the notional principal amount of \$92 million). The contingent component (the appreciation or depreciation amount) equals the product of the percentage appreciation or depreciation in the value of the S&P 500 stock index and the notional principal amount of \$8 million.

In order to reflect the economic substance of the notional principal contract, each component must be treated separately for purposes of applying the notional principal contract rules in *Regulation Section 1.446-3*. The fixed payment amount due on March 31, 2004, must be recognized over the term of the notional principal contract in a manner consistent with *Regulation Section 1.446-3(f)(2)(ii)* or (iii). This treatment of the fixed payment amount is not affected by the possibility that T will be required to pay a depreciation amount to CP that, under the terms of the contract, will be netted against CP's obligation to pay the fixed payment amount. In addition, T must accrue interest income and CP may accrue interest deductions under *Regulation Section 1.446-3(g)(4)*.

[4] Embedded Loans

A "swap" is a notional principal contract that most often involves one party making periodic payments of a fixed amount and the other party making periodic payments on a variable specified index. Under *Regulations Section 1.446-3(g)(4)*, a notional principal contract consisting of a swap with a "significant" nonperiodic payment is considered to comprise an embedded loan. For tax purposes, such a swap must be treated as two separate transactions consisting of: (1) an on-market, level payment swap, and (2) a loan.ⁿ¹

The loan must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan is *not* included in the net income or net deduction from the swap. In other words, the time value component is treated as interest for all purposes of the Code.

The final regulations, however, offer no safe harbor or brightline test to determine what amount is a "significant" portion. On the other hand, the Regulations do provide an example at *Regulations Section 1.446-3(g)(6)* Example 3. (See § 9A.04[5][c], below.)

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.446-3(d)*.

(n2)Footnote 2. *Treas Reg § 1.446-3(d)*.

(n3)Footnote 3. Preamble to *TD 8491* ; *Notice 89-21, 1989-1 CB 651* .

(n4)Footnote 1. *Treas Reg § 1.446-3(e)(1)*.

(n5)Footnote 2. *Treas Reg § 1.446-3(e)(2)(i)*.

(n6)Footnote 3. *Treas Reg § 1.446-3(e)(2)(ii)*.

(n7)Footnote 4. A related person is a person related (within the meaning of *IRC § 267(b)* or *IRC § 707(b)(1)*) to one of the parties to the notional principal contract, or a member of the same consolidated group (as defined in *Treas Reg § 1.1502-1(h)*) as one of the parties to the contract. *Treas Reg § 1.446-3(c)(4)(i)*.

(n8)Footnote 5. *Treas Reg § 1.446-3(e)(2)(ii)*.

(n9)Footnote 6. *Treas Reg § 1.446-3(e)(2)(iii)*.

(n10)Footnote 1. *Treas Reg § 1.446-3(f)(2)(i)*. Termination payments are discussed in § 9A.09.

(n11)Footnote 2. *Treas Reg § 1.446-3(f)(2)(i)*. Cap and floor agreements are discussed in § 9A.08. Off-market swap agreements are discussed in § 9A.07[6].

(n12)Footnote 3. *Treas Reg § 1.446-3(f)(2)(i)*.

(n13)Footnote 4. *Treas Reg § 1.446-3(f)(2)(i)*.

(n14)Footnote 5. *Treas Reg § 1.446-3(f)(2)(i), (ii)*.

(n15)Footnote 6. *Treas Reg § 1.446-3(g)(3)*. An option contract gives the optionee a right to purchase or sell property at an agreed upon price and terms within a specified period of time. (The tax treatment of options is discussed in Ch 9). A forward contract is a binding agreement relating to the purchase and sale of a commodity at a fixed price on a fixed future date.

(n16)Footnote 7. *Treas Reg § 1.446-3(f)(2)(i)*.

(n17)Footnote 8. *TD 8491* (Oct 14, 1993) ; *Notice 89-21, 1989-1 CB 651* .

(n18)Footnote 9. *Id.*

(n19)Footnote 10. *Rev Rul 2002-30, 2002-1 CB 971* .

(n20)Footnote 1. An on-market swap is one in which the present value of the payments to be made equals that of the payments to be received on the day the taxpayer enters into or acquires the contract (absent the swap premium or discount) A level-payment swap refers to one in which equal payments are made throughout the term of the contract.



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Taxation of Securities Transactions

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CHAPTER 9A Notional Principal Contracts--Financial Derivatives

1-9A Taxation of Securities Transactions § 9A.04

§ 9A.04 Interest Rate Swaps

[1] Definition

As mentioned above, a swap is a notional principal contract that most often involves one party making periodic payments of a fixed amount (e.g., fixed interest rate) and the other party ("counterparty") making periodic payments on a variable specified index (e.g., prime interest rate). Both parties' payments are determined by reference to the same notional principal amount. The payments by one party to a swap contract may be made on different dates than the payments by the counterparty. If both parties are to make payments on the same date, the swap contract will normally provide for the payments to be offset, so that only the net amount is paid by one party to the other. (See § 9A.03[1], above.)

An interest rate swap is a swap in which the notional principal amount is expressed in dollars and the specified index is an interest rate or interest rate index. A basis swap (or floating swap) is an interest rate swap in which the parties agree to swap payments based on one variable specified index (e.g., prime rate) multiplied by a notional principal amount, which is itself determined with reference to another variable specified index (e.g., six-month Treasury rate).

[2] Uses for Interest Rate Swaps

Interest rate swaps are designed to serve one or more of the following functions:ⁿ¹

- (1) An interest rate swap may facilitate indirect access to capital at more favorable interest rates than those that would otherwise be available. In other words, an interest rate swap lowers a party's effective cost of borrowing.
- (2) An interest rate swap allows borrowers to hedge against fluctuations in interest rates. For example, consider a firm with assets bearing a floating rate of interest and with liabilities bearing a fixed rate of interest. If market interest rates fall, the firm may have difficulty meeting its obligations on the fixed-rate liabilities, because the interest income on the floating-rate assets falls with the decline in market rates.
- (3) An interest rate swap allows for the speculation of interest rate movements for the purposes of asset or liability management. Note that this function is different from the hedging function (described in (2), above) because here the goal is to benefit from movements in market interest rates, rather than simply to

ameliorate, if not neutralize, the effects of interest rate movements.

[a] Lowering a Borrower's Effective Rate of Interest. The first major function seeks to reduce a party's effective cost of borrowing.ⁿ² This results from the fact that the interest rate differential between a high-rated borrower and a low-rated borrower in the floating-rate market tends to be lower than the differential in the fixed-rate market. The low-rated borrower with a variable-rate loan swaps it for a high-rated borrower's fixed-rate loan, generally paying the high-rated borrower some portion of the differential between the rates charged to the low-rated borrowers and high-rated borrowers in the fixed rate market. This gives the low-rated borrower a better rate in the fixed-rate market than he could have obtained otherwise. The payment by the low-rated borrower to the high-rated borrower as part of the swap--if substantial enough--enhances the credit worthiness of the high-rated borrower, thus permitting the latter to borrow in the floating-rate market at a less expensive rate than would normally be charged by a lender.

To illustrate, consider the following situation involving a savings and loan institution.

Example:

Best Savings and Loan (Best) has \$100 million dollars in deposits on which it pays a floating rate of interest equal to the sum of a specified prime rate plus 0.75 percent. Best lives from day to day at the edge of financial disaster. Because the capital market for fixed-rate borrowings is quite sensitive to credit quality, Best would have to pay a high rate of interest for fixed-rate borrowings, perhaps 13 percent a year. On the other hand, a finance company, Capital Finance Company (Capital), because it is somewhat more creditworthy than the savings and loan, can issue bonds in the principal amount of \$100 million dollars bearing interest of 11 percent, a rate fully two percentage points lower than Best's cost of fixed-rate borrowing. Capital can also borrow on a floating-rate basis, but only at a rate equal to prime plus 1/8 percent, only 5/8 percent of a point lower than Best.

Because Capital is more creditworthy than Best, it has an absolute advantage in borrowing money on either interest rate basis. However, Best has a comparative advantage in borrowing at a floating-rate. As a result, Best should borrow at a floating-rate, and Capital should borrow at a fixed-rate. The two entities should then "trade" through the use of a swap. Such a swap might call for Best to make payments of \$11.5 million each year to Capital in return for Capital making annual payments to Best equal to prime on the hypothetical principal amount of \$100 million. Best would effectively be paying 11.5 percent "interest" on a "notional principal amount" of \$100 million and would be receiving "interest" equal to prime applied to the same notional amount of \$100 million.

By entering into the swap, Best can effectively reduce its fixed-rate of interest from 13 percent per year to 12.25 percent (determined by adding the 0.75 percent above prime it must pay to borrow in the Floating - rate market to the 11.5 percent "interest" it must pay to Capital). At the same time, Capital can effectively reduce its floating-rate of interest from prime plus 1/8 percent to prime minus 0.5 percent (calculated by subtracting the 11.5 percent "interest" it receives from Best from the 11 percent interest it must pay on its fixed-rate obligation).ⁿ³

In short, the low-rated borrower (e.g., Best) enters into the interest rate swap because it either lacks access to fixed-rate financing or must pay substantially higher rates to obtain it from a bank. An additional incentive for a high-rated borrower (e.g., Capital) to enter into the interest rate swap is that a low-rated borrower may be required to pay the high-rated borrower a "spread" for access to its lower fixed-rate financing. The spread is an additional amount, expressed as a percentage of the principal amount, that a low-rated borrower is willing to pay the high-rated borrower as an incentive and as additional compensation for entering into the swap. The spread reduces the high-rated borrower's new, variable or floating-rate payments, resulting in a less expensive rate of borrowing in the floating-rate market than would otherwise be available.ⁿ⁴

Another way to view the scenario described above is if interest rates were to rise, the floating-rate payor's payments to the fixed-rate payor would be larger than the fixed-rate payor's payments to the floating-rate payor. On a net basis, the fixed-rate payor would receive money on the swap. Thus, the fixed-rate payor would be "in the money" on this swap, helping the fixed-rate payor ride out the period of higher interest rates. If interest rates were to fall, the fixed-rate payor's payments to the floating-rate payor would be larger than the floating-rate payor's payments to the fixed-rate payor. On a net basis, the floating-rate payor would receive money on the swap. The floating-rate payor would now be "in the money" on this swap.

Recall that a basis swap involves a notional principal amount that is itself determined with reference to a variable index. A basis swap can lower an institution's effective rate of borrowing by permitting the institution to match the index of its floating-rate assets with the index of its floating-rate liabilities. For example, an institution with loan assets fixed to the prime rate with the index of its floating rate loan liabilities based on a higher, specified Treasury rate might use a basis swap to convert its Treasury-rate-based liability payments into prime-rate-based payments.

[b] Hedging Against Fluctuations in Interest Rates. The second function of interest rate swaps is hedging to reduce interest rate risk. This is accomplished by matching fixed-rate assets with fixed-rate liabilities and variable-rate assets with variable-rate liabilities in order to lessen the impact of changing interest rates.ⁿ⁵ Consider a savings institution with a substantial portfolio of fixed-rate mortgages whose depositors are paid at a floating-rate. An increase in interest rates will have no effect on the institution's interest income (assuming no new mortgage loans), but will increase its interest expense. Use of a swap to substitute fixed-rate debt for variable-rate debt, and thereby match fixed-rate assets with fixed-rate liabilities, will benefit the institution by limiting the decrease in its net interest income that otherwise would have resulted from the increase in interest rates.

Example:

Consider the following:

Assets:	\$10 million variable rate at 10 percent	\$ 1,000,000
	90 million fixed-rate at 11 percent	9,900,000
	Total	\$ 10,900,000
		0
Liabilities	\$40 million variable rate at 9 percent	\$ 3,600,000
	60 million fixed-rate at 11 percent	6,600,000
	Total	10,200,000
		0
	Interest income	\$ 700,000

If interest rates were to rise by 2 percent, it would have the following effect on the above balance sheet:

Assets:	\$10 million variable rate at 12 percent	\$ 1,200,000
	90 million fixed-rate at 11 percent	9,900,000
	Total	\$11,100,000
		00
Liabilities	\$40 million variable rate at 11 percent	\$4,400,000
		0
	60 million fixed-rate at 11 percent	6,600,000
	Total	\$ 11,600,000
		0
	Interest income	\$ 1,000,000

Thus, a 2 percent rise in interest rates results in a \$600,000 decrease in interest income. By means of an interest rate swap, the variable rate debt could be reduced by substituting fixed-rate debt. A rise in interest rates would result in a smaller decrease in net interest income than would be the case without a swap. (Conversely, falling interest rates would result in a smaller increase in net interest income than would be the case without a swap.) The substantial amount of fixed-rate assets would be matched to fixed-rate liabilities, rather than variable-rate liabilities and thus a hedge against the risk of interest rate fluctuations would be achieved.

[c] Speculation in Interest Rate Movements A third function of interest rate swaps is to speculate on changes in interest rates for purposes of asset or liability management by reversing or modifying interest rate swaps to take advantage of movements in interest rates.ⁿ⁶ One method of achieving this is by the borrower entering into a second swap transaction that is the mirror image of the first, thereby neutralizing its position.

In a mirror image transaction, the party desiring to enter into the mirror image swap continues to abide by the obligations imposed on it in the original swap transaction, but enters into a second transaction that reverses the position it occupies in the first. For example, if, under the original transaction, the party is making variable-rate interest payments and is receiving fixed-rate interest payments, the party would enter into a new swap transaction with a third party in which it would make fixed-rate payments and receive variable-rate payments. If both variable-rate payments are geared to the same index, they will cancel each other out; the same holds true if the fixed rates are the same. However, if the fixed rate specified in the original swap transaction is different from the one called for by the mirror swap transaction, the second transaction will produce gain for the party if the fixed rate in the mirror swap is less than the fixed rate in the original swap, loss if it is greater.

[3] Tax Treatment of Periodic Payments: Examples

[a] Accrual of Periodic Swap Payments.ⁿ¹ On April 1, 1995, *A* enters into a contract with unrelated party *B* under which for a term of five years, *A* is obligated to make a payment to *B* each April 1, beginning April 1, 1996. The amount of each payment is equal to the London Interbank Offered Rate (LIBOR), as determined on the immediately preceding April 1, multiplied by a notional principal amount of \$100 million. Under the contract, *B* is obligated to make a payment to *A* each April 1, beginning April 1, 1996, in an amount equal to 8 percent, multiplied by the same notional principal amount. *A* and *B* are calendar-year taxpayers that use the accrual method of accounting. On April 1, 1995, LIBOR is 7.80 percent.

The contract is an interest rate swap, and, thus, a notional principal contract. Both LIBOR and the fixed interest rate are specified indices. All of the payments are periodic payments, because each party's payments are based on a specified index, are payable at periodic intervals of one year or less throughout the term of the contract, and are based on a single notional principal amount.

Under the terms of the swap agreement, on April 1, 1996, *B* is obligated to make a payment to *A* of \$8 million (8 percent of \$100 million), and *A* is obligated to make a payment to *B* of \$7,800,000 (7.80 percent of \$100 million), producing a \$200,000 net periodic payment. The ratable daily portions for 1995 are the amounts of those periodic payments attributable to *A*'s and *B*'s taxable year ending December 31, 1995, i.e., from April 1, 1995 (275 days in a contract year of 366 days). The ratable daily portion of the 8 percent fixed leg is \$6,010,929 (275/366 x \$8 million); the ratable daily portion of the floating leg is \$5,860,565 (275/366 x \$7,800,000). The net amount for the taxable year is the difference between the ratable daily portions of the two periodic payments, or \$150,273. The swap produces net income of \$150,273 for *A* in 1995; *B* has a deduction in that amount for the same year. The \$49,727 unrecognized balance of the \$200,000 net periodic payment made on April 1, 1996 is taken into account by *A* and *B* in 1996.

[b] Accrual of Swap Payments on Index Set in Arrears.ⁿ² Assume the same facts as in the preceding example, except that *A*'s obligation to make payments based upon LIBOR is determined by reference to LIBOR on the day each

payment is due. Assume further that LIBOR is 8.25 percent on December 1, 1995, and 8.16 percent on April 1, 1996.

On December 31, 1995, the amount that *A* is obligated to pay on April 1, 1996 is not determinable. Therefore, the ratable daily portion of the periodic payment relating to 1995 will be based on the value of LIBOR as of December 31, 1995 (unless *A* or *B* determines that the value of LIBOR on that date does not reasonably estimate the value of the specified index). This causes the ratable daily portion of the floating leg (accrued from April 1, 1995 to December 31, 1995) to be \$6,198,770 ($275/366 \times 8.25 \text{ percent} \times \$100 \text{ million}$); there is no change in the ratable daily portion of the fixed leg. The net amount for 1995 on the swap is \$187,841 (\$6,198,770 minus \$6,010,929). *B* has net income of \$187,841 for the swap in 1995. *A* has a net deduction of \$187,841 for that year.

On April 1, 1996, *A* makes a net payment to *B* of \$160,000 (\$8,160,000 on the floating leg, determined by the value of LIBOR on the payment date, less \$8 million payment due on the fixed leg). For purposes of determining their net income or net deduction from the swap for the year ended December 31, 1996, *A* and *B* must adjust the net income and net deduction they recognized in 1995 by \$67,623. This amount is the difference between the estimated ratable daily portion of the floating leg of \$6,198,770 and the actual ratable daily portion for that leg of \$6,131,147 ($275/366 \times 8.16 \text{ percent} \times \$8,160,000$).

[c] Accrual of Periodic Swap Payments by Cash Method Taxpayers.ⁿ³ On April 1, 1995, *C* enters into a contract with unrelated party *D* under which, for a period of five years, *C* is obligated to make a fixed payment to *D* each April 1, beginning April 1, 1996, in an amount equal to 8 percent multiplied by a notional principal amount of \$100 million. *D* is obligated to make semiannual payments to *C* each April 1 and October 1, beginning October 1, 1995, in an amount equal to one-half of the LIBOR amount as of the first day of the preceding six-month period multiplied by the notional principal amount. The payments are to be calculated using a 30/360 day convention. *C* is a calendar-year taxpayer that uses the accrual method of accounting. *D* is a calendar-year taxpayer that uses the cash receipts and disbursements method of accounting. LIBOR is 7.80 percent on April 1, 1995 and 7.46 percent on October 1, 1995.

Under the terms of the swap agreement, *D* pays *C* \$3,900,000 ($1/2 \times 7.8 \text{ percent} \times \$100 \text{ million}$) on October 1, 1995, and is obligated to pay *C* \$3,730,000 ($1/2 \times 7.46 \text{ percent} \times \$100 \text{ million}$) on April 1, 1996. *C* is obligated to pay *D* \$8 million on April 1, 1996. The ratable daily portion of the fixed leg attributable to 1995 is \$6 million ($270/360 \times \$8 \text{ million}$). The ratable daily portion of the floating leg attributable to 1995 is \$5,765,000 consisting of the sum of the October 1, 1995 payment of \$3,900,000 and \$1,865,000 ($90/180 \times$ the payment of \$3,730,000 due on April 1, 1996). The net payment for 1995 is \$235,000 (\$6 million less \$5,765,000), creating a net deduction for *C* from the contract for 1995 of \$235,000 and income for *D* from the contract in 1995 of \$235,000. The net unrecognized balance of \$135,000 (\$2 million balance of the fixed leg less \$1,865,000 balance of the floating leg) is included in *C*'s and *D*'s net income or net deduction from the swap for 1996.

[4] Tax Treatment of Nonperiodic Payments

As a general rule, a nonperiodic payment that relates to an interest rate swap must be recognized over the term of the contract by allocating it in accordance with the forward rates of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount.ⁿ¹ For purposes of this allocation, the forward rates used to determine the amount of the periodic payment will be respected, if reasonable. An example of the application of the general rule in the context of a commodity swap can be found in the discussion of commodity swaps at § 9A.05, *below*.

[a] Upfront Interest Rate Swap Payment Amortized Using Alternative Method. Solely for purposes of determining the timing of income and deductions, a nonperiodic payment made or received with respect to an interest rate swap may be allocated to each period of the swap contract using one of the alternative methods described below.ⁿ² The alternative methods cannot be used by a dealer in notional principal contracts for swaps entered into or acquired in its capacity as a dealer.ⁿ³

An upfront payment on a swap (a "prepaid swap") may be amortized by assuming that the nonperiodic payment represents the present value of a series of equal payments made throughout the term of the swap contract (the level-payment method), adjusted as appropriate to take into account increases or decreases in the notional principal amount.ⁿ⁴ The discount rate used in this calculation must be the rate (or rates) used by the parties to determine the amount of the nonperiodic payment. If that rate is not readily ascertainable, the discount rate used must be a rate that is reasonable under the circumstances. Under the level-payment method, an upfront payment is allocated by dividing each equal payment into its principal recovery and time value components. The principal recovery components of the equal payments are treated as periodic payments that are deemed to be made on each of the dates that the swap contract provides for periodic payments by the payor of the nonperiodic payments or, if none, on each of the dates that the swap contract provides for periodic payments by the recipient of the nonperiodic payment. The time value component is needed to compute the amortization of the nonperiodic payment, but is otherwise disregarded.

Example:

ⁿ⁵ On January 1, 1996, *C* enters into an interest rate swap agreement with unrelated counterparty *D* under which, for a term of five years, *C* is obligated to make annual payments at 11 percent and *D* is obligated to make annual payments at LIBOR on a notional principal amount of \$100 million. At the time *C* and *D* enter into the swap agreement, the rate for similar on-market swaps is LIBOR to 10 percent. To compensate for the difference in the LIBOR rate, *D* pays *C* a yield adjustment fee of \$3,790,786 on January 1, 1996. *C* provides *D* with information that indicates that the amount of the yield adjustment fee was determined as the present value, at 10 percent compounded annually, of five annual payments of \$1 million (1 percent of \$100 million). *C* and *D* are calendar-year taxpayers.

Under the level-payment method, the yield adjustment fee is recognized over the life of the agreement by assuming that the \$3,790,786 is repaid in five level payments. Assuming a constant yield to maturity and annual compounding at 10 percent, the ratable daily portions are computed as follows:

	Level Payment	Time Value Component	Principal Component
1996	\$1,000,000	\$ 379,079	\$ 620,921
1997	1,000,000	316,987	683,013
1998	1,000,000	248,685	751,315
1999	1,000,000	173,554	826,446
2000	1,000,000	90,909	909,091
	\$5,000,000	\$1,209,214	\$3,790,786

C also makes swap payments to *D* at 11 percent, while *D* makes swap payments to *C* based upon LIBOR. The net of the ratable daily portions of 11 percent payments by *C*, the LIBOR payments by *D*, and the principal component of the yield adjustment fee paid by *D* determines the annual net income or net deduction from the contract for both *C* and *D*.

[b] Backloaded Interest Rate Swap Payment Amortized Using Alternative Method. Nonperiodic payments on a swap other than an upfront payment can be amortized by treating the contract as if it provided for a single upfront payment (equal to the present value of the nonperiodic payments) and a loan between the parties.ⁿ⁶ The discount rate (or rates) used in determining the deemed upfront payment and the time value component of the deemed loan is the same as the rate (or rates) used in the level-payment method. The single upfront payment is then amortized under the level-payment method described above. The time value component of the loan is not treated as interest, but, together

with the amortized amount of the deemed upfront payment, is recognized as a periodic payment. If both parties make nonperiodic payments, this calculation is done separately for the nonperiodic payments made by each party.

Example:

n7 Assume the same facts as in the preceding example, except that *D* agrees to pay *C* a yield adjustment fee of \$6,105,100 on December 31, 2000. Under the alternative method for payments other than upfront payments, *D* is treated as paying a yield adjustment fee of \$3,790,786 (the present value of \$6,105,100, discounted at a 10 percent rate with annual compounding) on January 1, 1996. Solely for timing purposes, *D* is treated as borrowing \$3,790,786 for *C*. Assuming annual compounding at 10 percent, the time value component is computed as follows:

	Loan Balance	Time Value Component	Principal Component
1996	\$3,790,786	\$379,079	\$ -0-
1997	4,169,865	416,987	-0-
1998	4,586,852	458,685	-0-
1999	5,045,537	504,554	-0-
2000	5,550,091	555,009	6,105,100

The amortization of *D*'s yield adjustment fee is equal to the amortization of a yield adjustment fee of \$3,790,786 paid in advance, increased by the time value component of the \$3,790,786 deemed loan from *C* to *D*. Thus, the amount of *D*'s yield adjustment fee that is allocated to 1996 is \$1 million (the sum of the \$620,921 principal component, as shown in the prior example, and the \$379,079 time value component). The time value components of the \$3,790,786 loan are included in the periodic payments paid by *D*, but are not characterized as interest income or expense. The net of the ratable daily portions of the 11 percent swap payments by *C*, and the LIBOR payments by *D*, added to the principal components set out in the prior example and the time value components shown in this example, determines the annual net income or net deduction from the contract for both *C* and *D*.

[c] Swaps With Significant Nonperiodic Payments: Embedded Loans. If a taxpayer, either directly or indirectly through a related person, reduces risk with respect to a swap by purchasing, selling, or otherwise entering into other notional contracts, futures, forwards, options, or other financial contracts (other than debt instruments), the taxpayer may not use the alternative methods for allocating nonperiodic payments made or received with respect to the swap.ⁿ⁸ Moreover, where such positions are entered into to avoid the appropriate timing or character of income from the contracts taken together, the Service may require that amounts paid to or received by the taxpayer under the swap be treated in a manner that is consistent with the economic substance of the transaction as a whole.

A swap with significant nonperiodic payments is treated as two separate transactions consisting of: (1) an on-market, level payment swap, and (2) a loan.ⁿ⁹ The loan must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan is not included in the net income or net deduction from the swap, but is recognized as interest for all purposes of the Internal Revenue Code.

Example 1:

n10 On January 1, 1996, unrelated parties *X* and *Y* enter into an interest rate swap contract. Under the terms of the contract, *Y* agrees to make five annual payments to *X* equal to LIBOR times a notional

principal amount of \$100 million. In return, *X* agrees to pay *Y* 6 percent of \$100 million annually, plus \$15,163,147 on January 1, 1996. At the time *X* and *Y* enter into the swap agreement, the rate for similar on-market swaps is LIBOR to 10 percent, and *Y* provides *X* with information that the amount of the initial payment was determined as the present value, at 10 percent compounded annually, of five annual payments from *X* to *Y* of \$4 million (4 percent of \$100 million).

Although *X* and *Y* have characterized this transaction as an interest rate swap, the \$15,163,147 payment from *X* to *Y* is significant when compared with the present value of the total fixed payments due under the contract. Accordingly, the transaction is recharacterized as consisting of both a \$15,163,147 loan from *X* to *Y* that *Y* repays in installments over the term of the agreement, and an interest rate swap between *X* and *Y* in which *X* immediately pays the installment payments on the loan back to *Y* as part of its fixed payments on the swap in exchange for the LIBOR payments by *Y*.

The yield adjustment fee is recognized over the life of the agreement by treating the \$15,163,147 as a loan that will be repaid with level payments over five years. Assuming a constant yield to maturity and annual compounding at 10 percent, *X* and *Y* account for the principal and interest on the loan as follows:

	Level Payment	Interest Component	Principal Component
1996	\$ 4,000,000	\$1,516,315	\$ 2,483,685
1997	4,000,000	1,267,946	2,732,054
1998	4,000,000	994,741	3,005,259
1999	4,000,000	694,215	3,305,785
2000	4,000,000	,363,636	3,636,364
	\$20,000,000	4,836,853	\$15,163,147

In each taxable year, *X* recognizes interest income, and *Y* claims an interest deduction, equal to the interest component of the deemed installment payments on the loan. The amounts treated as interest are not included in the parties' net income or net deduction from the swap contract. The principal components are needed only to compute the interest component of the level payment for the following period, and do not otherwise affect the parties' net income or net deduction from the transaction.

Y also makes swap payments to *X* based on LIBOR, and receives swap payments from *X* at a fixed rate that is equal to the sum of (1) the stated fixed rate, and (2) the rate calculated by dividing the deemed level annual payments on the loan by the notional principal amount. Thus, the fixed rate on the swap in this example is 10 percent (the sum of the stated rate of 6 percent and the rate calculated by dividing the annual loan payment of \$4 million by the notional principal amount of \$100 million, or 4 percent). The swap payments from *X* to *Y* and the LIBOR swap payments from *Y* to *X* are included in the parties' net income or net deduction for each taxable year according to the recognition rules for periodic payments discussed above.

Example 2:

n11 Assume the same facts as in Example 1, except that *X* is obligated to make annual payments at 11 percent on the notional principal amount. To compensate for the difference between the on-market rate

(LIBOR to 10 percent) and the contract rate, Y pays X a yield adjustment fee of \$3,790,786 on January 1, 1996. The amount of the yield adjustment fee is the present value, at 10 percent compounded annually, of five annual payments of \$1 million (1 percent x \$100 million).

In this situation, the yield adjustment fee is not a significant nonperiodic payment, in light of the amount of the fee in proportion to the present value of the total amount of the fixed payments under the contract. Accordingly, no portion of the swap is recharacterized as a loan.

The regulations do not contain specific tests to determine when a nonperiodic payment is significant. However, the two preceding examples, taken from the regulations, do provide some guidance in this regard. In Example 1, the \$15,163,147 nonperiodic payment amounts to 40 percent of \$37,907,867, the present value of all fixed payments required to be made by X under the swap agreement. (The present value, at 10 percent compounded annually, of five annual payments of \$6 million each that X must make to Y is \$22,744,720. When added to the nonperiodic payment of \$15,163,147, the total fixed payments to be made by X becomes \$37,907,867.) In Example 2, the nonperiodic payment of \$3,790,786 that X is to receive from Y amounts to 10 percent of the present value of the fixed payments due from X to Y under the agreement, reduced by the amount of the nonperiodic payment made by Y to X. Thus, 40 percent is significant, while 10 percent is not.

Example 3:

n12 Assume the same facts as in Example 1, except that on January 1, 1996, Y also enters into an interest swap contract with unrelated counterparty Z under which, for a term of five years, Y is obligated to make annual payments at 12 percent, and Z is obligated to make annual payments at LIBOR on a notional principal amount of \$100 million. At the time that Y and Z enter into the swap agreement, the rate for similar on-market swaps is LIBOR to 10 percent. To compensate for this difference, Z pays Y an upfront yield adjustment fee of \$7,581,574, an amount equal to the present value, at 10 percent compounded semiannually, of five annual payments of \$2 million (2 percent of \$100 million).

In substance, the two interest rate swaps are the equivalent of a fixed-rate borrowing by Y of \$22,744,721 (\$15,163,147 from X plus \$7,581,574 from Z). If these positions were entered into to avoid interest character on a net loan position, the Service may recharacterize the swaps as a loan which Y will repay with interest in five annual installments of \$6 million each (the difference between the 12 percent Y pays under the swap with Z and the 6 percent Y receives under the swap with X, multiplied by the \$100 million notional principal amount).

Y recognizes no net income or net deduction from these contracts because, as to Y, there is no notional principal contract income or expense. However, the recharacterization of Y's separate transactions as a loan has no effect on the way X and Z must account for their notional principal contracts.

[5] Tax Characterization of Payments

As discussed in the preceding sections, certain swap transactions are treated as consisting, in part, of a loan between the parties. In the case of a nonperiodic payment on a swap other than an upfront payments, the time value component of the loan is not treated as interest, but is recognized as a periodic payment. On the other hand, where a swap has significant nonperiodic payments, the time value component of the loan portion of the transaction is recognized as interest for all purposes of the Code.

Except for the regulations governing the treatment of swaps with significant nonperiodic payments, there is nothing in the Code or regulations that specifically addresses the treatment of interest rate swaps for federal income tax purposes.

Therefore, as one commentator has suggested:

As new financial products and strategies are developed in the domestic and international capital markets, the tax system attempts to respond by assigning each new product to an appropriate cubbyhole, which in turn determines the tax consequences to users of that product.ⁿ¹

The first question is whether swap payments represent interest.ⁿ²

The generally accepted answer is that they do not.ⁿ³ Interest is defined as "the amount which one has contracted to pay for the use of *borrowed* money."ⁿ⁴ The definition of a notional principal amount expressly states that while the amount measures a party's rights and obligations under the notional principal contract, it does not constitute an amount borrowed or loaned between the parties as part of the contract.ⁿ⁵ Because the notional principal amount is not exchanged by the parties, the payments due under a typical interest rate swap are not compensation for the use or forbearance of money and, therefore, are not interest.ⁿ⁶

Apart from the general agreement that interest swap payments do not constitute interest, the issue of characterization provokes different responses from commentators. Some commentators believe that the payments should be treated as financial services fees and thus produce ordinary income and expense.ⁿ⁷ The view that this characterization is most appropriate for swaps is grounded in the perception that it is consistent both with their form and functions.ⁿ⁸ The mechanics of an interest rate swap involve each party to the transaction assuming the other's credit risk, somewhat similar to a guarantee. Using this as its rationale, the Service has held any payment by one party to another under such an arrangement is compensation for the act of serving as a guarantor of the payor's loan.ⁿ⁹ Thus, the recipient should be in receipt of ordinary income that is not interest income. Because interest rate swaps take place exclusively in the business world, an ordinary and necessary business deduction should be available under *IRC Section 162*.

A second approach views a swap that does not serve a hedging purpose as analogous to a futures or forward contract, and, therefore, as a capital asset with payments and receipts treated accordingly.ⁿ¹⁰ The first problem inherent in this approach is determining the basis of, and amount realized, from the interest rate swap. One way to resolve this issue is to treat outgoing swap payments as creating the purchase price or basis for the swap, and incoming payments as a return on that investment.ⁿ¹¹ The second problem is in fitting any return in excess of, or less than, the created basis into the definitional formula for capital gains and losses. There is no sale or exchange when a swap terminates according to its terms, and, without a sale or exchange, capital gains and losses cannot arise.ⁿ¹²

A further difficulty with the capital transaction characterization lies in the regulations governing accounting for notional principal contracts, discussed above at § 9A.03. Under those regulations, each party to the notional principal contract must recognize the ratable daily portion of a periodic payment for the taxable year to which that portion relates, and include or deduct any net payment, as the case may be, in the taxable year in which the payment is made. Such a requirement is at odds with a theory that would treat outgoing payments as the purchase price of a swap and incoming payments as an amount realized that would first reduce any previously created basis.

Finally, those persons who would treat an interest rate swap as a capital transaction would not attach that characterization to swaps that serve as an interest rate hedge. Thus, for them, the taxpayer's motivation in entering into a swap would be the pivotal factor in classifying the transaction. However, the U. S. Supreme Court's decision in *Arkansas Best Corporation v. Commissioner*,ⁿ¹³ makes motive irrelevant in determining whether a transaction should be treated as a capital transaction or not.

A third approach looks at the hedging nature of some interest rate swaps as insurance, not dealings in property, and treats such swaps as generating ordinary income or loss.ⁿ¹⁴

The conclusion to be reached from this discussion is that payments under an interest rate swap, whether viewed as

financial services income and expense, or as insurance, constitute ordinary income to the recipient and give rise to an ordinary deduction for the payor. The contrary view that the payments stem from capital assets and should be treated accordingly is laden with problems.

[6] Collateral Tax Problems--Unrelated Business Income Tax

For the average taxpayer, there is little additional concern once an interest rate swap payment is characterized as ordinary income other than interest. Suppose, however, that the party receiving the net payment is a tax-exempt organization. The issue then becomes whether the payment constitutes unrelated business taxable income subject to taxation under *IRC Section 511(a)*.

Under *IRC Section 513(a)*, an unrelated trade or business is one the conduct of which is not substantially related to the tax-exempt organization's charitable function. *IRC 512(a)* defines unrelated business taxable income as the gross income derived by a tax-exempt organization from any such unrelated trade or business "regularly carried on" by it, less allowable deductions directly connected with the carrying on of that trade or business. In determining whether a trade or business is regularly carried on by the organization, regard must be taken as to the frequency and continuity with which the activities producing the income are conducted and the manner in which they are pursued.ⁿ¹ This requirement must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities on the same tax basis as the nonexempt businesses with which they compete.ⁿ²

If it is found that the interest swap transactions entered into by a tax-exempt entity are so frequent and continuous as to constitute a trade or business that is regularly carried on, the inquiry shifts to the nature of that income. Interest income received by a tax-exempt organization is excluded from unrelated business taxable income, as are gains from the sale, exchange, or other disposition of property (with some exceptions).ⁿ³ However, payments made pursuant to an interest rate swap do not constitute interest income unless specifically designated as such as by the regulations. Moreover, the absence of any sale or exchange prevents the payments from falling within the category of gains excluded from unrelated business taxable income.ⁿ⁴

Although no specific statutory exclusion from unrelated business taxable income exists for interest swap payments, the regulations under *IRC Section 512* provide that income from notional principal contracts and all deductions directly connected with such income are to be excluded in computing unrelated business taxable income.ⁿ⁵ The exclusion does not apply to income earned by brokers or dealers, or to organizations that make a market in derivative financial products.ⁿ⁶

[7] Collateral Tax Problems--Foreign Taxpayers and Foreign Income

A second collateral issue concerns any foreign taxpayer who is a party to an interest rate swap. Specifically, what is the source of any income or expense attributable to the swap? This becomes important because a foreign taxpayer is subject to federal income taxation only on income from sources within the United States.ⁿ¹

As a general rule, the source of interest rate swap income (as well as other notional principal contract income) that is denominated in the taxpayer's functional currency is determined by reference to the residence of the taxpayer.ⁿ² The following residence rules apply: (1) an individual's residence is that person's tax home; (2) the residence of a United States corporation, partnership, estate, or trust is the United States; and (3) a foreign entity's residence is a country other than the United States.ⁿ³ The importance of the residence-source rule for foreign taxpayers is the elimination of federal income tax on payments made to them by United States citizens or resident aliens. Therefore, United States payors need not withhold any tax on payments made to foreign counterparties. For the United States taxpayer, payments made by a foreign party under the interest rate swap are sourced in the United States under the residence-source rule. The sourcing of income under these rules can be illustrated by the following example:

Example 1:

D is a United States corporation that uses the United States dollar as its functional currency. *F* is a foreign corporation that uses the currency of the country in which it is incorporated as its functional currency. *F* is not engaged in the conduct of a trade or business in the United States. *D* and *F* enter into an interest rate swap under which *F* assumes *D*'s fixed interest rate liability and *D* assumes *F*'s floating-rate liability. If, under the swap, net payments are made by *D* to *F*, the payments will be foreign-source income to *F* and not subject to federal income tax. If the net payments are made by *F* to *D*, the payments constitute United States-source income to *D*.

If a United States taxpayer has a qualified business unit (a separate trade or business that maintains separate books and records) with a principal place of business in a country outside the United States, the source of notional principal contract income for that United States taxpayer is the foreign country if: (1) the qualified business unit is engaged in the conduct of a trade or business in that country, and (2) the notional principal contract income is properly reflected on the books and records of the qualified business unit.ⁿ⁴ Whether a notional principal contract is properly reflected on the books and records of the qualified business unit is a question of fact, with the degree of participation in the negotiation and acquisition of the notional principal contract being considered in this determination. Participation in connection with the negotiation or acquisition of a notional principal contract may be disregarded if the Service determines that a purpose of the participation by the qualified business unit was to affect the source of notional principal contract income.

Example 2:

Assume the same facts as in Example 1, except that *D* engages in business in a foreign country via a qualified business unit, *S*, and *S* enters into the interest rate swap with *F*. *S* uses the United States dollar as its functional currency. If *D* receives net payments under the swap in any taxable year, the income represents foreign-source income for *D*.

If the income derived from an interest rate swap by a foreign taxpayer arises from the conduct of a United States trade or business by the taxpayer, the income is sourced in the United States if it is effectively connected to the conduct of a United States trade or business for purposes of federal income taxation.ⁿ⁵ In determining whether income is effectively connected with the conduct of a trade or business in the United States, the two principal tests are: (1) the asset-use test, i.e., whether the income is derived from assets used in, or held for use in, the conduct of a trade or business in the United States; and (2) the business activities test, i.e., whether the activities of the trade or business conducted in the United States were a material factor in the realization of the income.ⁿ⁶

Example 3:

Assume the same facts as in Example 1, except that *F* is engaged in the conduct of a trade or business in the United States through a branch office that uses the United States dollar as its functional currency. The branch enters into the interest rate swap with *D* in order to hedge its floating-rate interest risk. The branch receives net payments from *D* pursuant to the swap. The income is considered effectively connected income, taxable to *F*.

As stated above, for a United States taxpayer, income from an interest rate swap has its source in the United States. However, that rule applies only to the source of income, not the manner in which expenses or losses should be allocated for source purposes. The concern here is the effect of such expenses and losses on the amount of the taxpayer's foreign tax credit. According to the regulations, a deduction that is definitely related to a class of gross income must be allocated to that class of income.ⁿ⁷ Thus, for the United States taxpayer, expenses and losses produced by notional principal contract transactions are allocated against United States-source income.

If an interest rate swap has significant nonperiodic payments and is treated as two separate transactions consisting of: (1) an on-market, level payment swap, and (2) a loan, the time value component of the loan is recognized as interest for all purposes of the Code.ⁿ⁸ Any payment treated as an interest payment must be allocated and apportioned according to

Temporary Regulations Section 1.861-9T. The concept underlying that regulation is that, in general, money is fungible and that interest expense is attributable to all activities and property of the taxpayer regardless of the specific purpose for incurring the obligation on which the interest in question is paid.ⁿ⁹ Therefore, the aggregate of deductions for interest is considered related to all income-producing activities and assets of the taxpayer, and allocable to all the gross income that the assets generate, have generated, or could reasonably have been expected to generate.ⁿ¹⁰ Therefore, the deemed interest payments are allocated against the taxpayer's United States-source and foreign-source income in proportion to the taxpayer's United States-source and foreign-source assets.ⁿ¹¹

The general source rule for income and expense for United States taxpayers is modified if a taxpayer, other than a financial services entity or dealer in financial products, enters into a transaction involving a derivative financial product that alters the taxpayer's effective cost of borrowing with respect to an actual liability of the taxpayer.ⁿ¹² Any loss incurred in a transaction involving such a financial product is apportioned in the same manner as interest expense, whether or not the financial product is identified as a liability hedge on the taxpayer's books and records.ⁿ¹³ Any gains derived from such a financial product reduce the taxpayer's total interest expense subject to apportionment, but only if the financial product is identified as a liability hedge. The reduction is accomplished by directly allocating interest expense to the income derived from the financial product.ⁿ¹⁴ If the taxpayer fails to identify the financial product as a liability hedge, income is sourced under the general rule. Thus, any gain on the financial product is treated entirely as United States-source income, while any loss on the financial product is subject to allocation.

A taxpayer can identify a financial product as hedging a particular interest-bearing liability (or group of liabilities) by clearly identifying on its books and records on the same day that it becomes a party to the arrangement that the arrangement is a liability hedge.ⁿ¹⁵ (If that identification occurred at a later date, it would be invalid.) In the case of a partial hedge, the identification applies only to the part of the liability that it hedges. If the taxpayer clearly identifies a financial product as a hedge of an interest-bearing asset (or group of assets), the identification creates a rebuttable presumption that the financial product is not one designed to alter the taxpayer's effective cost of borrowing. A taxpayer can identify a hedge as relating to an anticipated liability, provided that the liability is, in fact, incurred within 120 days following the date of identification; gains and losses that accrue prior to the time that the liability is incurred constitute an adjustment to income expense.

Example 4:

X, a United States taxpayer, is not a financial services entity or regular dealer in derivative financial products. X's functional currency is the United States dollar. In 1995, X incurred \$20,000 of interest expense. On January 1, 1995, X entered into an interest rate swap agreement with Y in order to hedge its interest rate exposure with respect to a preexisting floating-rate liability. On the same day, X identified the agreement as a hedge of the liability. Under the agreement, X is required to pay Y an amount equal to a fixed rate of 10 percent on a notional principal amount of \$100,000. Y is required to pay X an amount equal to a floating rate of interest on the same notional principal amount. Assume that the mechanics of the agreement caused Y to make a net payment of \$2,500 to X. Because X identified the swap as a liability hedge, X can effectively reduce its total allocable interest expense for 1995 from \$20,000 to \$17,500 by allocating \$2,500 of interest expense to the swap income. If X had not properly identified the swap as a liability hedge, the net payment would have been U.S.-source income.

Example 5:

Assume the same facts as in Example 4, except that X did *not* properly identify the swap agreement as a liability hedge on January 1, 1995, and that X was required to make a net payment of \$2,500 to Y. Notwithstanding the absence of proper identification, the payment is allocated and apportioned in the same manner as interest expense.

Although *Temporary Regulations Section 1.861-9T(b)(6)* applies only to liability hedges, any expense or loss (to the extent deductible) incurred in a transaction in which the taxpayer secures the use of funds for a period of time is subject

to allocation if the expense or loss is substantially incurred in consideration of the time value of money, that is, is an interest equivalent.ⁿ¹⁶ The following example illustrates this rule in an interest rate swap in which a lump-sum payment is made at the start of the transaction:

Example 6:

On January 1, 1996, X, a domestic corporation with a United States dollar functional currency, entered into a United States, dollar interest rate swap with Y, a domestic counterparty. Under the terms of the agreement, X agreed to pay Y floating interest rate interest with respect to a notional principal amount of \$1 million for a period of five years. In return, Y agreed to pay X a fixed interest rate of 10 percent on the same notional principal amount for the same period of time. On the same day, Y prepaid the fixed leg of the swap by making a lump-sum payment of \$370,000, representing the present value of five \$100,000 swap payments. Because X secured the use of \$370,000 in the transaction, any net swap expense arising from the transaction represents an expense incurred substantially in consideration of the time value of money. Assuming that the lump-sum payment is not characterized a loan from Y to X, and that X must amortize the \$370,000 lump-sum payment under the principles set forth in *Regulations Section 1.446-3(f)*, any net swap expense incurred by X with respect to the transaction (namely, the excess, if any, of X's annual swap payment to Y over the annual amortization of the \$370,000 lump-sum payment taken into income by X) represents an expense equivalent to interest expense.

Although the preceding example presented the case of a lump-sum payment, the rule illustrated in the example also applies to any transaction in which the swap payments are not substantially contemporaneous if the pricing of the transaction is materially affected by the time value of money.

FOOTNOTES:

(n1)Footnote 1. "Note: Tax-Exempt Entities, Notional Principal Contracts, and the Unrelated Business Income Tax," 105 *Harv L Rev* 1265 (Apr 1992).

(n2)Footnote 2. *Treas Reg* § 1.446-3(e)(1).

(n3)Footnote 3. Example adapted from H Hu, "Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm," 138 *U Pa L Rev* 333 (Dec 1989).

(n4)Footnote 4. Olander and Spell, "Interest Rate Swaps: Status Under Federal Tax and Securities Laws," 45 *Md L Rev* 21 (Fall 1986).

(n5)Footnote 5. *Id.*

(n6)Footnote 6. *Id.*

(n7)Footnote 1. *Treas Reg* § 1.446-3(e)(3)Ex 1.

(n8)Footnote 2. *Treas Reg* § 1.446-3(e)(3)Ex 3.

(n9)Footnote 3. *Treas Reg* § 1.446-3(e)(3)Ex 2.

(n10)Footnote 1. *Treas Reg* § 1.446-3(f)(2)(ii).

(n11)Footnote 2. *Treas Reg* § 1.446-3(f)(2)(iii).

(n12)Footnote 3. A dealer in notional principal contracts is a person who regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in notional principal contracts with customers in the ordinary course of a trade or business. *Treas Reg* § 1.446-3(c)(4)(iii).

(n13)Footnote 4. *Treas Reg § 1.446-3(f)(2)(iii)(A)*.

(n14)Footnote 5. *Treas Reg § 1.446-3(f)(4)Ex 5*.

(n15)Footnote 6. *Treas Reg § 1.446-3(f)(2)(iii)(B)*.

(n16)Footnote 7. *Treas Reg § 1.446-3(f)(4)Ex 6*.

(n17)Footnote 8. *Treas Reg § 1.446-3(g)(2)*.

(n18)Footnote 9. *Treas Reg § 1.446-3(g)(4)*. For purposes of *IRC § 956*, discussed in § 20.04[2][d], below, the Service can treat any nonperiodic swap payment, whether or not it is significant, as one or more loans.

(n19)Footnote 10. *Treas Reg § 1.446-3(g)(6)Ex 3*.

(n20)Footnote 11. *Treas Reg § 1.446-3(g)(6)Ex 2*.

(n21)Footnote 12. *Treas Reg § 1.446-3(g)(6)Ex 4*.

(n22)Footnote 1. ED Kleinbard, "Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System," 69 *Tex L Rev* 1319, 1320 (1991).

(n23)Footnote 2. The discussion here relates to the payments made pursuant to the swap. Because each of the parties to the interest rate swap continues to be liable to its lender notwithstanding the swap, the interest paid by each party on its underlying debt remains interest deductible under *IRC § 163(a)*.

(n24)Footnote 3. Steinberg, "Selected Issues in the Taxation of Swaps, Structured Finance and Other Financial Products," 1 *Fla Tax Rev* 263, 275; Note: "Tax Exempt Entities, Notional Principal Contracts, and the Unrelated Business Income Tax," 105 *Harv L Rev* 1265, 1276 (1992); ABA Section of Taxation, Comm on Financial Transactions, Task Force of the Interest Rate Subcommittee, "Report on Selected Aspects of Interest Rate Caps, Floors, and Collars," 44 *Tax Lawyer* 1075, 1093 (1991).

(n25)Footnote 4. *Old Colony RR v Commr*, 284 *US* 552, 560 (1932) (emphasis supplied).

(n26)Footnote 5. *Treas Reg § 1.446-3(c)(3)*.

(n27)Footnote 6. Preamble to *Prop Treas Reg § 1.446-3*, 1991-2 *CB* 951.

Another reason given for not classifying a swap payment as interest for income or deduction purposes is that the payment represents the interest obligation of another. Interest is deductible only if the underlying debt is owed by the taxpayer rather than by someone else.

(n28)Footnote 7. Note, "Tax Treatment of Notional Principal Contracts," 103 *Harv L Rev* 1951, 1958 (1990).

(n29)Footnote 8. *Id*.

(n30)Footnote 9. See Ltr Rul 8508003 .

(n31)Footnote 10. Olander & Spell, "Interest Rate Swaps: Status Under Federal Tax and Securities Laws," 45 *Md L Rev* 21, 47 (1986).

(n32)Footnote 11. *Id at* 48 (1986).

(n33)Footnote 12. *IRC § 1222*.

(n34)Footnote 13. 485 US 212 (1988) . Regulations governing hedging transactions entered into in the ordinary course of business have been adopted. See § 2.04[2][a], above.

(n35)Footnote 14. Rudnick & Schenck, "The Tax Treatment of Interest Rate Hedges After *Arkansas Best*," 6 *J Taxn of Investments* 22, 30 (1988).

(n36)Footnote 1. *Treas Reg* § 1.513-1(c)(1).

(n37)Footnote 2. The unrelated business income tax was passed primarily because of Congress' concern that tax exemption would give tax-exempt activities a competitive edge vis-a-vis their taxable business counterparts. HR Rep No 2319, 81st Cong, 2d Sess, pt III(E)(1), 36 (1950), reprinted at 1950-2 CB 409.

(n38)Footnote 3. *IRC* § 512(b)(5).

(n39)Footnote 4. It would seem that, unless the IRS were to treat an interest rate swap as a capital asset, the payment could not be considered an "other disposition."

(n40)Footnote 5. *Treas Reg* § 1.512(b)-1(a)(1). The exclusion does not apply to gains or losses from the sale, exchange, or other disposition of any property, or to gains or losses from the lapse or termination of options to buy or sell securities. However, except for dealer property, these are excluded from unrelated business taxable income by *IRC* § 512(b)(5).

(n41)Footnote 6. *Treas Reg* § 1.512(b)-1(a)(2). An organization makes a market in derivative financial products by regularly and actively offering to enter into positions in such products to the public in the ordinary course of business. *Temp Treas Reg* § 1.954-2T(a)(4)(iii)(B).

(n42)Footnote 1. A second concern is whether a domestic payor must withhold tax on any nonperiodic payment treated as interest under the notional principal contract accounting rules. As a general rule, interest payments to foreign taxpayers that can be designated as portfolio interest are not subject to withholding. *IRC* §§ 871(h), 881(c). However, this rule does not apply to interest paid to a 10 percent or greater shareholder, a related controlled foreign corporation, or to a foreign bank on an extension of credit made under a loan agreement entered into in the ordinary course of the bank's business.

(n43)Footnote 2. *Treas Reg* § 1.863-7(b)(1).

(n44)Footnote 3. *IRC* § 988(a)(3)(B). An individual's tax home is defined as such person's home for purposes of *IRC* § 162(a)(2) (relating to the deduction for traveling expenses while away from home). *IRC* § 911(d)(3). If an individual does not have a tax home as so defined, the residence of the individual is the United States if the person is a US citizen or resident alien and a country other than the United States if the person is not a US citizen or resident alien.

(n45)Footnote 4. *IRC* § 988(a)(3)(B)(ii); *Treas Reg* § 1.863-7(a)(2).

(n46)Footnote 5. *Treas Reg* § 1.863-7(a)(3).

(n47)Footnote 6. For a discussion of the taxation of income effectively connected with a US trade or business see § 20.06[2], below.

(n48)Footnote 7. *Treas Reg* § 1.861-8(b)(2).

(n49)Footnote 8. *Treas Reg* § 1.446-3(g)(4).

(n50)Footnote 9. *Temp Treas Reg* § 1.861-9T(a).

(n51)Footnote 10. *Temp Treas Reg § 1.861-9T(a)*.

(n52)Footnote 11. This assumes that the taxpayer's interest payments are denominated in a functional currency. If the payments are denominated in nonfunctional currency, any portion of the deemed interest expense will be allocated against US-source and foreign source income in the manner mentioned, while any amount of currency exchange gain or loss will constitute US-source income or will be allocated against US-source income as specified in *Treas Reg § 1.988-4*.

(n53)Footnote 12. *Temp Treas Reg § 1.861-9T(b)(6)(i), (iv), (vi)*.

(n54)Footnote 13. *Temp Treas Reg § 1.861-9T(b)(6)(iv)(A)*.

(n55)Footnote 14. *Temp Treas Reg § 1.861-9T(b)(6)(iv)(B)*.

(n56)Footnote 15. *Temp Treas Reg § 1.861-9T(b)(6)(iv)(C)*.

(n57)Footnote 16. *Temp Treas Reg § 1.861-9T(b)(1)*.



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Taxation of Securities Transactions

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CHAPTER 9A Notional Principal Contracts--Financial Derivatives

1-9A Taxation of Securities Transactions § 9A.05

§ 9A.05 Commodity Swaps

[1] In General

Producers and users of commodities can hedge their exposure to price risks through commodity swaps. Since July 1989, banks have been allowed to offer commodity swaps in the United States as an alternative to traditional commodity contracts, such as forwards, futures, and options. A commodity swap is a swap in which the notional principal amount is expressed in units of a commodity and the specified index is a commodity index or commodity price index. Typically, one party agrees to make periodic payments equal to a specified fixed price (e.g., an average of the forward prices at the time the swap contract is entered into) multiplied by the notional principal amount, and the counterparty agrees to make periodic payments equal to a specified index (e.g., the spot price on specified dates in the future) multiplied by the notional principal amount.

Example 1:

A manufacturer of corn products that normally purchases corn on the spot market desires to fix the cost of its corn purchases for a period of three years. The manufacturer enters into an agreement with a bank under which it agrees that on each anniversary date of the agreement, it will pay the bank \$2,700,000, representing the price of 1 million bushels of corn at a fixed price of \$2.70 per bushel. The bank agrees to make an annual payment to the manufacturer equal to 1 million bushels at the spot price for corn on the anniversary date of the agreement. If the spot price is below \$2.70 per bushel, the manufacturer will pay the bank the difference between \$2.70 per bushel and the spot price. If the spot price exceeds \$2.70, the bank owes the manufacturer the difference between the two prices. The swap has enabled the manufacturer to fix a price of \$2.70 per bushel for the three-year period. The bank can hedge its risk by entering into a swap transaction with a corn producer, agreeing to pay the producer the fixed price while the producer agrees to pay the spot price.

As discussed in § 9A.03[3], above, the general rule regarding the tax treatment of a nonperiodic payment under a notional principal contract requires that it be recognized over the term of the contract. This is accomplished by allocating the nonperiodic payment in accordance with the forward rates of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount. The following example illustrates this rule in the context of a commodity swap agreement.

n1 On January 1, 1996, *A* enters into a commodity swap agreement with unrelated counterparty *B* under which, for a term of three years, *A* is obligated to make annual payments based on a fixed price of \$2.35 per bushel multiplied by a notional amount of 100,000 bushels of corn. Under that agreement, *B* is obligated to make annual payments equal to the spot price of corn multiplied by the same notional amount. Assume that on January 1, 1996, the price of a one-year forward contract for corn is \$2.40 per bushel, of a two-year forward contract \$2.55 per bushel, and of a three-year forward contract \$2.75 per bushel. To compensate for the below-market fixed price provided in the swap agreement, *A* pays *B* \$53,530 for entering into the swap. *A* and *B* are calendar-year taxpayers.

	Expected Forward Payment	Time Value Component	Principal Component
1996	\$ 5,000	\$ 4,282	\$ 718
1997	20,000	4,225	15,7 75
1998	40,000	2,963	37,0 37
			—
	\$65,000	\$11,470	\$53, 530
			—

The ratable daily portion of the principal component is added to A's periodic payments in computing its net income or net deduction from the commodity swap for each taxable year. The time value components are needed only to compute the principal components, and are otherwise disregarded.

[2] Tax Consequences

[a] Source, Character, and Timing of Payments. For federal income tax purposes, producers and users should consider the source, character, and timing of commodity swap payments. The source of income is significant for foreign tax credit purposes and for determining whether United States withholding tax could be imposed on payments to foreign parties.ⁿ¹ For users, the character of the gain or loss as ordinary or capital is particularly significant. The timing of income or loss recognition on commodity swap payments could depend on the application of the Code provisions providing for realization or deferral.

Under *Regulations Section 1.863-7(b)*, the source of income from a notional principal contract is determined by the taxpayer's residence. Thus, a United States corporation generally will have United States-source income, while a foreign corporation could have foreign-source income *not* subject to United States withholding tax.ⁿ² The preamble material to this regulationⁿ³ specifies that a commodity swap is treated as a notional principal contract for this purpose.

The typical form of a commodity swap acts as a hedge against price fluctuations in the price of the commodity. If the commodity forms part of the inventory of the taxpayer and if the swap is entered into in the normal course of the taxpayer's trade or business to reduce the risk of price changes, any property that is a part of the transaction is *not* a capital asset.ⁿ⁴ Thus, gain or loss realized on the transaction will be ordinary in nature, because there is no capital asset being sold.

[b] Applicability of Straddle and Mark-to-Market Rules. If commodity swaps involve actively traded personal property, the straddle rules of *IRC Section 1092* may apply. Under *IRC Section 1092*, losses on positions in actively traded personal property are deferred to the extent of unrecognized gains in offsetting positions at year-end.ⁿ⁵ However, *IRC Section 1092(e)* provides an exception for any hedging transaction (as defined in *IRC Section 1256(e)*). To avoid the straddle rules, commodity swaps that qualify for the hedging exception should be identified at the outset of the swap as hedging transactions. Similarly, a timely identification of a hedging transaction will preclude application of the mark-to-market rules of *IRC Section 1256*.ⁿ⁶

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.446-3(f)(4)*Ex 7.

(n2)Footnote 2. For discussions of the treatment of a nonperiodic payment under a notional principal contract as a loan, see §§ 9A.03[4] and 9A.04[4][c].

(n3)Footnote 1. See the discussion in § 9A.04[7].

(n4)Footnote 2. See the discussion in § 9A.04[7].

(n5)Footnote 3. *TD 8330* (Jan 11, 1991) .

(n6)Footnote 4. *Treas Reg § 1.1221-2(a)(1), (b)(1)*. See § 2.04[2][a].

(n7)Footnote 5. See § 9.02[4][d].

(n8)Footnote 6. *IRC § 1256(e)(1), (2)*. See § 18.05 for a discussion of the mark-to-market rules and § 2.04[1] and § 9A.04[7] for a discussion of the timely identification of a hedging transaction.

IRC § 1256(e)(2) defines a hedging transaction by reference to *IRC § 1221(b)(2)(A)*, discussed in § 2.04[1].



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CHAPTER 9A Notional Principal Contracts--Financial Derivatives

1-9A Taxation of Securities Transactions § 9A.06

§ 9A.06 Equity Swaps

[1] In General

[a] The Typical Equity Swap. In a typical equity swap, one party (also known as the "equity payor" or "short counterparty") transfers stock in a corporation to a counterparty ("equity recipient," "long counterparty," or "floating rate party") for a period of time in exchange for the equity recipient paying the equity payor the income from an alternative investment (e.g., based on LIBOR). The equity recipient is entitled to an amount equal to the dividends on the stock and the amount, if any, by which the value of the stock increases during the transfer period. The equity payor is entitled to the income from the alternative investment plus the amount of any decrease in the value of the stock during the transfer period. The net difference in cash flow (the difference between dividends on the stock and the income from the alternative investment) will generally be made periodically; the payment representing the change in value of the stock will normally be made at maturity of the equity swap.

The transferor retains the voting rights on the transferred shares. The goal of the transferor is diversification for the period of the swap without capital gains taxation. The premise for successfully avoiding capital gains taxation is that no sale and, thus no taxable event, has occurred.

[b] The Equity Index Swap. The equity index swap involves one party who agrees to make periodic payments for a specified term of amounts based on any increase in value during each period of a specified equity index (e.g., Standard & Poor's 500 Index) and amounts equal to dividends paid on that index. The counterparty agrees to make payments of a floating rate of interest keyed to an interest rate index and amounts based on any decrease during the period of the equity index.

[2] Recognition of Gain or Loss

Although the shares are transferred to the equity recipient, the swap does not confer on the equity recipient the right to vote the stock or other ancillary rights of ownership. Thus, it would appear that the swap should not be considered a sale or exchange of the stock, a prerequisite for the realization of gain. However, *IRC Section 1259* changes that apparent result and treats a constructive sale of an appreciated financial position as giving rise to gain, but not loss, on the date of the constructive sale; the gain is taken into account for the taxable year in which the constructive sale takes place.ⁿ¹

An appreciated financial position includes any position with respect to stock if there would be gain were such position

sold, assigned, or otherwise terminated at its fair market value.ⁿ² A constructive sale of an appreciated financial position occurs whenever a taxpayer (or a related person) enters into an offsetting notional principal contract with respect to the same or substantially identical property, unless the contract is for the sale of stock that is not publicly traded and the contract settles within one year after the date the contract is entered into.ⁿ³

Two consequences other than immediate gain recognition flow from the constructive sale. First, proper adjustment must be made in the amount of any gain or loss subsequently realized with respect to the position for any gain taken into account on the constructive sale.ⁿ⁴ Second, the holding period of the position is determined as if the position were originally acquired on the date of the constructive sale.ⁿ⁵

A transaction that otherwise would cause a constructive sale is disregarded if (a) the transaction is closed on or before the 30th day after the close of the taxable year, (b) the taxpayer holds the appreciated financial position throughout the 60-day period after the transaction is closed, and (c) at no time during the 60-day period is the taxpayer's risk of loss with respect to the position reduced because (i) the taxpayer has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of substantially identical stock or securities, (ii) the taxpayer is the grantor of an option to buy substantially identical stock or securities, or (iii) as prescribed by regulations, the taxpayer has diminished his risk of loss by holding one or more other positions with respect to substantially similar or related property.ⁿ⁶ If a transaction that is closed is reestablished in a position, the exception applies provided the reestablished position is closed on or before the 30th day after the close of the taxable year, and the 60-day holding period and lack of reduced risk requirements are met.ⁿ⁷

If there is a constructive sale of any appreciated financial position, the position is subsequently disposed of, and at the time of the disposition the transaction resulting in the constructive sale of the position is open with respect to the taxpayer or any related person, then, solely for the purposes of determining whether the taxpayer has entered into a constructive sale of any other appreciated financial positions held by the taxpayer, the taxpayer is treated as entering into the transaction immediately after the disposition.ⁿ⁸

For this purpose, an assignment or other termination is treated as a disposition.

A constructive sale does not include a transaction involving an appreciated financial position that is mark to market, including provisions governed by *IRC Section 475* (mark to market for securities dealers) or *IRC Section 1256* (mark to market for futures contracts, options and currency contracts).ⁿ⁹ It also does not include any contract for sale of an appreciated financial position that is not a marketable security (as defined in *IRC Section 453(f)*) if the contract settles within one year after the date it is entered into.

[3] Character of Payments

The net payments made or received during the year are periodic payments accounted for in the manner described in § 9A.03, *above*. The payments will be treated as ordinary income or expense (rather than capital gain or loss), because they will not be made as part of a sale or exchange of property. Any net expense made by a corporation will be deductible under *IRC Section 162* as an ordinary and necessary expense incurred in a trade or business. Net payments made by an individual should be deductible under *IRC Section 212* either as an expense paid or incurred for the production of income (the anticipated income from the equity swap) or for the management, conservation, or maintenance of property held for the production of income (the shares of stock).ⁿ¹

There is no definitive authority governing the tax consequences of the final payment that reflects the change in value of the shares during the equity swap period. The payment could be characterized as a termination payment (a payment made or received to extinguish or assign all or part of the remaining rights or obligations of any party under a notional principal contract)ⁿ² or as a nonperiodic payment (a payment that is not a periodic payment or a termination payment)ⁿ³ Because the final payment is made at the scheduled maturity of the equity swap, it seems more likely that

the payment is a nonperiodic payment.ⁿ⁴

In the accounting for notional principal contracts and interest rate swaps, the regulations provide that a nonperiodic payment must be taken into account over the term of a notional principal contract in a manner that reflects the economic substance of the contract. Any portion of the nonperiodic payment that is allocated to a particular taxable year is taken into account as an item of ordinary income or expense for that year.ⁿ⁵ However, the regulations deal only with nonperiodic payments that are fixed at the inception of the transaction; no provision is made for contingent payments.ⁿ⁶

One possible method of accounting for a contingent final payment would be to resort to general principles of tax accounting. Under the accrual method of accounting, income and expense are generally taken into account when the right to receive a payment, or the liability to make a payment, becomes fixed and the amount thereof can be determined with reasonable accuracy.ⁿ⁷ Under the cash receipts and disbursements method of accounting, the general rule is that all items that constitute gross income are to be included in gross income for the taxable year in which they are actually or constructively received, while expenditures are to be deducted for the taxable year in which they are actually made.ⁿ⁸

In addition, the economic substance of an equity swap is that one party (the equity recipient) has a long position and the other (the equity payor) a short position in the shares and alternative investment, with the cash settlement of those positions taking place at the end of the transactions. In true long and short positions, gains and losses are taxed when the positions are closed.ⁿ⁹ The principle that tax recognition should reflect economic substance suggests that gain or loss resulting from the equity swap should likewise be accounted for when the long and short positions in the swap are closed.

A second possibility would be to account for the final contingent payment via a method similar to the general rule applicable to fixed nonperiodic payments in a notional principal contract, namely to estimate the amount of the payment and amortize it over the term of the contract.ⁿ¹⁰ At the conclusion of the term of the swap, the difference between the amortized amounts and the actual final payment would be taken into account.

[4] Collateral Tax Problems--Unrelated Business Income Tax

Any periodic payments made to a tax-exempt party to an equity swap will not be treated as unrelated business taxable income unless the entity is acting as a broker, dealer, or market maker in derivative financial products.ⁿ¹ Gain realized on a sale of one of the positions in the swap will generally be excluded from unrelated business taxable income by *IRC Section 512(b)(5)*.ⁿ² However, if the entity receives a termination payment, the exclusion will remain only if the payment can be characterized as capital gain under *IRC Section 1234A* and fall within the ambit of *IRC Section 512(b)(5)*.ⁿ³

[5] Collateral Tax Problems--Foreign Taxpayers and Foreign Income

The income source rules discussed in connection with interest rate swapsⁿ¹ should apply with equal force to equity swaps. The definition of notional principal contract contained in *Regulations Section 1.863-7(a)(1)* is identical to the definition found in *Regulations Section 1.446-3(c)*. The latter provision includes equity swaps and equity index swaps as examples of notional principal contracts. However, when those regulations were proposed, the following language appeared in the preamble:

The Internal Revenue Service is currently considering whether equity and equity index swaps should be treated in the same manner as interest rate and commodity swaps for sourcing and withholding tax purposes.ⁿ²

The *IRC Section 446* notional principal contract regulations were proposed after adoption of the final *IRC Section 863* notional principal contract regulations, leaving the question of sourcing and withholding with respect to equity swaps in

doubt.

[6] Collateral Tax Problems--Dividends Received Deduction

Two questions arise in connection with the dividends received deduction:

- (1) Can a corporate equity payor claim the dividends received deduction if it is obligated to pay over an amount equivalent to those dividends to the equity recipient?
- (2) If the equity recipient is a corporation, is the payment from the equity payor a dividend or some other form of income?

Under *IRC Section 243(a)*, a corporate shareholder is allowed a deduction of at least 70 percent of the amount received as dividends from a domestic corporation.ⁿ¹ *IRC Section 245* permits a similar deduction for the United States-source portion of dividends from a foreign corporation, other than a foreign personal holding company or passive foreign investment company, if the domestic corporation owns at least 10 percent of the stock of the foreign corporation.

IRC Section 246(c) disallows the dividends received deduction in two instances that may be relevant to equity swaps. The first denies the deduction in respect of any dividend on stock held by the taxpayer for 45 days or less (90 days in the case of certain preferred stock dividends).ⁿ² The holding period will be reduced (according to regulations to be prescribed) for any period in which:

- (1) the taxpayer has an option, is under a contractual obligation to sell, or has made (and not closed) a short sale of substantially identical stock or securities;
- (2) the taxpayer is the grantor of an option to buy substantially identical stock or securities (a "put"); or
- (3) under regulations to be prescribed by the Service, the taxpayer's risk of loss has been diminished by the taxpayer holding one or more positions with respect to substantially similar or related property.ⁿ³

Although an equity swap consists of long and short positions, it is not a true short sale. In a short sale, the seller sells stock that he does not own. Because the short seller does not own any stock at the time of the short sale except in the case of a short sale against the boxⁿ⁴ (but rather borrows the stock), he must later repurchase the stock to close out the sale but suffers a loss if the price rises. The short seller makes a profit if the stock's price falls in the time between selling short and closing out the sale. Moreover, the equity payor should not be treated as holding an option to sell or as the grantor of an option to buy substantially identical stock or securities. Finally, the equity payor does not appear to hold another position that diminishes risk with respect to similar or related property. The definitive answer must await the issuance of regulations.

The second instance, and the one that appears to have a greater impact on the equity payor, precludes the deduction to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.ⁿ⁵ The issue is whether the payment by the equity payor to the equity recipient of an amount equal to the dividends on the stock is the type of payment contemplated by the disallowance provision. According to the legislative history, the disallowance rule is designed to prevent the double tax benefit that would arise if the taxpayer were allowed to claim the dividends received deduction and an ordinary and necessary business expense deduction under *IRC Section 162*.ⁿ⁶ Allowing the corporate equity payor to claim the dividends received deduction would produce that double tax benefit.

The dividend equivalent amount received by the equity recipient cannot qualify for the dividends received deduction. The equity recipient is not a shareholder of the distributing corporation.

FOOTNOTES:

(n1)Footnote 1. *IRC § 1259(a)(1)*.

(n2)Footnote 2. *IRC § 1259(b)(1)*. A position means an interest, including a futures or forward contract, short sale, or option. *IRC § 1259(b)(3)*.

(n3)Footnote 3. *IRC § 1259(c)(1)(B), (2)*. An offsetting notional principal contract with respect to stock is an agreement that includes (a) a requirement to pay (or provide credit for) all or substantially all of the investment yield (including appreciation) on the stock for a specified period, and (b) a right to be reimbursed for (or receive credit for) all or substantially all or any decline in the value of the stock. *IRC § 1259(d)(2)*.

A person is related to another person with respect to a transaction if the relationship is described in *IRC § 267(b)* or *707(b)*, and the transaction is entered into with a view toward avoiding the purposes of *IRC § 1259*. *IRC § 1259(c)(4)*.

(n4)Footnote 4. *IRC § 1259(a)(2)(A)*.

(n5)Footnote 5. *IRC § 1259(a)(2)(B)*.

(n6)Footnote 6. *IRC §§ 246(c)(4), 1259(c)(3)(A)*.

(n7)Footnote 7. *IRC § 1259(c)(3)(B)*.

(n8)Footnote 8. *IRC § 1259(e)(1)*.

(n9)Footnote 9. H Rep No 105-148, 105th Cong, 1st Sess 442 (1997).

(n10)Footnote 1. Any expense to which *IRC § 212* is applicable is a miscellaneous itemized deduction that must be added to other miscellaneous itemized deductions of the taxpayer for the year and become subject to *IRC § 67(a)*, allowing such deductions only to the extent that they exceed the taxpayer's adjusted gross income for the year. In addition, miscellaneous itemized deductions are not deductible for purposes of the alternative minimum tax. *IRC § 56(b)(1)(A)*.

(n11)Footnote 2. *Treas Reg § 1.446-3(h)(1)*. The tax treatment of termination payments is discussed in § 9A.09.

(n12)Footnote 3. *Treas Reg § 1.446-3(f)(1)*. The tax treatment of nonperiodic payments is discussed in §§ 9A.03[3] and 9A.04[4].

(n13)Footnote 4. *Treas Reg § 1.446-3(f)(4)* Ex 6, treats a fixed amount payable at the end of a swap as a nonperiodic payment.

(n14)Footnote 5. *Treas Reg § 1.446-3(d)*.

(n15)Footnote 6. *TD 8491, 1993-2 CB 215, 216*. The IRS expects to address the issue in future regulations.

(n16)Footnote 7. *Treas Reg § 1.446-1(c)(1)(ii)*.

(n17)Footnote 8. *Treas Reg § 1.446-1(c)(1)(i)*.

(n18)Footnote 9. See, eg, *Commr v Levi's Estate, 127 F2d 796 (2d Cir 1942)* (gain or loss on short sale realized when short sale is closed); *Rev Rul 88-31, 1988-1 CB 302* (gain or loss on cash settlement put option realized when settlement payment is made).

(n19)Footnote 10. See § 9A.03[3].

(n20)Footnote 1. *Treas Reg § 1.512(b)-1(a)(1), (2).*

(n21)Footnote 2. The exclusion does not apply if the property is dealer property, that is, property that is not a capital asset pursuant to *IRC § 1221(a)(1)*. *Treas Reg § 1.512(b)-1(d)(1).*

(n22)Footnote 3. See § 9A.09[2].

(n23)Footnote 1. See § 9A.04[7].

(n24)Footnote 2. *56 Fed Reg 31350, 31351* (July 10, 1991) .

(n25)Footnote 1. The percentage increases to 80 percent if the shareholder owns 20 percent or more of the distributing corporation, and to 100 percent if the receiving corporation is a member of the same affiliated group as the distributing corporation. *IRC § 243(b), (c)*. See § 4.04[2][a] for a discussion of the dividends received deduction.

(n26)Footnote 2. *IRC § 246(c)(1)(A), (2)*. The 45-day holding period must occur during the 91-day period beginning 45 days before the ex-dividend date. The 90-day holding period must take place within the 181-day period beginning 90 days before the ex-dividend date. See § 4.04[2][a][v] for a discussion of the effective date and transitional rule regarding this holding period.

(n27)Footnote 3. *IRC § 246(c)(4)*.

(n28)Footnote 4. Short sales against the box are discussed in § 10.02[2].

(n29)Footnote 5. *IRC § 246(c)(1)(B)*.

(n30)Footnote 6. HR Rep No 775, 85th Cong, 1st Sess 824 (1957).



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CHAPTER 9A Notional Principal Contracts--Financial Derivatives

1-9A Taxation of Securities Transactions § 9A.07

§ 9A.07 Foreign Currency Swaps

[1] Economic Definition and Uses

Foreign currency swaps involve the exchange of the two parties' periodic payments in different currencies. A simple currency swap consists of two corporations from different countries exchanging their obligations across different currencies. For example, if a United States corporation wants pounds, and a British corporation wants United States dollars, the United States party can loan dollars to the British counterparty, and the British party can loan pounds to the United States party. Over the term of the swap agreement, the United States party makes payments in pounds to the British party for interest on the pound loan, and the British party makes payments in dollars to the United States party for interest on the dollar loan. At the end of the agreed-upon terms of the swap contract, the United States party pays the British party the principal amount in pounds, and the British party pays the United States party the principal amount in dollars.ⁿ¹

One form of foreign currency swap involves a loan in one currency (e.g., Deutsche marks) and the simultaneous purchase or sale of a second currency (e.g., United States dollars), normally via a forward contract--specifically, a private contract to purchase the currency at a future date.

Example:

A bank has deposits on which it must pay interest in Deutsche marks. It has assets that produce income in United States dollars. This creates a foreign currency risk that can be avoided by the bank exchanging marks for dollars in the spot market and, at the same time, entering into a forward contract to sell dollars at a specified future date. The transaction fixes the selling price for the acquired dollars and eliminates the chance of a loss that would occur by a decrease in the value of the dollar as against the mark.

A foreign currency swap can also be combined with an interest rate swap, sometimes referred to as a complex swap. A party that has borrowed in the fixed-rate market in one currency enters into a transaction with a counterparty who has borrowed in the floating-rate market in a different currency. This goal of this transaction is reduction of interest rate risk and foreign exchange rate risk.

A foreign currency swap can also provide inexpensive term financing for a corporation's foreign subsidiaries and affiliates in local currency. A United States parent can provide local currency funding by financing itself in United States dollars, entering into a foreign currency swap, and then lending the foreign currency to the subsidiary or affiliate

at a lower cost than could be achieved in the foreign capital or money market by the foreign entity.ⁿ²

Foreign currency swaps can also be used as an arbitrage mechanism. A company that has a competitive advantage in the fixed-interest rate Deutsche mark capital market, but prefers floating rate United States dollars, could reduce its borrowing costs through a currency swap. The company can borrow in the fixed-rate Deutsche mark capital market and then, through a currency swap, transform the fixed-rate Deutsche marks into floating-rate United States dollars. Obtaining funds in this manner may be cheaper than obtaining the same funds directly in the United States financial markets.ⁿ³

[2] Tax Definition

For tax purposes, a currency swap is defined as a contract involving different currencies between two or more parties to (1) exchange periodic interim payments on or prior to maturity of the contract, and (2) exchange the swap principal amount upon maturity of the contract.ⁿ¹ The swap principal amount is an amount of two different currencies that, under the terms of the currency swap, is used to determine the periodic interim payments in each currency and is exchanged upon maturity of the swap.ⁿ²

An exchange of periodic interim payments is an exchange of one or more payments in one currency specified by the contract for one or more payments in a different currency specified in the contract where the payments in each currency are computed by reference to an interest index applied to the swap principal amount.ⁿ³ A currency swap contract must clearly indicate the periodic interim payments, or the interest index, used to compute the payments, in each currency.

[3] Gain or Loss Recognition

Because foreign currency is treated as personal property, rather than money, for federal income tax purposes, fluctuations in the dollar value of foreign currency in a United States taxpayer's hands result in potentially taxable exchange gain or loss. The amount of any income or loss from a foreign currency swap is generally treated as exchange gain or loss (and not as interest income or expense).ⁿ¹ However, this treatment applies solely for the purpose of determining the realization, recognition, and amount of exchange gain or loss with respect to the currency swap, and not for purposes of determining the source of the gain or loss, or for characterizing the gain or loss as interest. The source of exchange gain or loss is determined by reference to the residence of the taxpayer.ⁿ²

Exchange gain or loss is characterized as ordinary gain or loss and not capital gain or loss.ⁿ³ In addition, exchange loss realized by the holder of a tax-exempt state or local bond is treated as an offset to and reduces total interest income received with respect to the bond.ⁿ⁴ Finally, no gain or loss is recognized by the taxpayer in any hedging transaction in which the currency swap is integrated with certain debt instruments.ⁿ⁵

If a taxpayer enters into a hyperinflationary currency swap after February 14, 2000, the taxpayer realizes exchange gain or loss for the taxable year with respect to the instrument determined by reference to the change in exchange rates between (i) the later of the first day of the taxable year, or the date the instrument was entered into by the taxpayer, or (ii) the earlier of the last day of the taxable year, or the date the instrument is disposed of or otherwise terminated.ⁿ⁶ The rule does not apply if a qualified business unit uses the United States dollar approximate separate transactions method of accounting (DASTM).ⁿ⁷

[4] Timing and Computation of Periodic Interim Payments

As a general rule, the timing and computation of the periodic interim payments must be determined by treating (1) payments made under the swap as payments made pursuant to a hypothetical borrowing that is denominated in the currency in which payments are required to be made (or are determined with reference to) under the swap; and (2) payments received under the swap as payments received pursuant to a hypothetical loan denominated in the currency in

which the payments are received (or are determined with reference to) under the swap.ⁿ¹ The hypothetical issue price of the hypothetical borrowing and loan is the swap principal amount. The hypothetical stated redemption price at maturity is the total of all payments (excluding any exchange of the swap principal at the inception of the contract) provided under the hypothetical borrowing or loan other than periodic interest payments under the principles of *IRC Section 1273*. For purposes of determining economic accrual under the currency swap, the number of hypothetical interest compounding periods of the hypothetical borrowing and loan must be determined pursuant to the semiannual compounding convention unless the currency swap contract indicates otherwise. For purposes of determining the timing and amount of the periodic interim payments, the general economic accrual principles regarding the amortization of interestⁿ² apply to the hypothetical interest income and expense, but not to the time when principal is deemed paid on the hypothetical loan and borrowing.

The amount treated as exchange gain or loss with respect to the periodic interim payments for the taxable year equals the amount of hypothetical interest income and exchange gain or loss attributable to the interest income from the hypothetical borrowing and loan for the year minus the amount of hypothetical interest expense and exchange gain or loss attributable to the interest expense from the hypothetical borrowing and loan for the year.

Example 1:

ⁿ³ A is an accrual-method corporate calendar-year taxpayer with the dollar as its functional currency. On January 1, 1995, A enters into a currency swap with B, a United Kingdom corporation, under which (1) the principal amount is \$150,000 and 100,000 British pounds (£)(the equivalent of \$150,000 on the effective date of the contract assuming a spot rate of £1 = \$1.50 on January 1, 1995); (2) A will make payments equal to 10 percent of the dollar principal amount on December 31, 1995 and December 31, 1996; (3) B will make payments equal to 12 percent of the pound principal amount on December 31, 1995 and December 31, 1996; and (4) on December 31, 1996, A will pay B the \$150,000 principal amount and B will pay A the £100,000 principal amount. Assume that the spot rate is £1 = \$1.40 on December 31, 1995 and £1 = \$1.30 on December 31, 1996. Assume further that the average rate for 1995 is £1 = \$1.45, and for 1996 is £1 = \$1.35.

Solely for determining the realization of gain or loss, A will treat the dollar payments made by it as payments made pursuant to a dollar borrowing with an issue price of \$150,000, a stated redemption price of \$150,000, and a yield to maturity of 10 percent. A will treat the pound payments received as payments received pursuant to a pound loan of £100,000, a stated redemption price of £100,000, and a yield to maturity of 12 percent. Under *Regulations Section 1.988-2(b)*, A is required to compute hypothetical accrued pound interest at the average rate for the accrual period and then determine exchange gain or loss on the day payment is received with respect to the accrued amount. Accordingly, A will accrue \$17,400 in 1995 (£12,000 x \$1.45) and \$16,200 (£12,000 x \$1.35) in 1996. A will also compute hypothetical exchange loss of \$600 on December 31, 1995 (£12,000 x \$1.40) less (£12,000 x \$1.45), and hypothetical exchange loss of \$600 on December 31, 1996 (£12,000 x \$1.30) less (£12,000 x \$1.35). All the hypothetical interest income and exchange loss are characterized and sourced as exchange gain or loss. In addition, A is treated as having paid \$15,000 (\$150,000 x 10 percent) of hypothetical interest on December 31, 1995, and again on December 31, 1996. These hypothetical interest payments are characterized and sourced as exchange loss. Therefore, A will have a net exchange gain of \$1,800 (\$17,400 minus \$600 minus \$15,000) with respect to the periodic interim payments in 1995 and a net exchange gain of \$600 (\$16,200 minus \$600 minus \$16,200) in 1996.

Example 2:

ⁿ⁴ C is an accrual method calendar-year corporate taxpayer with the dollar as its functional currency. On January 1, 1995, when the spot rate is £1 = \$1.50, C enters into a currency swap contract with D, a United Kingdom corporation under which C agrees to make and receive the following payments:

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Date	C Pays	D Pays
December 31, 1995	\$ 15,000	£ 12,000
December 31, 1996	\$ 41,040	£ 12,000
December 31, 1997	\$ -0-	£ 12,000
December 31, 1998	\$150,000	£112,000

C must treat the dollar periodic payments under the swap as made pursuant to a hypothetical dollar borrowing with an issue price of \$150,000 and a stated redemption price at maturity of \$206,040. The amount of hypothetical interest expense must be amortized in accordance with economic accrual. Thus, D must include and C must deduct periodic interim payments as follows:

	Amount Taken into Account	Adjusted Issue Price
December 31, 1995	\$ 15,000	\$150,000
December 31, 1996	\$ 15,000	\$123,960
December 31, 1997	\$ 12,400	\$136,360
December 31, 1998	\$ 13,640	

[5] Timing and Determination of Exchange Gain or Loss With Respect to the Swap Principal Amount

Exchange gain or loss with respect to the swap principal amount is realized on the day the units of swap principal are exchanged, that is, on the maturity of the contract.ⁿ¹ The gain or loss is determined by subtracting the value on that date of the units of swap principal paid from the value of the units of swap principal received.ⁿ²

Example 3:

Assume the same facts as in Example 1. A will realize an exchange loss of \$20,000 with respect to the exchange of the swap principal amount on December 31, 1996. This is determined by subtracting the units of swap principal paid (\$150,000) from the units of swap principal received (£100,000 x \$1.30 = \$130,000).

Example 4:

Assume the same facts as in Example 2. Gain or loss with respect to the principal payments exchanged on December 31, 1998 is determined on that date, notwithstanding that under the general principles regarding amortization of interest, \$206,040 would have been regarded as a payment of principal on December 31, 1996.

[6] Off--Market Currency Swaps

An "off-market currency swap" is a swap under which the present value of the payments to be made is not equal to that of the payments to be received on the day that the taxpayer enters into or acquires the contract (absent the swap premium or discount). In general, the values will not be equal if the swap exchange rate (the single rate stated in the contract at which the swap principal amounts are determined) is not the spot rate, or the interest indices used to compute the periodic interim payments do not reflect current values, on the day that the taxpayer enters into or acquires the currency swap.ⁿ¹

If a taxpayer that enters into or acquires a currency swap pays a premium to enter into or acquire a currency swap ("swap premium"), or enters into or acquires the currency swap at a discount ("swap discount"), in order to make the

present values of the amounts to be paid equal to the amounts to be received, the premium or discount is amortized in a manner that places the taxpayer in the same position it would have been in had the taxpayer entered into a currency swap under which the present value of the payments to be paid equal the payments to be received. To accomplish this:

- (1) the amount of swap premium or discount attributable to the difference between the swap exchange rate and the spot rate on the date the contract is entered into or acquired is taken into account as income or expense on the date the swap principal amounts are taken into account; and
- (2) the amount of swap premium or discount attributable to the difference in values of the periodic payments are amortized in a manner consistent with economic accrual principles.ⁿ² Any amount taken into account is treated as exchange gain or loss.

Example 5:

ⁿ³ *E* is a calendar-year accrual method corporate taxpayer with the dollar as its functional currency. On January 1, 1995 it enters into a three-year currency swap contract with *F*, a Swiss corporation. The swap principal amount is \$100,000 and the Swiss franc equivalent of such amount is Sf200,000, translated at the swap exchange rate of \$1 = Sf2. There is no initial exchange of the swap principal amount. The interest rates used to compute the periodic interim payments are 10 percent compounded annually for the United States dollar payments and 5 percent compounded annually for the Swiss franc payments. Assume that the average rate for 1995 and the spot rate on December 31, 1995 is \$1 = Sf2.50.

On December 31, 1995, *E* will pay *F* \$10,000 (10 percent of \$100,000), and *F* will pay *E* Sf10,000 (5 percent of Sf200,000). The payments made and received by *E* will produce an exchange loss for *E* of \$6,000 (\$10,000 loss from the periodic interim payment made to *F* less \$4,000 of gain, the value of Sf10,000 received from *F*).

On January 1, 1996, *E* transfers the rights and obligations under the swap contract to *G*, an unrelated calendar-year accrual method corporation that has the dollar as its functional currency. On January 1, 1996, the exchange rate is \$1 = \$2.50, the relevant dollar interest rate is 8 percent compounded annually, and the relevant Swiss franc interest rate is 5 percent compounded annually. Because of the change in exchange and interest rates, the agreement between *E* and *G* to transfer the currency swap requires *E* to pay *G* \$23,560.

E treats the payment as an exchange loss that can be deducted in 1996. The loss is treated as a United States source loss because *E* is a domestic corporation.

For *G*, the portion of the \$23,560 discount that is attributable to the change in exchange rates (\$20,000) is taken into account on December 31, 1997, the date that the swap principal amounts are exchanged. This amount is the present value (discounted at 10 percent, the rate under the currency swap contract used to compute the dollar periodic interim payments) of the financial asset required to compensate *G* for the loss in value of the hypothetical Swiss franc loan resulting from the change in exchange rates between January 1, 1995 and January 1, 1996. This amount is determined by assuming that interest rates did not change from the date that the swap was originally entered into (January 1, 1995), but that the exchange rate is \$1 = Sf2.50. Under this assumption, a taxpayer undertaking the obligation to pay dollars under the currency swap on January 1, 1996, would agree to pay only \$8,000 for Sf10,000 on December 31, 1996 and \$88,800 for Sf210,000 on December 31, 1997. Thus, *G* needs \$2,000 on December 31, 1996 and \$22,000 on December 31, 1997 to compensate for the amount of dollar payments *G* is required to make in exchange for the Swiss francs received on December 31, 1996 and December 31, 1997. The present value of \$2,000 on December 31, 1996 and \$22,000 on December 31, 1997, discounted at the rate for United States dollar payments of 10 percent is \$20,000 (\$1,820 and

\$18,180).

G is also required to amortize the portion of the \$23,560 discount attributable to changes in interest rates under principles of economic accrual over the term of the currency swap. The amount of the discount attributable to those changes (assuming that exchange rates have not changed) is the present value (\$3,560) of the excess (\$2,000 in 1996 and \$2,000 in 1997) of the periodic interim payments G is required to make under the currency swap agreement (\$10,000 in 1996 and \$10,000 in 1997) over the amount that G would be required to pay if the currency swap agreement reflected current interest rates on the date that G acquired the swap contract (\$8,000 in 1996 and \$8,000 in 1997). Under principles of economic accrual, G will include in income, \$1,715 on December 31, 1996, the amount that, when added to the interest (\$285) on \$3,560 computed at the 8 percent rate on the date that G acquired the swap will equal the \$2,000 needed to compensate G for the change in interest rates between January 1, 1995 and January 1, 1996. G will also include in income \$1,850 on December 31, 1997, the amount that when added to the interest (\$150) on the \$1,845 remaining balance of the \$3,560 payment, computed at 8 percent, will equal the \$2,000 needed to compensate G for the change in interest rates.

FOOTNOTES:

(n1)Footnote 1. "Note: Tax Treatment of Notional Principal Contracts," *103 Harv L Rev 1951 (June 1990)*.

(n2)Footnote 2. Fallon, "The Corporate Problem Solver," *Intermarket*, 3 (March 1987).

(n3)Footnote 3. H Hu, "Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm," *138 U Pa L Rev 333 (Dec 1989)*.

(n4)Footnote 1. *Treas Reg § 1.988-2(e)(2)(ii)(A)*. A currency swap contract can also require an exchange of the swap principal amount at the outset of the swap.

(n5)Footnote 2. *Treas Reg § 1.988-2(e)(2)(ii)(B)*. If the swap principal amount is not set forth in the contract, the Service can determine the swap principal amount.

(n6)Footnote 3. *Treas Reg § 1.988-2(e)(2)(ii)(C)*.

(n7)Footnote 1. *Treas Reg § 1.988-2(e)(2)(i)*.

(n8)Footnote 2. *Treas Reg § 1.988-3(a)*.

(n9)Footnote 3. *Treas Reg § 1.988-4(a)*.

(n10)Footnote 4. *Treas Reg § 1.988-3(c)(1), (2)*.

(n11)Footnote 5. *Treas Reg § 1.988-5(a)(1), (4)*.

(n12)Footnote 6. *Treas Reg § 1.988-2(e)(7)(i)*. Proper adjustment is made in the amount of any gain or loss subsequently realized for gain or loss taken into account under this rule. *Treas Reg § 1.988-2(e)(7)(ii)*.

A hyperinflationary currency swap contract is one that provides for (a) payments denominated in or determined by reference to a currency that is hyperinflationary at the time the taxpayer enters into or otherwise acquires the currency swap, or (b) payments that are adjusted to take into account that the currency is hyperinflationary during the current taxable year. A currency swap that provides for periodic payments determined by reference to a variable interest rate based on local conditions and generally responding to changes in the local consumer price index is an example of the second type of currency swap contract. *Treas Reg § 1.988-2(e)(7)(iv)*.

See § 20.09[1] for the definition of hyperinflationary currency.

(n13)Footnote 7. *Treas Reg § 1.988-2(e)(7)(iii)*. DASTM is described in § 20.09[1].

(n14)Footnote 1. *Treas Reg § 1.988-2(e)(2)(iii)(A)*.

(n15)Footnote 2. *IRC §§ 163(e), 1272 through 1275*.

(n16)Footnote 3. *Treas Reg § 1.988-2(e)(5)*, Ex 1.

(n17)Footnote 4. *Treas Reg § 1.988-2(e)(5)Ex 2*.

(n18)Footnote 1. *Treas Reg § 1.988-2(e)(2)(iv)*.

(n19)Footnote 2. The rule does not apply to an equal exchange of the swap principal amount at the commencement of the agreement at a market exchange rate. *Treas Reg § 1.988-2(e)(2)(iv)*.

(n20)Footnote 1. *Treas Reg § 1.988-2(e)(3)(i)*.

(n21)Footnote 2. *Treas Reg § 1.988-2(e)(3)(ii)*.

(n22)Footnote 3. *Treas Reg § 1.998-2(e)(5)*, Ex.3.



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CHAPTER 9A Notional Principal Contracts--Financial Derivatives

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§ 9A.08 Interest Rate Caps, Floors and Collars

[1] Definitions and Uses

An interest rate cap is a notional principal contract that generally involves an initial cash payment by one party to a counterparty in exchange for an agreement by the counterparty to make cash payments at specified future dates equal to the product of a notional principal amount and the excess, if any, of a specified interest rate index over a fixed interest rate (the cap rate). In other words, the seller of an interest rate cap agreement receives an initial cash payment and becomes obligated to make cash payments in the future if and when interest rates under the specified index *exceed* the cap rate. Typically, borrowers use interest caps to limit interest rate exposure on the costs of borrowing funds under an adjustable rate loan.

An interest rate floor is the converse of an interest rate cap. It provides that one party will make payments equal to the excess of a fixed interest rate over the specified interest rate index. The seller of the interest rate floor receives an initial cash payment and becomes obligated to make cash payments in the future if and when interest rates under the specified index fall *below* a fixed interest rate (the floor rate). Typically, lenders buy interest rate floors to limit interest rate exposure on earnings from funds loaned at an adjustable rate. Borrowers may sell interest rate floors to receive the premium and so reduce interest rate costs if interest rates do not fall below the floor rate.

An interest rate collar results from the combination of a cap and a floor. In a collar transaction, a party purchases a cap and simultaneously sells a floor, or purchases a floor and simultaneously sells a cap. Ordinarily, the cap and the floor are based on the same notional principal amount and specified index.

[2] Accounting for Interest Rate Caps and Floors

[a] Premium Amortized Using General Rule. As a general rule, a payment to purchase or sell a cap or a floor must be recognized over the term of the agreement by allocating it in accordance with the prices of cash-settled option contracts that reflect the specified index and notional principal amount.ⁿ¹ For purposes of this allocation, the option pricing used by the parties to determine the total amount paid for the cap or floor will be respected, if reasonable. Only the portion of the purchase price that is allocable to the option contract or contracts that expire during a particular period is recognized for that period. Thus, straight-line or accelerated amortization of a cap or floor premium is normally not permitted.

Example 1:

n2 On January 1, 1996, when LIBOR is 8 percent, *L* pays unrelated party *K* \$600,000 for a contract that obligates *K* to make a payment to *L* each quarter equal to one-quarter of the excess, if any, of three-month LIBOR over 9 percent with respect to a notional principal amount of \$25 million. Both *K* and *L* are calendar year taxpayers. *K* provides *L* with a schedule of allocable premium amounts indicating that the cap was priced according to a reasonable variation of the Black-Scholes option pricing formula and that the total premium is allocable to the following periods

Pricing allocation

199 \$ 55,000

6

199 225,000

7

199 320,000

8

\$600,000

The Black-Scholes model is recognized in the financial industry as a standard technique for pricing interest rate cap agreements. Therefore, because *K* has used a reasonable option pricing model, the schedule generated by *K* is consistent with the economic substance of the cap, and may be used by both *K* and *L* for calculating their ratable daily portions of the cap premium. *K* recognizes the ratable daily portion of the cap premium as income in the amounts and taxable years determined under the pricing allocation set forth in the preceding paragraph; *L* recognizes the ratable daily portion as a deduction in the same amounts and taxable years.

Any periodic payments under the cap agreement (payments by *K* to *L* because LIBOR exceeds 9 percent) are included in the parties' net income or net deduction from the contract according to the accounting rules for periodic payments discussed in § 9A.03[2].

Example 2:

n3 The facts are the same as in Example 1, except that the cap is purchased by *L* on November 1, 1995. The first determination under the cap agreement is January 1, 1996 (the last day of the first quarter to which the contract relates). LIBOR is 9.1 percent on December 31, 1995, and 9.15 percent on January 31, 1996.

K and *L* recognize \$9,192 (61 days/365 days x \$55,000) as the ratable daily portion of the nonperiodic payment for 1995, and include that amount in their net income or net deduction from the contract for 1995. If *K*'s pricing model allocated the cap premium to each quarter covered by the contract, the ratable daily portion would be 61 days/92 days multiplied by the premium allocated to the first quarter.

Because the amount of the January 31, 1996 payment is not determinable at the end of 1995 because it is based on the value of the specified index (LIBOR) on January 31, 1996, *K* and *L* calculate the payments using LIBOR as of December 31, 1995. *L* recognizes as income the ratable daily portion of the presumed payment of \$6,250 (1/4 x .1 percent x \$25 million), or \$4,144 (61 days/92 days x \$6,250). *K* reports \$5,048 of net income from the contract for 1995 (\$9,192-\$4,144); *L* reports a net deduction from the contract of \$5,048 for 1995.

On January 31, 1996, *K* pays *L* \$9,375 ($1/4 \times .15$ percent $\times$ \$25 million) under the terms of the cap agreement. For purposes of determining their net income or net deduction from the contract for the year ended December 31, 1996, *K* and *L* must adjust their respective net income and net deduction by \$2,072 ($61 \text{ days}/92 \text{ days} \times [\$9,375 \text{ actual payment under the cap on January 31, 1996, less } \$6,250 \text{ presumed payment under the cap on December 31, 1995}]$).

[b] Alternative Amortization Method for Hedges.

Solely for purposes of determining the timing of income recognition and the taking of deductions, if a cap or floor is entered into primarily to reduce risk with respect to a specific debt instrument or group of instruments held or issued by the taxpayer, the taxpayer can amortize a payment to purchase or sell the cap or floor using an alternative method, adjusted as appropriate to take into account increases or decreases in the notional principal amount.ⁿ⁴ The alternative methods may not be used by a dealer in notional principal contracts for caps or floors entered into or acquired in its capacity as a dealer.ⁿ⁵

[i] Upfront Payments. A premium paid upfront for a cap or a floor may be amortized using the level payment method described in § 9A.04[5].ⁿ⁶

Example 3:

ⁿ⁷ The facts are the same as in Example 1, except that the cap provides for annual payments by *K* and is entered into by *L* primarily to reduce risk with respect to a debt instrument issued by *L*. *L* elects to amortize the cap premium using the alternative level payment method. Accordingly, *L* amortizes the cap premium by assuming that the \$600,000 is repaid in three equal payments of \$241,269, assuming a discount rate of 10 percent. Each payment is divided into a time value component and a principal component:

	Level Payment	Time Value Component	Principal Component
1996	\$241,269	\$ 60,000	\$181,269
1997	241,269	41,873	199,396
1998	241,269	21,934	219,335
	\$723,807	\$123,807	\$600,000

The net of the ratable daily portions of the principal component and the payments, if any, received from *K* comprise *L*'s annual net income or net deduction from the cap. The time value components are needed only to compute the ratable daily portions of the cap premium, and otherwise are disregarded.

[ii] Other Nonperiodic Payments Related to Caps and Floors. Nonperiodic payments on a cap or floor other than an upfront payment are amortized by treating the contract as if it provided for a single upfront payment (equal to the present value of the nonperiodic payments) and a loan between the parties.ⁿ⁸ The discount rate (or rates) used in determining the deemed upfront payment and the time value component of the deemed loan is the same as the rate (or rates) used in the level-payment method. The single upfront payment is then amortized under the level-payment method. The time value component of the loan is not treated as interest, but, together with the amortized amount of the deemed

upfront payment, is treated as a periodic payment. If both parties to the cap or floor make nonperiodic payments, the calculation is done separately for the nonperiodic payments made by each party.

Example 4:

n9 Assume the same facts as in Example 3, except that *L* agrees to pay for the cap in three level installments of \$241,269 (a total of \$723,807) on December 31, 1996, 1997, and 1998. The present value of the three payments, discounted at 10 percent, is \$600,000. For purposes of amortizing the cap premium under the alternative method for nonperiodic payments that are not upfront payments, *L* is treated as having paid \$600,000 for the cap on January 1, 1996, and as borrowing \$600,000 from *K* to be repaid in three annual installments of \$241,269. The time value component of the loan is computed as follows:

	Loan Balance	Time Value Component	Principal Component
1996	\$600,000	\$ 60,000	\$181,269
1997	418,731	41,873	199,396
1998	219,335	21,934	219,335
		\$123,807	\$600,000

L is treated as making periodic payments equal to the amortized principal components from a \$600,000 cap paid in advance (as described in Example 3), increased by the time value components of the \$600,000 loan, a total of \$241,269 each year. The time value components of the \$600,000 loan are included in the periodic payments made by *L*, but are not characterized as interest income or expense. The effect of the alternative method in this situation is to allow *L* to amortize the cap premium in level installments, the same way it is paid. The net of the ratable daily portions of *L*'s deemed periodic payments and the payments, if any, received from *K* comprise *L*'s net income of deduction from the cap.

[iii] Other Nonperiodic Payments Related to Collars. A taxpayer can also treat a cap and a floor that make up a collar as a single notional principal contract and amortize the net nonperiodic payment to enter into the cap and floor over the term of the collar in accordance with the alternative methods prescribed above for caps and floors.ⁿ¹⁰

In accounting for swaps, if a taxpayer reduces risk with respect to the swap by hedging the swap, the taxpayer cannot use an alternative method of accounting for nonperiodic payments. The same rule holds true for interest rate caps and floors.

Example 5:

On July 1, 1996, *S* sells to unrelated counter party *T* three cash settlement European-style put options on Eurodollar time deposits with a strike rate of 9 percent. The options have exercise dates on January 1, 1997, January 1, 1998, and January 1, 1999, respectively. If LIBOR exceeds 9 percent on any of the

exercise dates, *T* will be entitled, by exercising the relevant option, to receive from *S* an amount that corresponds to the excess of LIBOR over 9 percent times \$25 million. *T* pays *S* \$650,000 for the three options. Assume further that *S* is related to *L*, the cap purchaser in Example 1.

S's option agreements with *T* reduce risk with respect to *L*'s cap agreement with *K*. Therefore, *L* cannot use the alternative methods to amortize the premium paid under the cap agreement, but must do so under the general rule described above. The method that *K* can use to account for its agreement with *L* is not affected by the treatment of *L*.

[3] Character of Interest Cap and Floor Payments

The discussion of the character of interest rate swap payments noted that payments made under the notional principal contract are not compensation for the use or forbearance of money, and, thus, could not be treated as interest.ⁿ¹ A second interest-negating factor is the lack of an existing, unconditional, and legally enforceable obligation, that is, an indebtedness.ⁿ² The premium paid to purchase a cap or floor is not the result of an indebtedness. Moreover, any obligation to make payments during the term of the cap or floor agreement is contingent upon interest rates relevant to the fixed rate at the dates specified in the agreement.ⁿ³

The interest swap discussion also noted that payments under the swap might be treated as financial income or expense, and, therefore, constitute ordinary income and deductions. The same analysis applies to caps and floors. Finally, it was asserted that payments made pursuant to an interest rate swap should not be treated as giving rise to capital gain or loss because of the absence of a sale or exchange. The same holds true for interest rate caps and floors.

[4] Collateral Tax Consequences--Source of Payments and Unrelated Business Income Tax

The question of whether payments made pursuant to a notional principal contract should be treated as United States-source payments is discussed in § 9A.04[7], above. Because a cap or floor agreement is a notional principal contract, the rules discussed in that section applies here.

A tax-exempt entity that enters into an interest rate cap or floor agreement might have to face the issue of whether any payments received under the agreement constitute unrelated business taxable income. See § 9A.04[6], above.

[5] Collateral Tax Consequences--Hedging and Straddle Transactions

IRC Section 1221(a)(7) defines a hedging transaction as one that a taxpayer normally enters into in the normal course of the taxpayer's trade or business primarily to manage the risk of interest rate price or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred, or to be incurred, by the taxpayer.ⁿ¹ The first consequence is that property that is part of the hedging transaction is not a capital asset.ⁿ²

A second consequence is that if the interest rate cap or floor is a hedging transaction because it reduces risk, the transaction will not be subject to the loss deferral rules of *IRC Section 1092* applicable to straddles or to the mark-to-market rules of *IRC Section 1256*.ⁿ³

FOOTNOTES:

(n1)Footnote 1. *Treas Reg* § 1.446-3(f)(2)(iv).

(n2)Footnote 2. *Treas Reg* § 1.446-3(f)(4)Ex 1.

(n3)Footnote 3. *Treas Reg* § 1.446-3(f)(4)Ex 2.

(n4)Footnote 4. *Treas Reg* § 1.446-3(f)(2)(v).

(n5)Footnote 5. *Id.*

(n6)Footnote 6. *Treas Reg* § 1.446-3(f)(2)(v)(A).

(n7)Footnote 7. *Treas Reg* § 1.446-3(f)(4)Ex 3.

(n8)Footnote 8. *Treas Reg* § 1.446-3(f)(2)(v)(B)

(n9)Footnote 9. *Treas Reg* § 1.446-3(f)(4)Ex 4.

(n10)Footnote 10. *Treas Reg* § 1.446-3(f)(2)(v)(C).

(n11)Footnote 1. See § 9A.04[5].

(n12)Footnote 2. *Titcher v Commr*, 57 TC 315, 322 (1971) .

(n13)Footnote 3. *Gilman v Commr*, 53 F2d 47, 49-50 (8th Cir 1931) .

(n14)Footnote 1. See § 2.04[1] for a discussion of the hedging transaction rules.

IRC § 1221(a)(7) applies to hedging transactions entered into on or after Dec 17, 1999. *Treas Reg* § 1.1221-2 applies to transactions entered into before that date. The definition of hedging transaction under the regulations is slightly different. See § 2.04[2][a].

(n15)Footnote 2. *Treas Reg* § 1.1221-2(a)(1).

(n16)Footnote 3. *IRC* §§ 1092(e), 1256(e)(1), (2). The loss deferral rules applicable to straddles are discussed in § 9.02[4][d]; the mark-to-market rules are discussed in § 18.05.



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CHAPTER 9A Notional Principal Contracts--Financial Derivatives

1-9A Taxation of Securities Transactions § 9A.09

§ 9A.09 Termination Payments

[1] Defining and Accounting Termination Payments

A payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under a notional principal contract is a termination payment to the party making the payment and the party receiving it.ⁿ¹ Any of the following constitutes a termination payment:

- (1) a payment made between the original parties to the contract (an extinguishment);
- (2) a payment made between one party to the contract and a third party (an assignment);
- (3) any gain or loss realized on the exchange of one notional principal contract for another; or
- (4) any economic benefit that is given or received by a taxpayer in lieu of a termination payment.

Where one party assigns its remaining rights and obligations to a third party, the original nonassigning party realizes gain or loss if the assignment results in a deemed exchange of contracts and a realization event under *IRC Section 1001*.

Except as otherwise provided (e.g., in *IRC Section 453* governing installment payments and *IRC Section 1092*, the loss deferral rules for straddles), a party to a notional principal contract recognizes a termination payment in the year the contract is extinguished, assigned, or exchanged.ⁿ² When the termination payment is recognized, the party also recognizes any other payments that have been made or received pursuant to the notional principal contract, but that have not been recognized. If only a proportionate part of a party's rights and obligations is extinguished, assigned, or exchanged, only that proportion of the unrecognized payment is recognized.

A termination payment made or received by an assignee of a notional principal contract is treated as a nonperiodic payment for the notional principal contract that is in effect after the assignment and is recognized by the assignee under the rules relating to nonperiodic payments.ⁿ³

A payment is not a termination payment if it is made or received by a party in exchange for assigning all or a portion of one leg of a notional principal contract at a time when a substantially proportionate amount of the other leg remains

unperformed and unassigned.ⁿ⁴ The payment is either an amount loaned, an amount borrowed, or a nonperiodic payment, depending on the economic substance of the transaction to each party. This last stated rule applies whether or not the original notional principal contract is terminated as a result of the assignment.

[a] Termination by Extinguishment

Example 1:

ⁿ⁵ On January 1, 1996, A enters into an interest rate swap agreement with unrelated counterparty B under which, for a term of seven years, A is obligated to make annual payments based on 10 percent and B is obligated to make semi-annual payments based on LIBOR and a notional principal amount of \$100 million. A and B are calendar year taxpayers. On January 1, 1998, when the fixed rate on a comparable LIBOR swap has fallen to 9.5 percent, A pays B \$1,895,393 to terminate the swap.

The payment from A to B is a termination payment because it extinguishes the swap contract. Therefore, in 1998, A recognizes a loss of \$1,895,393 while B recognizes a gain of \$1,895,393.

[b] Termination by Assignment

Example 2:

ⁿ⁶ The facts are the same as in Example 1, except that on January 1, 1998, A pays unrelated party C \$1,895,393 to assume all of A's rights and obligations under the swap with B. In return for this payment, C agrees to pay 10 percent of \$100 million annually to B and to receive LIBOR payments from B for the remaining five years of the swap.

The payment from A to C is an assignment and, thus, a termination payment. A recognizes a loss of \$1,895,393 in 1998. Whether B also has a termination payment with respect to the payment from A to C is determined under *IRC Section 1001*.

The assignment payment that C receives from A is a nonperiodic payment for an interest rate swap. Because the assignment payment is not a significant nonperiodic payment, C amortizes the \$1,895,393 over the remaining five-year term of the swap agreement.

[c] Assignment of Swap With Yield Adjustment Fee

Example 3:

ⁿ⁷ The facts are the same as in Example 2, except that on January 1, 1996, B paid A a yield adjustment fee to enter into the seven-year interest rate swap. A and B included the ratable daily portions of that nonperiodic payment in their net income or net deduction from the contract for 1996 and 1997. On January 1, 1998, \$300,000 of the nonperiodic payment has not yet been recognized by A and B.

A recognizes a loss of \$1,595,393 (\$1,895,393 less \$300,000) in 1998. C accounts for the termination in the same way it did in Example 2; the existence of an unamortized payment with respect to the original swap has no effect on C.

[d] Assignment of One Leg of a Swap

Example 4:

ⁿ⁸ On January 1, 1996, D enters into an interest rate swap agreement with unrelated counterparty E under which, for a term of five years, D will make annual payments at 10 percent and E will make annual

payments at LIBOR on a notional principal amount of \$50 million. On January 1, 1997, unrelated party *F* pays *E* \$15,849,327 for the right to receive the four remaining \$5 million payments from *D*. Under the terms of the agreement between *D* and *E*, *D* is notified of the assignment, and *D* is contractually bound thereafter to make its payments to *F* on the appropriate payment dates. *D*'s obligation to pay *F* is conditioned on *E* making its LIBOR payment to *D* on the appropriate payment dates.

Because *E* has assigned to *F* its rights to the fixed payments, but not its floating rate obligations under the notional principal contract, *F*'s payment to *E* is not a termination payment. The economic substance of the transaction between *E* and *F* is a loan that does not affect the way that *D* and *E* account for the notional principal contract.

[2] Character of Payments

Except in the case of a dealer, a notional principal contract will constitute a capital asset in the hands of the taxpayer.ⁿ¹ If the termination or assignment of the notional principal contract is, or is deemed to be, a sale or exchange, gain or loss resulting therefrom will be capital gain or loss.ⁿ² If not, the gain or loss will be an item of ordinary income or deduction.ⁿ³

The characterization is straightforward if the termination payment is an assignment, i.e., a transfer of the notional principal contract to a third party; the transfer should be treated as a sale or exchange producing capital treatment.ⁿ⁴ When the payment is from one of the original parties to another to extinguish the transaction, capital gain treatment comes from *IRC Section 1234A*, which provides that "gain or loss attributable to the cancellation, lapse, expiration, or other termination of (1) a right or obligation (other than a securities futures contract) 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."ⁿ⁵

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.446-3(h)(1)*.

(n2)Footnote 2. *Treas Reg § 1.446-3(h)(2)*.

(n3)Footnote 3. *Treas Reg § 1.446-3(h)(3)*. The rules relating to nonperiodic payments under notional principal contracts are discussed in §§ 9A.03[3] and 9A.04[4].

(n4)Footnote 4. *Treas Reg § 1.446-3(h)(4)*.

(n5)Footnote 5. *Treas Reg § 1.446-3(h)(5)Ex 1*.

(n6)Footnote 6. *Treas Reg § 1.446-3(h)(5)Ex 2*.

(n7)Footnote 7. *Treas Reg § 1.446-3(h)(5)Ex 3*.

(n8)Footnote 8. *Treas Reg § 1.446-3(h)(5)Ex 4*.

(n9)Footnote 1. *IRC § 1221*.

(n10)Footnote 2. *IRC § 1222*.

(n11)Footnote 3. See, eg, *Treas Reg § 1.1221-2(a)* (governing when payment part of a hedging transaction).

(n12)Footnote 4. *Foy v Commr*, 84 TC 50, 72 (1985) .

(n13)Footnote 5. Terminations taking place prior to September 4, 1997 came under *IRC § 1234A* only if the

property was personal property as defined in *IRC § 1092(d)(1)*, namely, personal property that was actively traded. Because of the active trading requirement, it is unclear whether extinguishments prior to the change in the law could give rise to capital gain or loss.



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CHAPTER 10 Short Sales

1-10 Taxation of Securities Transactions § 10.01

§ 10.01 Introduction

Traditionally, an investor achieves his profit on an investment by purchasing at one price and later selling at a higher price. This works well in a rising market, or when the price of the particular stock is on the rise. Other means of achieving investment gain must be found when the general or specific market is declining. This is the place for the short sale, the sale of stock or securities that the seller does not own.



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CHAPTER 10 Short Sales

1-10 Taxation of Securities Transactions § 10.02

§ 10.02 Gains and Losses on Short Sales

[1] The Basic Rules.

A short sale is a sale of securities that are not owned by the seller.ⁿ¹ As described in *Zlotnick v Tie Communications*,ⁿ²

"Short selling is accomplished by selling stock which the investor does not yet own; normally this is done by borrowing shares from a broker at an agreed upon fee or rate of interest. At this point the investor's commitment to the buyer of the stock is complete; the buyer has his shares and the short seller his purchase price. The short seller is obligated, however, however, to buy an equivalent number of shares in order to return the borrowed shares. In theory, the short seller makes this covering purchase using the funds he received from selling the borrowed stock. Herein lies the short seller's potential for profit: if the price of the stock declines after the short sale, he does not need all the funds to make his covering purchase; the short seller then pockets the difference. On the other hand, there is no limit to the short seller's potential loss: if the price of the stock rises, so too does the short seller's loss, and since there is no cap to a stock's price, there is no limitation on the short seller's risk. There is no time limit on this obligation to cover.

'Selling short,' therefore, actually involves two separate transactions: the short sale itself and the subsequent covering purchase."ⁿ³

In a "typical" short sale,ⁿ⁴ the short seller does not realize gain or loss as a result of a sale of borrowed securities, i.e., the first step in the transaction, for though the amount realized has been established, the short seller's cost will not be known until he delivers identical securities to the lender to replace those borrowed. For income tax purposes, a short sale is not deemed consummated until completion of the second step: delivery of the securities to close the short sale.ⁿ⁵ Gain or loss on the short sale is computed by subtracting the basis of the securities delivered from the amount realized on the sale of the borrowed securities. The character of the gain or loss is determined with reference to the securities delivered to close the sale: if the delivered securities were a capital asset in the hands of the taxpayer (i.e., an investor and not a dealer holding the securities primarily for sale to customers), *IRC Section 1233(a)* provides that the gain or loss will be considered gain or loss from the sale or exchange of a capital asset. The holding period (long or short term) is determined by the period during which the taxpayer held the securities delivered to close the short sale.ⁿ⁶

The tax consequences of a short sale to the lender of the securities, typically the short seller's broker, are determined by *IRC Section 1058*. In general, no gain or loss is recognized by the lender⁷ if the lending agreement meets all of the following requirements:⁸

- (1) It provides for the return to the transferor of securities identical to the securities transferred;⁹
- (2) It requires that payments shall be made to the transferor of amounts equivalent to all interest, dividends and other distributions which the owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the transferor and ending with the transfer of identical securities back to the transferor;¹⁰
- (3) It does not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred;¹¹
- (4) It meets such other requirements as the Secretary may by regulation prescribe.¹²

The nature of the borrower/short seller's obligation to the lender/broker was examined by the US Supreme Court in *Deputy v DuPont*.¹³ The Court held that the borrower's obligation is not "indebtedness," since that term's ordinary meaning only includes an obligation to return borrowed money, not borrowed property; hence, carrying charges paid by the borrower to the lender are not deductible as interest under *IRC Section 163*. By parity of reasoning, a short sale of stock by a tax-exempt organization does not give rise to debt-financed income within the meaning of *IRC Section 514*.¹⁴ On the other hand, the Internal Revenue Service has ruled that, while not indebtedness, the borrower's obligation is a liability which, if assumed by a corporation as part of a tax-free exchange, must be taken into account for purposes of *IRC Sections 357* and *358* in an amount equal to the original proceeds of the short sale.¹⁵ The Service similarly ruled that if the short seller/borrower is a partnership, its obligation is a liability that must be taken into account for purposes of computing a partner's outside basis under *IRC Section 752*, and in computing the amount realized on a sale or exchange of the partnership interest under *IRC Section 752(d)*.¹⁶

In *Kornman & Assoc v US*, the taxpayer argued that *Rev Rul 95-26* and *Rev Rul 95-45* were incorrectly decided because, while the short seller's obligation might be a liability, it is a *contingent* liability the ultimate amount of which cannot reasonably be ascertained until the replacement shares are purchased or otherwise identified and delivered to the lender. As such, the obligation cannot be measured for purposes of determining the amount realized on a sale of the partnership interest for purposes of *IRC Section 752(d)*, nor can it be included in the basis of a partnership interest. The Court of Appeals, while acknowledging the relevance of this observation, ultimately deferred to the reasoning of the Service's rulings. The short seller's liability, at least for purposes of determining gain or loss under *IRC §§ 357, 358* and *752* on the sale or exchange of stock, securities or a partnership interest, can reasonably be fixed at the amount realized by the short seller in the short sale. Adopting the taxpayer's position would endorse the result of the short sale "tax shelter" it had built, where by disregarding the short seller's liability entirely it was able to show \$102.6 million in short-term capital losses as a result of transactions in which the economic loss sustained by the taxpayer was only \$200,000. "We simply find that the Commissioner's desire to define the term 'liability' in a manner that prevents a taxpayer from deducting non-economic losses is imminently (*sic*) reasonable ... "¹⁷

[2] "Selling Short Against the Box": Constructive Sales and the Substantially Identical Property Rule.

The normal short sale contemplates the covering purchase as the taxpayer's first acquisition of the subject stock. However, the taxpayer may own substantially identical shares at the time of the short sale (commonly known as "selling short against the box") or may acquire such shares prior to the covering purchase and closing. Here, in effect, the taxpayer has "hedged his bet" by taking both a long position (represented by the substantially identical shares) and a short position in the same stock. If the rules governing ordinary short sales were likewise applicable to short sales

against the box, a taxpayer would have the ability to convert short-term into a long-term gain, or to realize both a long-term gain and a short-term loss, depending upon the flow of the market following the short sale.

To illustrate, suppose a taxpayer purchases stock at \$30 per share intending to hold his investment until the price reaches \$60 per share. If his investment goal is achieved more than one year after the initial purchase, the gain is long-term. But suppose the desired price is reached within one year. If the general short rule applied, the taxpayer could choose his tax consequences based on the subsequent flow of the market. If the price of the stock were to decline, he would wait until a point in time more than one year from the date of purchase of the original shares, and then use such shares to cover the short sale. Through use of the short sale, the taxpayer would transform short-term gain into long-term gain. If the market price increased, the taxpayer would close the short sale with newly purchased shares, thereby realizing a short-term loss. He would then secure a long-term gain on the sale of the original shares by delaying their disposition until he had held the shares for at least one year.

Before 1997, the only consequence of a short sale against the box was the application of *IRC Sections 1233(b) and 1233(d)*, discussed below. *IRC Section 1259*, added by the Taxpayer Relief Act of 1997, now treats a short sale against the box of stock, a debt instrument, or a partnership interest as a constructive sale requiring the taxpayer to recognize gain (but not loss) on the date of the short sale itself; the gain resulting from the constructive sale is taken into account in determining the amount of gain or loss subsequently realized with respect to the short sale.ⁿ¹ The new rule also treats the acquisition of substantially identical property after the short sale, but before the closing date, as a constructive sale taking place on the date of acquisition.ⁿ² A taxpayer is not treated as having made a constructive sale solely because the taxpayer enters into a contract for the sale of any stock, debt instrument or partnership that is not a marketable security if the contract is settled within one year after the date the contract is entered into.ⁿ³ It does not apply as well to:

(1) any position with respect to debt if:

- (a) the position unconditionally entitles the holder to receive a specified principal amount,
- (b) the interest payments with respect to the position are payable at a fixed rate (or to the extent provided in regulations, at a variable rate), and
- (c) the position is not convertible (directly or indirectly) into the stock of the issuer or any related person;

(2) any hedge with respect to a position just described; or

(3) any position that is marked to market under any provision of the Code or regulations.ⁿ⁴

A transaction that otherwise would cause a constructive sale is disregarded if:

- (1) the transaction is closed on or before the 30th day after the close of the taxable year;
- (2) the taxpayer holds the appreciated financial position throughout the 60-day period after the transaction is closed; and
- (3) at no time during the 60-day period is the taxpayer's risk of loss with respect to the position reduced because:
 - (a) the taxpayer has an option to sell, is under a contractual obligation to sell, or has made

(and not closed) a short sale of substantially identical stock or securities,

(b) the taxpayer is the grantor of an option to buy substantially identical stock or securities, or

(c) as prescribed by regulations, the taxpayer has diminished his risk of loss by holding one or more other positions with respect to substantially similar or related property.ⁿ⁵

If a transaction that is closed is reestablished in a position, the exception applies provided the reestablished position is closed on or before the 30th day after the close of the taxable year, and the 60-day holding period and lack of reduced risk requirements are met.ⁿ⁶

The constructive sale provision is generally effective for constructive sales entered into after June 8, 1997.ⁿ⁷ In the case of a decedent dying after June 8, 1997, if:

(1) a constructive sale occurred on or before that date;

(2) the short sale remained open for not less than two years, and was open at some time during the three-year period ending on the decedent's death; and

(3) the short sale was not closed by September 4, 1997,

the short sale and the constructive sale are treated as property constituting rights to receive an item of income in respect of a decedent.ⁿ⁸

IRC Sections 1233(b) and 1233(d) continue to apply to short sales against the box that are not treated as constructive sales under *IRC Section 1259*.ⁿ⁹ Under the former, any gain realized on the closing of a short sale will be short-term capital gain (even if stock held more than one year is used to close the sale), if on the date of the short sale, the taxpayer has held substantially identical property for less than one year, or if the taxpayer acquires substantially identical property between the date of the short sale and the date the sale is closed.ⁿ¹⁰ In addition, the holding period of the substantially identical property becomes tainted, for it is deemed to begin either on the date of closing of the short sale, or on the date of sale, gift, or other disposition of the shares, whichever occurs first.ⁿ¹¹ The special holding period provision is applied to substantially identical property in the order of its acquisition, and, then, only to the extent of the property sold short.ⁿ¹²

Example:

A taxpayer enters into the following transactions in a particular stock:

January 15, 2000-- Purchases 100 shares for \$1,000

February 15, 2001-- Purchases 100 shares for \$1,200

March 15, 2001-- Sells short 100 shares for \$1,400

September 15, 2001-- Covers the short sale by purchasing 100 shares for \$1,300

The taxpayer's gain will be taxed as short-term capital gain; he owned substantially identical property for less than one year at the time of the short sale. The holding period of the January 2000 shares will be deemed to begin on September 15, 2001 the date on which the short sale was closed. Since

the special holding period provision is inapplicable to substantially identical property in excess of the property sold short, the holding period of the February 2001 shares will be unaffected by the short sale.

IRC Section 1233(d) affects the character of any loss realized on a short sale by decreeing long-term treatment, if on the date of the short sale, the taxpayer has held substantially identical property for more than one year. The holding period of substantially identical property is unaffected when the transaction is governed solely by *IRC Section 1233(d)*. To illustrate:

Example 1:

A taxpayer enters into the following transactions with respect to a particular stock:

January 15, 2000--Purchases 100 shares for \$1,000
 March 15, 2000--Purchases 100 shares for \$1,200
 September 15, 2001--Sells short 100 shares for \$900
 October 15, 2001--Closes the short sale by delivering the shares purchased in January 2000
 November 15, 2001--Sells the remaining 100 shares for \$1,400

The loss of \$100 realized on the closing of the short sale is a long-term capital loss. On the date of the short sale, property substantially identical to that sold short had been held for more than one year. The \$200 gain realized in November 2001 is a long-term capital gain; the holding period of the March 2000 shares was not affected by the short sale.

Example 2:

Assume the same facts as in Example 1, except that the short sale takes place on August 1, 2000 rather than September 15, 2001. The loss realized on the closing of the short sale would still be a long-term capital loss under the rule prescribed by *IRC Section 1233(d)*. However, the gain realized in November would become a short-term capital gain because of the application of *IRC Section 1233(b)*; at the time of the short sale, the taxpayer had held substantially identical property (the shares purchased in March 2000) for less than one year.

In applying *IRC Sections 1233(b)* and *1233(d)*, it should be kept in mind that stock acquired on the exercise of a conversion privilege may take a holding period that includes the period of time that the convertible stock or security was held.ⁿ¹³ So, if a taxpayer purchases convertible preferred stock in March 2000, sells short shares of common stock in October 2001, converts the preferred into common in November 2001, and then closes the short sale at a gain by delivering the shares acquired on the conversion, the gain will be long-term. The holding period of the common will be deemed to have commenced in March 2000, more than one year prior to the short sale.

Under the regulations, property is to be considered substantially identical to other property "according to the facts and circumstances in each case."ⁿ¹⁴ In general, as applied to stocks and securities, the term has the same meaning as the term "substantially identical stock or securities" used in the wash-sale provision, *IRC Section 1091*.ⁿ¹⁵ Thus, stock or securities in one corporation are most often not substantially identical to those of another, but the stock or securities of predecessor and successor corporations in a reorganization may be. Likewise, bonds or preferred stock cannot be considered substantially identical to common stock of the same corporation. However, if the bonds or preferred stock contain a conversion privilege, the "facts and circumstances" may make them substantially identical to the common

stock.

In applying the short sale rules, a taxpayer and his spouse are looked upon as one taxpayer, unless separated by a decree of divorce or decree of separation.ⁿ¹⁶ Thus, a short sale by a husband at the time his wife owns substantially identical property will invoke the special rules of *IRC Section 1233(b)* and *1233(d)*.

[a] Options to Sell and the Substantially Identical Property Rule. We have seen that, in instances in which a short sale is not treated as a constructive sale, *IRC Section 1233(b)* makes it impossible for a taxpayer to convert short-term gain into long-term gain through the medium of a short sale. The same result could be achieved by acquiring an option to sell (a "put") exercisable after the originally acquired shares had been held for at least one year, and then exercising the option by delivering those shares to the optionee. However, *IRC Section 1233(b)* prevents this by treating the acquisition of the option as a short sale, and the exercise of the option, or its lapse, as the closing of the short sale. The rule has no application, and normal capital gains rules apply, if the option and the stock identified as intended to be used in exercising the option are acquired on the same day.ⁿ¹⁷ In such case, if the option is not exercised, its cost is added to the basis of the stock with which the option is identified.ⁿ¹⁸ Furthermore, since the rule announced by *IRC Section 1233(b)* is made applicable only for the purposes of that subsection, it has no effect when the short sale transaction produces a loss.

[b] Arbitrage Operations. The special holding period rule of *IRC Section 1233(b)(2)* is limited when the short sale is entered into as an arbitrage operation, that is, a transaction involving the purchase and sale of stock and securities, or the rights to acquire stock and securities, for the purpose of profiting from a current difference between the price of the asset purchased and the price of the asset sold.ⁿ¹⁹ A transaction qualifies as an arbitrage operation only if the taxpayer identifies the transaction as such on his records as soon as he is able to do so, ordinarily the day of the transaction.ⁿ²⁰ Under *IRC Section 1233(f)(1)*, the rule applies first to substantially identical property acquired for arbitrage operations and held by the taxpayer at the close of business on the day the short sale is made.ⁿ²¹ For this purpose, only property acquired in a transaction properly identified as an arbitrage operation will be deemed acquired for an arbitrage operation.ⁿ²² The holding period of substantially identical property not acquired for arbitrage operations will be affected only to the extent that the amount of property sold short exceeds the amount of substantially identical property acquired for arbitrage operations and held by the taxpayer at the close of business on the day of the short sale. The following example illustrates the operation of *IRC Section 1233(f)(1)*:

Example:

On January 1, a taxpayer acquires 100 shares of convertible preferred stock of X Corporation. The stock is convertible into common stock of X Corporation on a one-for-one basis. On May 1, the taxpayer sells short 100 shares of X Corporation common stock in a transaction intended to be part of an arbitrage operation. On the same day, and as part of the same arbitrage operation, the taxpayer purchases an additional 100 shares of convertible preferred stock. The short sale is closed on June 1 by the purchase and delivery of 100 shares of common stock purchased on that day. Since acquired for arbitrage purposes and held at the close of business on the day of the short sale, the holding period of the preferred stock acquired on May 1 is deemed to commence on June 1, the date the short sale was closed. The holding period of the preferred stock acquired on January 1 will be unaffected; the number of shares sold short does not exceed the number of shares acquired for arbitrage operations. The January stock would similarly be unaffected if the taxpayer converted the May preferred into common stock and used that stock to cover the short sale.

Suppose the taxpayer does not close the short sale, but instead disposes of the assets acquired as part of the arbitrage operation. If the disposition creates a net short position in arbitrage assets, a short sale is deemed to have been made on the date the net short position is created.ⁿ²³ This, in turn, causes a tainting of the holding period of substantially identical property not acquired for arbitrage purposes to the extent that the short sale is deemed so made.ⁿ²⁴ Thus, if in the last example, the taxpayer sold the preferred shares on June 1 without closing the short sale, he would be considered

as having made a short sale on that date. Accordingly, since the preferred shares purchased in January were acquired less than one year prior to the time of the short sale, their holding period would be affected by *IRC Section 1233(b)(2)*, and would not commence until the closing of the short sale or earlier disposition of the shares.

[3] Property That Becomes Substantially Worthless.

If a taxpayer enters into a short sale of property, and the property becomes substantially worthless, the taxpayer must recognize gain in the same manner as if the short sale were closed when the property becomes substantially worthless.ⁿ¹ The statute of limitations with respect to such gain recognition is extended to the earlier of three years after the Service is notified that the position has become substantially worthless, or six years after the filing of the tax return for the year during which the position became substantially worthless.ⁿ²

FOOTNOTES:

(n1)Footnote 1. *Provost v US*, 269 US 443 (1926) .

(n2)Footnote 2. 836 F2d 818, 820 (3d Cir 1988) .

(n3)Footnote 3. See *Kornman & Assoc v US*, 527 F3d 443, 450 (5th Cir 2008) ; *Marriott Int'l Resorts, LP v US*, 83 Fed Cl 291, 297-298 (2008) .

(n4)Footnote 4. For purposes of this section, it is assumed that at the time of the short sale the short seller does not own securities that are substantially identical to those borrowed; the covering purchase is thus the investor's first acquisition of the subject securities. It is not unusual, however, for an investor to "lock in" a gain on a long position in a given stock by selling the same stock short in anticipation of a declining market. Special tax rules apply in such a case, as discussed in the next section.

(n5)Footnote 5. *Treas Reg § 1.1233-1(a)(1)*. The short sale remains "open" as long as the short seller has an obligation to replace the borrowed securities, even if that obligation is transferred to a person other than the original lender. See *Rev Rul 2004-15, 2004-1 CB 515* (short sale not consummated, and no gain or loss recognized, when the taxpayer, having borrowed securities from Broker A to make a short sale, borrows substantially identical securities from Broker B to satisfy her obligation to Broker A.) See also *Rev Rul 2003-31, 2003-1 CB 643* (change in the terms of short seller's margin account is not a delivery of the stock which closes a short sale).

(n6)Footnote 6. *Treas Reg § 1.1233-1(a)(3)*. In the typical case under discussion, in which the taxpayer's first acquisition of the securities sold short occurs just prior to closing by delivery of the shares to the lender/broker, an investor will have short-term capital gain or loss as a result of the short sale transaction, regardless of the length of time between the short sale and the closing date.

(n7)Footnote 7. If *IRC § 1058* applies, "the lender will not recognize gain or loss on the exchange of the securities for the obligation of the borrower under the [securities lending] agreement nor will the lender recognize gain or loss on the exchange of the rights under such agreement in return for securities identical to the securities transferred by the lender." *Prop Treas Reg § 1.1058-1(a)*.

(n8)Footnote 8. *IRC § 1058(b)*.

(n9)Footnote 9. The definition of "securities" in *IRC § 1236(c)* applies for purposes of *IRC § 1058*; "any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing." See *IRC § 1058(a)*. "Identical securities" means securities of the same class and issue as the securities lent to the borrower. *Prop Treas Reg § 1.1058-1(b)(1)*. *Prop Treas Reg § 1.1058-1(b)(1)* also permits the borrower to return "equivalent securities" to the lender in the event of a recapitalization, reorganization or merger of the issuer during the term of the loan if the agreement so provides.

(n10)Footnote 10. Substitute payments made by an investor/borrower to the broker/lender in lieu of dividends, interest and other distributions are considered fees paid for the temporary use of the securities. *Prop Treas Reg § 1.1058-1(d)*. Thus, payments made in lieu of dividends are not considered dividends for purposes of the dividends received deduction, *IRC § 243*, or for purposes of qualifying for taxation at long-term capital gain rates under *IRC § 1(h)*. See *Prop Treas Reg § 1.1058-1(d)*; *Rev Rul 60-177, 1960-1 CB 9*. Similarly, payments made by a borrower to a lender in lieu of interest on a municipal bond are not tax-exempt in the hands of the lender under *IRC § 103*. *Rev Rul 80-135, 1980-1 CB 18*. All such substitute payments are taken into account by the lender as ordinary income. *Prop Treas Reg § 1.1058-1(d)*.

Substitute payments are deductible by investor/borrowers under *IRC § 212* if they are individuals. See *Rev Rul 72-521, 1972-2 CB 178*. Corporate short sellers, however, may deduct such payments only if they are traders or dealers with respect to the securities sold short. See § 19.05[2].

(n11)Footnote 11. In *Samueli v Commr, 132 TC 37 (2009)*, the Tax Court held that a securities lending agreement did not qualify under *IRC § 1058* because it reduced the lenders' opportunity for gain. The agreement did so by providing, contrary to normal commercial practice, that the lenders could only terminate the loan of the securities on one of three days of an approximate 450-day transaction period, thus "limit[ing] the [lenders'] ability to sell the Securities at any time that the possibility for a profitable sale arose." *Samueli v Commr, 132 TC N at pp 18-19*. Cf *IRC §§ 512(b) and 512(a)(5)(B)* (excluding "payments with respect to securities loans" from the unrelated business taxable income of certain tax-exempt organizations provided the lending agreement provides for (i) reasonable procedures to implement the obligation of the transferee to furnish to the transferor, for each business day during such period, collateral with a fair market value not less than the fair market value of the security, (ii) termination of the loan by the transferor upon notice of not more than 5 business days, and (iii) return to the transferor of securities identical to the transferred securities upon termination of the loan."

(n12)Footnote 12. Treasury has not prescribed additional requirements, but in proposed regulations has provided that in the event the borrower defaults under an agreement meeting the requirements of *IRC § 1058*, whether by failing to return to the lender securities identical to the securities transferred or otherwise, gain or loss is recognized to the lender on the day the borrower fails to return identical securities as required by the agreement, or otherwise defaults under the agreement. *Prop Treas Reg § 1.1058-1(e)*. However, in *Rev Proc 2008-63, 2008-2 CB 946*, one of a series of extraordinary pronouncements made by the Internal Revenue Service in the wake of the "financial meltdown" of mid-2008, see Elliott, "Year in Review: Treasury Provides Certainty and Relief in Economic Crisis," *122 Tax Notes* 47 (Jan. 5, 2009), the Service created an exception in cases where the borrower's default is a direct or indirect result of its bankruptcy, or the bankruptcy of an affiliate. In the case of such a bankruptcy-caused default, and assuming the lending agreement meets the requirements of *IRC § 1058* and requires the borrower to transfer collateral to secure the borrower's obligations under the agreement, *IRC § 1058* will continue to apply and prevent gain or loss recognition provided that, as soon as is commercially practical after the default (but in no event more than 30 days following the default) the lender applies the borrower's collateral (or cash generated by the sale of such collateral) to the purchase of identical securities.

(n13)Footnote 13. *308 US 488 (1940)*.

(n14)Footnote 14. *Rev Rul 95-8, 1995-1 CB 53*.

(n15)Footnote 15. *Rev Rul 95-45, 1995-1 CB 53*.

(n16)Footnote 16. *Rev Rul 95-26, 1995-1 CB 131*

(n17)Footnote 17. *Kornman & Assoc v US, 527 F3d 443, 455 fn 11*. Accord: *Marriott Int'l Resorts, LP v US, 83 Fed Cl 291 (2008)*.

(n18)Footnote 1. *IRC § 1259(a)(1), (2), (c)(1)(A)*. The Code calls the transaction the constructive sale of an appreciated financial position, defined as any position with respect to any stock, debt instrument, or partnership interest if there would be gain were the position sold, assigned, or otherwise terminated at its fair market value. *IRC § 1259(b)(1)*. A position is an interest including a futures or forward contract, short sale, or option. *IRC § 1259(b)(3)*. A forward contract is a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price. *IRC § 1259(d)(1)*.

An interest in a trust that is actively traded is treated as stock unless substantially all (by value) of the property is debt that is not an appreciated financial position. *IRC § 1259(e)(2)*.

A shareholder is not treated as having entered into a constructive sale under *IRC § 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 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. *Rev Rul 2003-7, 2003-1 CB 363*. In the ruling, the shareholder retained the right to vote the pledged shares and to receive dividends. The transaction involved in the ruling was a variable prepaid forward contract. At issue, in *Ltr Rul 200604033*, was whether there was a current sale of shares when the taxpayer placed the shares in a pledge account for the benefit of the counterparty who was given all incidents of ownership of the shares. The Service ruled that beneficial ownership of the shares had been transferred so that gain could not be deferred.

(n19)Footnote 2. *IRC § 1259(c)(1)(D)*.

(n20)Footnote 3. *IRC § 1259(c)(2)*, The definition of marketable security is contained in *IRC § 453(f)*.

(n21)Footnote 4. *IRC § 1259(b)(2)*. The requirements relating to interest payments on debt instruments are set forth in *IRC § 860G(a)(1)(B)(i)*.

A person is related to another person with respect to a transaction if the relationship is described in *IRC § 267(b)* or *707(b)*, and the transaction is entered into with a view toward avoiding the purposes of *IRC § 1259*. *IRC § 1259(c)(4)*.

(n22)Footnote 5. *IRC § 1259(c)(3)(A)*. The reduced risk circumstances are prescribed by *IRC § 246(c)(4)*.

(n23)Footnote 6. *IRC § 1259(c)(3)(B)*.

The interaction between *IRC § 1259(c)(3)(A)* and *1259(c)(3)(B)* is described in *Rev Rul 2003-1, 2003-1 CB 291*.

(n24)Footnote 7. Taxpayer Relief Act of 1997, § 1001(d)(1).

(n25)Footnote 8. *Id*, § 1001(d)(3). *IRC § 1014(c)*, relating to the basis of an item of income in respect of a decedent, does not apply to so much of the position's or property's value (as included in the decedent's estate for estate tax purposes) as exceeds its fair market value as of the date the transaction is closed.

(n26)Footnote 9. *IRC § 1233(e)(2)(A)* limits the effect of *IRC § 1233(b)* and *(d)* to short sales of stock and securities (including those traded on a "when issued" basis) and commodity futures (other than certain straddles in commodities futures), which are capital assets in the hands of the taxpayer. Furthermore, the character of gain or loss of any quantity of property in excess of the substantially identical property is unaffected by those sections.

(n27)Footnote 10. *IRC § 1233(b)(1)*.

(n28)Footnote 11. *IRC § 1233(b)(2)*.

(n29)Footnote 12. *IRC § 1233(e)(1)*.

(n30)Footnote 13. See Ch 8.

(n31)Footnote 14. *Treas Reg § 1.1233-1(d)(1)*. A securities futures contract to acquire substantially identical property is treated as substantially identical property. *IRC § 1233(e)(2)(D)*.

(n32)Footnote 15. *Treas Reg § 1.1233-1(d)(1)*. See Ch 2.

(n33)Footnote 16. *IRC § 1233(e)(2)(C)*.

(n34)Footnote 17. *IRC § 1233(c)*.

(n35)Footnote 18. *IRC § 1233(c)*.

(n36)Footnote 19. *IRC § 1233(f)(4)*.

(n37)Footnote 20. *Treas Reg § 1.1233-1(f)(2)*.

(n38)Footnote 21. The taxpayer is deemed to hold property at the close of any business day if he is entitled to acquire the property by virtue of any other asset acquired for arbitrage operations, or by virtue of any contract acquired in an arbitrage operation. *IRC § 1233(f)(3)*.

(n39)Footnote 22. *Treas Reg § 1.1233-1(f)(2)*.

(n40)Footnote 23. *IRC § 1233(f)(2)*.

(n41)Footnote 24. *Treas Reg § 1.1233-1(f)(1)(ii)*.

(n42)Footnote 1. *IRC § 1233(h)(1)*. To the extent provided in regulations similar gain recognition rules will apply to any option with respect to property, any offsetting notional principal contract with respect to property, any futures or forward contract to deliver property, or any other similar transaction.

(n43)Footnote 2. *IRC § 1233(h)(2)*.



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CHAPTER 11 "When Issued" Securities

1-11 Taxation of Securities Transactions 11.syn

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Taxation of Securities Transactions

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CHAPTER 11 "When Issued" Securities

1-11 Taxation of Securities Transactions § 11.01

§ 11.01 Introduction

Judicial or regulatory agency approval may be required before a plan of corporate reorganization, calling for the issuance of new securities in exchange for then outstanding securities of the corporation, becomes effective. The time interval between submission of the plan and its ultimate approval or denial may run to several years. In the interim, trading in the securities to be issued under the plan may be commenced on a "when issued" basis. Since the new securities are not in existence, and will never come into existence if the plan fails, the trading vehicle is the "when issued" contract.

This chapter will be concerned with the tax consequences which attend transactions in "when issued" contracts, as well as those which arise when the plan is approved and the new securities are issued, or when the plan is disapproved and the contracts become valueless.



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Taxation of Securities Transactions

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CHAPTER 11 "When Issued" Securities

1-11 Taxation of Securities Transactions § 11.02

§ 11.02 Transactions in "When Issued" Securities

To properly understand the tax consequences of dealing in securities on a "when issued" basis, one must first understand the nature of the transaction. In holding that a delivery of old outstanding stock of a corporation did not constitute performance of a contract to sell "when issued" stock, the Board of Tax Appeals stated:

"Dealings in stock on a 'when issued' basis are not sales of stock, but merely sales of contracts to sell stock which are made on the express condition that no delivery and payment are required unless and until the stock is issued ... Unless and until the stock is issued, no performance is required and if the stock is never issued the contract falls by its own terms. ..."¹

Clearly then, the actual sale of the security takes place only after it is issued. While it is traded on a "when issued" basis, the transactions are in contracts to buy and sell the security, and not in the security itself.

[1] Transactions in "When Issued" Securities by an Owner of Securities in the Reorganized Corporation

Should an owner of outstanding securities in the corporation in reorganization continue to hold the securities until the plan or reorganization is approved, he would become entitled to the new securities to be issued pursuant to the plan. If he were to sell the new securities on a "when issued" basis, the quantum and character of the gain or loss realized on the disposition would depend upon the nature of the reorganization, that is, whether taxable or tax-free.

If the posture of the reorganization is such that it gives rise to a taxable transaction, gain or loss will be realized and recognized to the extent of the difference between the basis of the old securities and the value of the new.² The new shares will assume a basis equal to their value at the time of the exchange, so that any gain or loss realized on a "when issued" sale of the new securities will be measured by the difference between such basis and the agreed upon sales price. If, as is usually the case, the transaction is completed within a relatively short time after the new securities are issued, the gain or loss on their sale will be short-term;³ the holding period of the new securities begins with acquisition.

If the reorganization is of a type afforded nonrecognition treatment by the Code, the new securities take a basis equal to the adjusted basis of the old, making the gain or loss which results from the "when issued" transaction dependent upon the basis of the old securities.⁴ In determining whether the gain or loss is long- or short-term, the period of time the old

securities were held must be added to the holding period of the new.ⁿ⁵

Suppose, however, the taxpayer finds it advantageous to assign his contract to sell "when issued" securities prior to the date of issuance of the new securities. The assignee may be another holder of outstanding securities, or, perhaps, the owner of a contract to buy "when issued" securities. In this case, the taxpayer's gain or loss will be determined, not by reference to his basis in the old securities (that basis will continue to attach to the old securities which the taxpayer still holds), but by computing the difference between his basis in the contract to sell and the consideration received for the assignment.ⁿ⁶ Since the executory contract to sell probably cost the taxpayer nothing, his basis in the contract will be zero,ⁿ⁷ giving him a gain equal to the amount realized on the assignment. His gain will be capital gain, for the contract itself is a capital asset.ⁿ⁸ The gain will be long-term gain if the contract was entered into more than one year prior to its disposition, and short-term, if the contract was held for one year or less.

Finally, the taxpayer may find that his investment objectives dictate retention of the new stock. In order to complete his obligation under the contract to sell, the taxpayer would be required to enter into a contract to buy the subject securities, placing him in the same position as one who did not originally own securities in the reorganized corporation.

[2] Transactions in "When Issued" Securities by a Person Owning No Securities in the Reorganized Corporation

[a] The Basic Rules. Suppose that stock in a corporation in reorganization is selling on a "when issued" basis at \$50 a share. A taxpayer, not an owner of outstanding stock in the reorganized corporation, believing that the price will increase, enters into a contract to buy shares of stock "when issued" at \$50 a share. The price of the stock does, in fact, increase to \$65 a share. If the taxpayer desires to obtain the benefit of the increase, he may (1) dispose of his buy contract at a stated consideration, (2) enter into a contract to sell "when issued" stock, or (3) enter into a contract to sell "when issued" stock and then dispose of both the contract to buy and the contract to sell.

In the first case, the disposition will produce a capital gain, includable in income in the year of disposition,ⁿ⁹ equal to the difference between the taxpayer's basis in the contract and the consideration received by him.ⁿ¹⁰ The gain will be long-term if the interval between the date of contract and the date of assignment is more than one year; otherwise, the gain will be short-term.

Although the taxpayer seals the amount of his gain by his agreement to sell the shares "when issued," he realizes no gain unless and until the reorganization is consummated and the shares are issued.ⁿ¹¹ His acquisition of the newly issued shares pursuant to the buy contract commences the holding period of the stock; his disposition of the shares under the sell contract is the taxable event which ends the holding period and gives rise to the realization of gain.ⁿ¹² Since performance under the contract to sell will, no doubt, come soon after receipt of the shares, the realized gain will be short-term gain.ⁿ¹³

Even though a taxpayer, who holds a contract to buy 100 shares of stock "when issued" at \$50 a share and a contract to sell that stock at \$65 a share, has fixed his potential gain at \$1,500, he has not insured actual realization of the gain--the plan of reorganization may never become operative. For this reason, the taxpayer may decide to convert a contingent future profit into a present realized gain by disposing of both the buy contract and the sell contract for, say, \$1,200. It is clear that if the contracts were acquired at no cost to the taxpayer he has realized an economic gain of \$1,200. However, the tax consequences of the transaction are not so simply resolved.

Of utmost importance is the fact that each of the contracts is considered a separate capital asset, so that the assignment of both contracts in a single transaction is, in reality, two dispositions.ⁿ¹⁴ Accordingly, if a single consideration is received for the dual assignment, it becomes necessary to determine the amount paid for the transfer of each contract in order to determine the gain or loss realized on the disposition of each contract. If the parties to the transaction have themselves stated the consideration allocable to each contract, the stated consideration will be accepted as correct,

unless patently arbitrary or unreasonable.¹⁵ If, as is usually the case, the parties fail to allocate consideration, the amount paid for each contract is determined by apportioning the total consideration on the basis of the value of each contract on the date of disposition.¹⁶

Since, in general, "when issued" stock has an established market value, changes in the price of such stock will cause consequent changes in the value of contracts to buy and sell the stock. Therefore, at any one time, the consideration received for the assignment of both a buy and a sell contract may be attributable solely to the value of the buy contract or to the value of the sell contract, or proportionately to the value of each of the contracts. Clearly, if the consideration is represented by the value of only one of the contracts, the other is, in essence, a liability. Looking at it in another way, the net amount realized represents the value of the valuable contract less an amount attributable to the assignee's assumption of the liability.¹⁷

The foregoing principles may be illustrated by the following examples:

Example 1:

On January 1, a taxpayer enters into a contract to purchase one hundred shares of X Corp. stock "when issued" at \$50 a share. On March 15, he enters into a contract to sell X Corp. stock "when issued" at \$65 a share. Four months later, on July 15, when X Corp. stock is selling on a "when issued" basis at \$70 a share, the taxpayer assigns both contracts for \$1,200. The buy contract has a presumed value of \$2,000 (\$20 a share) since the assignee can enter into a contract to sell X Corp. stock "when issued" at \$70 a share. For the same reason, the taxpayer's contract to sell "when issued" stock at \$65 a share is a liability in the hands of the assignee. The taxpayer will be considered as having sold his buy contract for the fair market value thereof, giving him a short-term capital gain of \$2,000. Disposition of the sell contract will produce a short-term capital loss of \$800, the difference between the fair market value of the buy contract, \$2,000, and the amount received for the assignment, \$1,200. The gain and loss are short-term because the contracts were not held for more than six months.

Example 2:

The facts are the same as those in Example 1, except that when the transfer takes place on July 15, the stock of X Corp. is selling on a "when issued" basis at \$40 a share. Now the sell contract is valuable, and the buy contract, a liability. The value of the contract to sell is \$2,500 (\$25 a share), measured by the difference between the selling price set forth in the contract and the prevailing market price of the "when issued" stock. (It is assumed that the assignee could go into the market and enter into a contract to buy at \$40 a share.) The taxpayer now realizes a short-term capital gain of \$2,500 on his disposition of a capital asset held less than one year. His loss on the disposition of the contract to buy is a short-term loss of \$1,300, the difference between \$2,500, the value of the sell contract, and \$1,200, the consideration received for the assignment.

Example 3:

Again the facts are the same as before, except that when the transfer takes place on July 15, the stock is selling on a "when issued" basis at \$55 a share. In this instance, both the buy contract and the sell contract are valuable. The buy contract is worth \$500; the assignee can enter into a contract to sell at \$55 a share and achieve a \$500 profit. The contract to sell has a value of \$1,000, the profit to be realized if the transferee enters into a contract to purchase "when issued" shares at \$55 a share. The consideration received must, therefore, be allocated between the two contracts. This is done by multiplying the consideration received by the proportion which the value of each contract bears to the total value of both contracts. Thus, the amount realized on the buy contract is:

500

_____ x\$1,200 = \$400

 —
 1,500

while the consideration attributable to the disposition of the sell contract is:

1,000
 _____ x _____ \$1,200 =
 _____ \$800

 —
 1,500

This produces a double gain--a short-term gain of \$400 on the transfer of the buy contract, and a long-term gain of \$800 on the assignment of the contract to sell.

Suppose that the taxpayer is of the opinion that stock selling on a "when issued" basis at \$50 a share will decline in value. If he seeks to turn a profit on the decrease in price of the stock, the taxpayer must first enter into a contract to sell stock "when issued" at \$50 a share. If the stock price falls to \$40 a share, the taxpayer has a potential profit of \$10 a share. To obtain the benefit of this potential profit, he must either dispose of the sell contract for a stated consideration, enter into a contract to buy "when issued" stock at the lower price and hold both contracts until the reorganization is consummated, or enter into the buy contract and then dispose of both contracts. It should be obvious that, except for the order of contracting, the taxpayer has the same options as one who foresees an increase in price and acts accordingly. Consequently, the tax consequences just discussed apply with equal force here.

[b] Variations on the Basic Theme

[i] Paying Another to Assume a "When Issued" Contract Obligation. Assume that *A*, who owns no shares in the corporation in reorganization, believes that the price of the corporation's "when issued" stock, currently traded at \$50 a share, will increase, and, accordingly, enters into a contract to buy 100 shares "when issued" at \$50 a share. Within three months the price has dropped to \$25 a share. In order to prevent any further loss, *A* pays *B* \$2,000 to assume the former's obligations under the buy contract. *A* has a short term capital loss of \$2,000; he held the buy contract for less than one year.¹⁸ The same rule would apply if *A* had originally entered into a contract to sell, the price of the corporation's "when issued" stock increased, and *A* paid *B* a sum of money to be relieved of this obligation under the sell contract.

[ii] Receiving an Amount to Assume the "When Issued" Contract Obligation of Another. In the last example, *B* received \$2,000 in consideration of his assumption of *A*'s obligation under a buy contract. While at first blush it would appear that the receipt of this sum gives rise to ordinary taxable income in the year of receipt, such is not the case. The amount received is a factor to be taken into consideration in fixing the amount of gain or loss realized when *B* performs his obligation under the contract, or when it becomes definite that the reorganization will not be consummated.¹⁹ For example, if *B* were subsequently to enter into a contract to sell 100 shares of stock "when issued" at \$28 a share, and the plan of reorganization were to become operative, *B* would ultimately realize a \$200 loss, arrived at by comparing the total amount realized of \$4,800 (\$2,800, the amount received under the sell contract, plus the \$2,000 received from *A*) with the amount paid for the stock, \$5,000. Whether the loss is long-term or short-term depends on the length of time *B* holds the stock before delivering it in satisfaction of his obligation under the sell

contract.

If the reorganization is not consummated, the \$2,000 received from *A* will constitute ordinary income to *B* in the year that it is established that the reorganization will not become operative.ⁿ²⁰

[iii] Conditional Assignments of "When Issued" Contracts. A taxpayer, who assigns a buy or sell contract to another for a stated consideration but agrees to refund the amount received for the assignment to the assignee if the reorganization is not consummated, realizes no income until the reorganization is approved. This rule is premised on the theory that the disposition is not final until it is certain that the reorganization will in fact occur. Thus, the taxpayer's holding period for the contract will not end with its assignment, but will continue until the sale is deemed final.ⁿ²¹

Since the taxpayer is not required to take the amount realized on the transfer of the contract into income unless and until the reorganization is consummated, his refund of the consideration to the assignee, in the event the reorganization fails, does not result in the realization of a loss for tax purposes. Of course, if the taxpayer had a basis in the contract other than zero (as would be the case if he had purchased the contract from another), he would realize a loss equal to his basis when it is established the reorganization will not be accomplished.

[iv] Satisfying a "When Issued" Contract Obligation by the Assignment of a Corresponding Contract. Suppose that *A*, an individual owning no stock in the corporation in reorganization, enters into a contract to sell *B* 100 shares of the corporation's stock "when issued" at \$50 a share. If *A* were the holder of a buy contract, he could satisfy his obligation to *B* by assigning the buy contract to *B*. The tax consequences of the assignment will be affected by the manner in which *A* acquired the buy contract and the consideration which he receives for its assignment.

For example, suppose that at no cost to him, *A* had acquired a contract to buy "when issued" stock at \$40 a share. If *B* was willing to accept an assignment of the buy contract in full satisfaction of *A*'s obligation to *B* under the sell contract, and if *B* paid *A* \$800 for the assignment, *A* would realize a gain of \$800. Whether the gain is long-term or short-term would depend on the length of time that *A* held the buy contract.

If *A* had purchased the buy contract from another, his gain or loss would be measured by the extent to which the consideration received from *B* on the assignment exceeded the amount paid by *A* to acquire the contract. To illustrate, suppose that following the execution of the sell contract the price of the stock increased rapidly to \$70 a share, so that the contract became a liability in *A*'s hands. *A* finds that *C*, the holder of a contract to buy "when issued" shares at \$50 a share, is willing to sell the contract for \$1,500. *A* acquires the contract and assigns it to *B* in satisfaction of his obligation under the sell contract. Assuming that *A* receives nothing for the assignment, he will realize a \$1,500 capital loss on his transfer of the buy contract to *B*. Once again the length of time that *A* held the buy contract will determine whether the loss is long-term or short-term.ⁿ²²

[v] Worthless "When Issued" Contracts. If the plan of reorganization is not approved, all "when issued" contracts, by their nature, become worthless. A taxpayer who acquired his contract at no cost to him will obviously suffer no loss for tax purposes.ⁿ²³ One who has paid a consideration for the acquisition of a "when issued" contract does have a loss which he may claim as an offset against ordinary income. The loss cannot be a capital loss; the requisite sale or exchange is missing.ⁿ²⁴

[3] Wash Sales of "When Issued" Securities

It will be remembered that the wash sale rules disallow a loss sustained on the disposition of stock or securities if the taxpayer acquires substantially identical stock or securities within thirty days of the sale.ⁿ²⁵ Since a sale of "when issued" securities is deemed made only when the new stock is issued, any loss realized on the transaction will be disallowed if the taxpayer acquires additional new shares through ownership of old shares of the corporation, ownership of buy contracts, or purchase on the open market.ⁿ²⁶

The foregoing may be illustrated by the case of the taxpayer who holds a contract to buy 200 shares of stock "when issued" at \$25 a share and a contract to sell 100 shares of the same stock "when issued" at \$20 a share. Settlement of the buy and sell contracts will result in the acquisition by the taxpayer of 200 shares of stock and his sale at a loss of 100 shares. If the acquisition of the additional 100 shares is accomplished within the prescribed period, the provisions of *IRC Section 1091(a)* will become operative and disallow the loss, unless the sale can be considered the bona fide reduction of a larger holding.ⁿ²⁷

[4] Short Sales and "When Issued" Securities

It was indicated in Chapter 10, that a gain realized on a short sale transaction will be considered a short-term capital gain whenever property substantially identical to that sold short has been held by the taxpayer for less than one year, or is acquired by him prior to the closing of the short sale.ⁿ²⁸ Another provision makes any loss realized on a short sale transaction a long-term loss, if on the date of the short sale the taxpayer has held substantially identical property for more than one year.ⁿ²⁹

Of importance here is the fact that stock and securities dealt with on a "when issued" basis are considered property for the purposes of the special gain and loss provisions of *IRC Section 1223*.ⁿ³⁰ So, if stock or securities traded on a "when issued" basis can be considered substantially identical to outstanding stock or securities in the corporation in reorganization, a short sale of "when issued" stock at a time when the taxpayer holds outstanding stock of the corporation may cause the special short sale rules to apply. Here, as in all short sales, determining whether the properties are substantially identical calls for consideration of all of the facts and circumstances in the case.ⁿ³¹

[5] Identification Problems

Suppose the taxpayer, having acquired 500 shares on the consummation of the reorganization, disposes of 200 of the shares. The taxpayer faces no difficulty in ascertaining the basis and holding period of the transferred shares if (1) they were acquired by reason of his ownership of old shares, and the reorganization was a taxable reorganization,ⁿ³² (2) they were acquired by reason of his ownership of old shares, the reorganization was nontaxable, and the taxpayer acquired his original shares in a single lot, or (3) the shares were acquired pursuant to a single buy contract. Where, however, the old shares were obtained on different days at different prices, and the reorganization is tax-free so that the new shares take a substituted basis and "tacked" holding period, or where the new shares were acquired under a number of buy contracts, the taxpayer is presented with the problem of identifying the securities sold. Unless he can adequately do so, he will be forced to match the sales against the earliest acquired old shares, or the shares acquired pursuant to the earliest acquired buy contract, as the case may be.ⁿ³³

FOOTNOTES:

(n1)Footnote 1. *Walker v Commr*, 35 BTA 640, 645 (1937), acq., 1938-1 CB 32 .

(n2)Footnote 2. *IRC § 1001(a)*.

(n3)Footnote 3. The gain will be capital gain if the old securities were capital assets in the hands of the taxpayers. *IRC § 1222*.

(n4)Footnote 4. *IRC § 358(a)*.

(n5)Footnote 5. *IRC § 1223(2)*.

(n6)Footnote 6. IT 3721, 1945 CB 164 .

(n7)Footnote 7. *Rev Rul 57-29*, 1957-1 CB 519 .

(n8)Footnote 8. IT 3721, 1945 CB 164 .

(n9)Footnote 9. IT 3721, 1945 CB 164 .

(n10)Footnote 10. *Id.*

(n11)Footnote 11. *Walker v Commr*, 35 BTA 640 (1937) , *acq.*, 1938-1 CB 32 . IT 3721, 1945 CB 164 .

(n12)Footnote 12. The basis of the stock will be the price paid therefor, plus any amount paid by the taxpayer to acquire either the buy contract or sell contract.

(n13)Footnote 13. *Shanis v Commr*, 19 TC 641 (1953), *acq* 1954-2 CB 5, *affd* 213 F2d 151 (3d Cir 1954).

(n14)Footnote 14. IT 3721 , N 6 *supra*.

(n15)Footnote 15. *Id.*

(n16)Footnote 16. *Id.*

(n17)Footnote 17. *Id.*

(n18)Footnote 18. IT 3721 , N 6 *supra*, at 170-172.

(n19)Footnote 19. *Id.*

(n20)Footnote 20. *Id.*

(n21)Footnote 21. IT 3721 , N 6 *supra*, at 172-173.

(n22)Footnote 22. IT 3721 , N 6 *supra*, at 173.

(n23)Footnote 23. The taxpayer has no basis in the contract. *Rev Rul* 57-29 , N 7 *supra*. The taxpayer would be entitled to deduct any expenses incurred, such as broker's commissions.

(n24)Footnote 24. *IRC* § 1222. *IRC* § 165(g) cannot provide the missing element since the contract is not a "security" as defined in that subsection.

(n25)Footnote 25. See § 2.07[3][a] *supra*.

(n26)Footnote 26. IT 3858, 1947-2 CB 71.

(n27)Footnote 27. *Rev Rul* 56-502, 1956-2 CB 527 , discussed in § 2.07[3][b][i] *supra*.

(n28)Footnote 28. *IRC* § 1233(b)(1); see § 10.02[1] *supra*.

(n29)Footnote 29. *IRC* § 1233(d).

(n30)Footnote 30. *IRC* § 1233(e)(2)(A).

(n31)Footnote 31. *Treas Reg* § 1.1233-1(d)(1).

(n32)Footnote 32. The stock would acquire a basis equal to its value at the time of exchange and a holding period which commences with acquisition.

(n33)Footnote 33. IT 3858, N 26 *supra*; see also § 1.05[7] *supra*.



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CHAPTER 12 Regulated Investment Companies

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CHAPTER 12 Regulated Investment Companies

1-12 Taxation of Securities Transactions § 12.01

§ 12.01 Introduction

Regulated investment companies ("RICs"), often called mutual funds, "are essentially instruments for gathering together and investing the funds of a relatively large number of investors. ... Ideally, they secure for the investor expert management of his capital and diversification of his holdings, advantages which otherwise the small, nonprofessional investor cannot easily obtain."¹ The benefits to be derived from ownership of an interest in an RIC would be severely limited if the income and distributions of the RIC were taxed in the same manner as the income and distributions of an ordinary business corporation. By providing for a "conduit" theory of taxation, Congress has placed the person who invests his capital in an RIC on equal plane with one who makes direct investments in business enterprises. If the RIC meets the tests prescribed by the Internal Revenue Code, it is effectively taxed only on the income it retains and does not distribute to its shareholders. The income it does distribute retains the character it had in the hands of the RIC, that is, the shareholder treats ordinary income earned and distributed as ordinary income, and capital gains realized and distributed as capital gains.

FOOTNOTES:

(n1)Footnote 1. Motley, Jackson & Barnard, "Federal Regulation of Investment Companies Since 1940," 63 *Harv L Rev* 1134 (1950). [Copyright 1950 by The Harvard Law Review Association. Reprinted with the permission of the Association.]



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CHAPTER 12 Regulated Investment Companies

1-12 Taxation of Securities Transactions § 12.02

§ 12.02 Regulated Investment Company Defined

[1] The Basic Definition

A "regulated investment company," as defined by *IRC Section 851(a)* of the Code, is a domestic corporation which is either (1) registered under the Investment Company Act of 1940ⁿ¹ as a management company or unit investment trust,ⁿ² or has in effect an election under the Act to be treated as a business development company, or (2) a common trust fund or similar fund excluded (a) from the definition of "investment company" by Section 3(c)(3) of the Act,ⁿ³ because maintained by a bank as a means of investing funds held by it as a fiduciary, or because created prior to June 22, 1936 by a corporation subject to supervision by federal or state banking authorities, and (b) from the definition of "common trust fund" by *IRC Section 584(a)* of the Code.

[2] Additional Requirements for Qualification

Meeting the statutory definition of *IRC Section 851(a)* is only the first step toward qualification as an RIC for tax purposes.ⁿ¹ The corporation seeking to be taxed as an RIC must also satisfy the conditions and limitations contained in *IRC Section 851(b)* and *IRC Section 852(a)*.

In the case of an RIC having more than one fund, each fund shall be treated as a separate corporation for purposes of taxation (except for the definition of an RIC).ⁿ² A fund is defined as a segregated portfolio of assets, the beneficial interests in which are owned by the holders of a class or series of stock of the RIC that is preferred over all other classes or series of stock in respect of the portfolio.ⁿ³

[a] Election to Be a Regulated Investment Company. Even though a corporation meets all the requirements necessary for achieving RIC status, it will not be considered an RIC unless it affirmatively elects to be one.ⁿ⁴ Only one method of making the election is permitted--the taxpayer must compute its taxable income as an RIC in its return for the first taxable year for which the election is applicable.ⁿ⁵ Once made, the election is irrevocable for the initial taxable year and all succeeding taxable years.ⁿ⁶

[b] Gross Income Requirements. A further limitation concerns the source of the RIC's income. *IRC Section 851(b)(2)* requires that at least 90 percent of the corporation's gross income for the taxable year be derived from (a) dividends,ⁿ⁷ interestⁿ⁸ (including earned original discount on short-term obligations held for less than three months),ⁿ⁹ payments with respect to securities loans (as defined in *IRC Section 512(a)(5)*), and gains from the sale or other

disposition of stock and securities (as defined in Section 2(a)(36) of the Investment Company Act of 1940, as amended) or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in stock, securities, or currencies and (b) net income derived from an interest in a qualified publicly traded partnership.ⁿ¹⁰

Any gain or loss resulting from the sale, exchange, or distribution of property by an RIC after adoption of a plan of complete liquidation is not taken into account.

For the purposes of *IRC Section 851(b)*, gross income includes gains from the sale or other disposition of stock or securities undiminished by losses arising from such transactions.ⁿ¹¹ For purposes of *IRC Section 851(b)(2)*, amounts included in the gross income of a United States shareholder of a controlled foreign corporation under *IRC Section 951(a)(1)(A)(i)*, or *IRC Section 1293(a)* are considered dividends to the extent that a distribution of earnings and profits of the foreign corporation can be excluded from the income of the shareholder because previously taxed to the shareholder. If, by reason of *IRC Section 959(a)(1)*, or *IRC Section 1293(c)*, a distribution of earnings and profits of the foreign corporation is not included in the shareholder's gross income, then the distribution is allocated proportionately between amounts attributable to amounts included under each clause of *IRC Section 951(a)(1)(A)*.ⁿ¹² Custodian fees and sponsor fees received from investors by an RIC will not constitute income to the investment company, where it is clear that the custodian and the sponsor are performing services for the investor, and not the RIC, and that the investor is under a contractual obligation to pay the specified fees.ⁿ¹³

Recent rulings give examples of the scope of RIC income treated as qualifying income.^{n13.1}

[c] Asset Diversification Requirements. At the close of each quarter of the taxable year, the corporation must meet a set of asset diversification requirements.ⁿ¹⁴ These are imposed, in part, to deny RIC tax benefits "to companies which undertake to control the enterprises in which the bulk of their funds are placed."ⁿ¹⁵

The first of these requires that at least 50 percent of the value of the total assets of the company be represented by (1) cash and cash items (including receivables),ⁿ¹⁶ (2) government securities, (3) securities of other RICs, and (4) other securities.ⁿ¹⁷ For the purpose of the calculation, other securities which the RIC owns in any one corporation or issuer are taken into account only if the amount owned (a) is not greater in value than 5 percent of the value of the investment company's total assets, and (b) does not exceed 10 percent of the outstanding voting securities of the issuer.ⁿ¹⁸

The second, applicable even if the 50-percent requirement just described is met, requires that the corporation not have more than 25 percent of the value of its total assets invested in securities (other than government securities or securities of other regulated investment companies) of any one issuer, or of two or more issuers controlled by the taxpayer and engaged in similar or related trades or businesses, or the securities of one or more qualified publicly traded partnerships.ⁿ¹⁹ For the purpose of this second requirement, control means the ownership of 20 percent or more of the total combined voting power of all classes of stock of a corporation entitled to vote.ⁿ²⁰ Two or more issuers will be considered to be engaged in the same or related trades or businesses if they are engaged in a distinct branch of business, trade, or manufacture in which they produce or deal in the same type of product, or render the same kind of service, and the product or service fulfills the same economic need. However, two corporations will not be deemed to be in the same or related trades or businesses merely because they are engaged in the broad field of manufacturing or any other general classification of industry.ⁿ²¹

Example:

At the end of the first quarter of the taxable year, Investment Company X has its total assets invested in the following manner:

Cash	20 percent
Government securities	25 percent
A Corp. securities	5 percent

<i>B Corp.</i> securities	20 percent
<i>C Corp.</i> securities	20 percent
<i>D Corp.</i> securities	10 percent

If the ownership of *A Corp.* securities represents less than 10 percent of the outstanding voting stock of *A Corp.*, the RIC will satisfy the first asset diversification requirement. Since the RIC does not have more than 25 percent of its assets invested in the securities of a single issuer, it will meet the second requirement if it owns less than 20 percent of the voting power of each of the corporations. However, if the RIC owns, say, 22 percent of the outstanding stock of *B Corp.* and 22 percent of the outstanding stock of *C Corp.*, the second requirement will be met only if *B Corp.* and *C Corp.* are not engaged in the same or similar trades or businesses or in related trades or businesses.

One other factor must be considered in connection with the second requirement. In ascertaining the extent of asset investment in the securities of a particular issuer, the Code calls for inclusion of a "proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of [the] issue..."²² A controlled group is here defined as one or more chains of corporations connected through stock ownership with the taxpayer, if (a) 20 percent of the total combined voting power of all classes of stock entitled to vote of each of the corporations, except the taxpayer, is owned directly by one or more of the other corporations, and (b) the taxpayer owns directly 20 percent or more of the total combined voting power of all classes of stock entitled to vote of at least one of the other corporations.²³ Thus, if in the foregoing example, Investment Company *X* owned more than 20 percent of the outstanding voting stock of *B Corp.*, and *B Corp.* owned more than 20 percent of the voting stock of *C Corp.*, Investment Company *X*, *B Corp.*, and *C Corp.* would constitute a controlled group. In determining whether Investment Company *X* had more than 25 percent of its assets invested in *C Corp.*, there would be added to the 20 percent directly invested in *C Corp.* securities, the proper proportion of the investment of *B Corp.* in the securities of *C Corp.* This proper proportion is arrived at by multiplying the percentage of total assets that Investment Company *X* has invested in the securities of *B Corp.* (20 percent) by the percentage of total assets that *B Corp.* has invested in *C Corp.* securities. So, if *B Corp.* had more than 25 percent of its total assets invested in *C Corp.* securities, the second requirement would not be met, for the "proper proportion" would be greater than 5 percent, causing Investment Company *X*'s investment in *C Corp.* securities to be greater than 25 percent.²⁴

Suppose an RIC meets the asset diversification requirements at the end of the first quarter of the taxable year, but fails to do so at the end of the second quarter due to fluctuations in the market values of the securities in its portfolio, or to the fact that the company made distributions to its shareholders. While this situation literally violates the provisions of *IRC Section 851(b)(3)*, it does not result in the loss of status as an RIC.²⁵ That will occur only when the failure to meet the requirements of *IRC Section 851(b)(3)* at the end of a subsequent quarter of the taxable year is due in whole or in part to the acquisition of any security or other property.²⁶ Even then the taxpayer will not lose its status as an RIC for that quarter if the discrepancy between the value of its investments and the asset diversification requirements is eliminated within thirty days of the close of the quarter.²⁷

[d] Income Distribution Requirements. The final requirement does not affect the corporation's status as an RIC. However, it does determine whether the special rules applicable to regulated investment companies will apply for the taxable year. Under *IRC Section 852(a)(1)*, the RIC is required to distribute at least 90 percent of its investment company taxable income (in effect, its ordinary income) for the taxable year and at least 90 percent of the excess of its tax-exempt interest income over the sum of (a) any deductions for expenses relating to such income which are disallowed by *IRC Section 265*²⁸ and (b) any deductions for amortizable bond premium which are disallowed by *IRC Section 171(a)(2)*. In addition, the rules applicable to RIC must have been applicable to the company for all years ending on or before November 8, 1983, or as of the close of the taxable year, the RIC must not have any earnings and profits accumulated in any taxable year to which the rules did not apply.²⁹ If these requirements are not met for the

year in question, the RIC will be taxed in such year as an ordinary corporation.ⁿ³⁰ However, the Service can waive the distribution requirements for any taxable year if the RIC establishes to the satisfaction of the Service that it was unable to meet them because of distributions previously made to meet the requirements of *IRC Section 4982*.

It should be noted that actual distribution to shareholders is not required. It is sufficient if the RIC credits dividends to investors' accounts under a reinvestment arrangement, provided the investors either have an unqualified right to withdraw the dividends at any time, or can obtain the dividends by partially terminating their interest at any time, without substantial limitations or restrictions.ⁿ³¹ In similar fashion, a distribution to a trustee acting for the shareholders will satisfy the requirements of *IRC Section 852(a)(1)*.ⁿ³² The Internal Revenue Service has also issued "temporary guidance" which, under certain conditions and for a limited time, permit a RIC to meet the 90 percent test under *IRC Section 852(a)(1)* by declaring dividends payable largely through a distribution of shares of the RIC's own stock.ⁿ³³

[3] Investment Companies Furnishing Capital to Development Corporations

A venture capital company, a registered management company or registered business development company whose principal business is to provide capital for other companies engaged in the development or exploitation of inventions, technological improvements, or new products and processes not generally available previously, is given partial relief from the provisions of *IRC Section 851(b)(3)(A)*, the 50-percent asset diversification requirement. In ascertaining whether 50 percent of its assets are invested in the specified securities, a venture capital company can include the value of any securities of an issuer, even if the investment company owns more than 10 percent of the voting securities of the issuer, provided the latest acquisition of any securities of such issuer did not cause the *basis* of all the securities of the issuer held by the corporation to exceed 5 percent of the total value of its assets at the time of such acquisition.ⁿ¹ The effect of this qualification on the first asset diversification requirement may be illustrated by the following:

Example:

On March 31, 1987, the end of the first quarter of its taxable year, the value of the total assets of Investment Company X amounted to \$1 million, \$55,000 of which was represented by the value of 1,000 shares of ABC Corporation. Of these shares, 900 had been purchased in 1968 at a cost of \$45,000, and the remaining 100 on December 31, 1986, for \$4,000. The value of the investment company's total assets on December 31, 1986, was also \$1 million. If the investment company is not a venture capital company, its investment in ABC securities cannot be counted towards the 50-percent investment requirement, since the end-of-quarter value of the investment in ABC Corporation securities exceeds the 5-percent limit imposed by *IRC Section 851(b)(3)(A)*. If, however, Investment Company X qualified as a venture capital company, the value of its investment in the securities of ABC Corporation would be counted toward the 50-percent requirement. The key here is that the basis of the investment company's securities in ABC Corporation (\$49,000) did not exceed 5 percent of \$1 million, the value of its assets on December 31, 1986, the date of the latest acquisition of ABC Corporation securities.

The special treatment afforded venture capital companies will not be applicable with respect to the securities of any issuer, if the investment company has continuously held any security of the issuer, or any security of a predecessor company of the issuer, for a period of ten years or more preceding the quarter of the taxable year in question.ⁿ² This does not prevent the investment company from counting the securities of such issuer for the 50-percent investment test, provided the value of the securities is less than 5 percent of the value of the company's total assets and the 10-percent voting securities test is met.

Finally, the special exception will not apply at the close of any quarter of a taxable year, if, at the close of the quarter, more than 25 percent of the value of the investment company's assets is represented by securities of issuers with respect to each of which the investment company holds more than 10 percent of the outstanding voting securities, and in respect to each of which the company has continuously held a security for ten or more years. However, this limitation will not

become effective if the value of the total assets so represented is reduced to 25 percent or less within 30 days of the end of the particular quarter.ⁿ³

[4] Periodic Payment Plans

Prior to 1969, a group of investors subscribing to a periodic payment plan for the accumulation of mutual fund shares was treated by the Internal Revenue Service as an association taxable as a corporation. As a result, if an investor asked for his stock to be delivered to him, gain or loss resulted from the transaction, although the investor merely took down his own shares.ⁿ¹ Present lawⁿ² provides that a unit investment trust that issues a periodic payment plan is not to be treated as a separate tax entity. Instead, the mutual fund shares are deemed to be owned directly by the investors, so that delivery of stock by the custodian to the investor is not a taxable event. Gain or loss will arise only when the investor sells his mutual fund shares.

The provision does not apply in the case of a unit investment trust that is a segregated asset account under the insurance laws or regulations of a state.ⁿ³ Such accounts will continue to be taxed as before.ⁿ⁴

FOOTNOTES:

(n1)Footnote 1. *15 USC §§ 80a-1 to 80b-2.*

(n2)Footnote 2. The Code requires the corporation to be registered at all times during the taxable year. The Service has ruled that, although a corporation registers after the beginning of its taxable year, it will meet the registration requirement if, prior to registration, it transacted no business and was completely inactive. *Rev Rul 56-499, 1956-2 CB 497*.

(n3)Footnote 3. *15 USC § 80a-3(c).*

(n4)Footnote 1. The issuance of both common and preferred stock will not prevent a management company from qualifying as an RIC for tax purposes; the issuance of bearer certificates will. *Rev Rul 78-44, 1978-2 CB 216*; *Rev Rul 74-177, 1974-1 CB 165*.

(n5)Footnote 2. *IRC § 851(g)(1).*

(n6)Footnote 3. *IRC § 851(g)(2).*

(n7)Footnote 4. *IRC § 851(b)(1).* An investment company that does not elect to be an RIC is subject to the accumulated earnings tax. Ltr Ruls 8705092, 8705001.

(n8)Footnote 5. *Treas Reg § 1.851-2(a)* See Ltr Rul 9345016 for an example of an instance in which the Service granted an extension of time to file the election. Shortly before the due date of the return, the advisor hired by the taxpayer to review and file the taxpayer's returns moved its accounting operations to another floor and reassigned responsibility for such review and filing to a different segment of its accounting department.

(n9)Footnote 6. *Id.*

(n10)Footnote 7. An RIC, that is the holder of record of any share of stock on the record date for any dividend payable with respect to the stock, must include the dividend in gross income as of the later of (i) the date on which the share became ex-dividend, or (ii) the date the company acquired the stock. *IRC § 852(b)(9).*

(n11)Footnote 8. For this purpose, gross income includes interest on state and local bonds excluded from gross income by *IRC § 103(a)(1).*

(n12)Footnote 9. *Rev Rul 75-376, 1975-2 CB 267*; *Rev Rul 75-225, 1975-1 CB 191*.

(n13)Footnote 10. The Treasury may, by regulation, exclude from qualifying income foreign currency gains that are not ancillary to the company's principal business of investing in stock or securities (or options and futures with respect to stock or securities). *IRC § 851(b)(3)*.

A qualified publicly traded partnership is a partnership interests in which are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof), if 90 percent of its gross income is derived from dividends, interest, payments on securities loans, and gains from the sale or other disposition of stock or securities or foreign currencies, or other income derived with respect to its business of investing in stock, securities, or foreign currencies. *IRC §§ 851(h), 7704(b), and 7704(c)(2)*.

Income derived from a partnership or trust is treated as income described in *IRC § 851(b)(2)* only to the extent the income would have been treated as such if realized directly by the RIC. For purposes of satisfying the requirements of *IRC § 851(b)(2)*, an RIC holding an interest in a partnership will be deemed to own a proportionate share of the assets of the partnership and will be deemed to be entitled to the gross income of the partnership attributable to that share. Ltr Ruls 200025015 , 9507006 .

The Service has ruled that gains realized by an RIC from the sale of real estate must be included in gross income without reduction on account of losses from such transactions. *Rev Rul 85-167, 1985-2 CB 178* . This has the effect of increasing the amount of the company's nonqualified income.

A RIC entered into a derivative contract that provided for a total-return exposure on a commodity index. The RIC did not enter into the contract in connection with a business of investing in stock, securities, or currency, or in order to reduce or hedge the level of risk in such a business. The Service ruled that the contract was not a security for purposes of *IRC § 851(b)(2)*. Therefore, income from the contract was not qualifying income for purposes of *IRC § 851(b)(2)*. *Rev Rul 2006-1, 2006-2 1 CB 261* .

If, in the normal course of business, an RIC receives a reimbursement from its investment advisor, and the reimbursement is includable in the RIC's gross income, the reimbursement is qualifying income under *IRC § 851(b)(2)*. *Rev Rul 92-56, 1992-2 CB 153* . Two earlier rulings, *Rev Rul 74-248, 1974-1 CB 167* , and *Rev Rul 64-247, 1964-2 CB 179* , had held that the refund of excess management fees as a result of litigation did not jeopardize the company's status as an RIC. The Service has declared the two rulings obsolete to the extent they imply that the payments are not qualifying income and that they constitute dividend income.

A fund incurred expenses to rectify errors made by its accounting firm as a result of the firm's negligence. Payments by the firm's liability insurance carrier to compensate the fund were made in the same year that the expenses were incurred. The reimbursement was a return of capital, not includable in gross income under *IRC § 61* or taken into account under *IRC § 851(b)(2)*. Ltr Ruls 9211029, 9211015.

(n14)Footnote 11. *Treas Reg § 1.851-2(b)*; *Rev Rul 63-118, 1963-1 CB 121* .

(n15)Footnote 12. *Treas Reg § 1.851-2(b)(2)*.

(n16)Footnote 13. *Rev Rul 68-377, 1968-2 CB 301* .

(n17)Footnote 13.1. Eg, LTR 200842014, LTR 200846019.

(n18)Footnote 14. *IRC § 851(b)(3)*. The asset diversification requirement must be applied to each entity that purports to be an RIC, and, in a parent-subsidary situation, cannot be applied at the parent level on a combined asset basis. *Rev Rul 84-138, 1984-2 CB 123* .

For purposes of satisfying the requirements of *IRC § 851(b)(3)*, an RIC holding an interest in a partnership will be

deemed to own a proportionate share of the assets of the partnership. *Rev Proc 2005-20, 2005-1 CB 990* ; Ltr Ruls 200025015 , 9507006 . The IRS extended this "look-through" treatment to certain RICs with respect to their interests in Public-Private Investment Partnerships (PPIPs) holding Legacy Securities (mortgage-backed securities originally acquired by the Treasury Department pursuant to its Troubled Asset Relief Program (TARP) under the Emergency Economic Stabilization Act of 2008). *Rev Proc 2009-42, 2009-40 IRB 459* .

(n19)Footnote 15. H Rep No 586, 82d Cong, 1st Sess 34 (1951). The diversification requirement also prevents RICs from concentrating their assets in a small number of companies or in certain forms of assets. *Rev Rul 76-392, 1976-2 CB 249* .

(n20)Footnote 16. Certificates of deposit held by an RIC as short-term investments are cash items for purposes of the asset diversification requirement. *Rev Rul 77-199, 1977-2 CB 195* .

(n21)Footnote 17. Overnight loans of federal funds made by an RIC to commercial banks or savings institutions whose accounts are insured by the FDIC or FSLIC are securities and not cash or cash items. The loans cannot be treated as government securities since they are not federally issued or guaranteed. *GCM 39531* .

For purposes of *IRC § 851(b)(3)*, exchange-traded call options are securities, the issuer of which is the corporation whose stock or securities underlie the option. *Rev Rul 83-69, 1983-1 CB 126* . The same holds true for options on a stock index, positions on stock index futures, and options on stock index futures. *Ltr Rul 8811053* . Futures contracts involving US securities and exchange-traded options on such contracts are treated as government securities. Ltr Ruls 8548016, 8434027.

In valuing other securities for purposes of *IRC § 851(b)(3)*, an RIC need not value call options on (1) stock it holds, (2) bonds convertible into stock if the value of the bonds is within 10 percent of the conversion value at any point, (3) on stock or a stock index, if the company holds call options on the stock or stock index and the exercise price of the held call option is equal to or less than the exercise price on the written call option, or (4) on a narrow-based stock index, if during the life of the call option, the company holds groups of securities that correlate with the index. However, in the last instance, the company must count that portion of the value of the written index option that is not covered by securities owned by the company. *GCM 39565* .

The Service has identified certain stock and debt obligations that qualify as both securities and Government securities for purposes of *IRC § 851(b)(3)*. *Rev Rul 92-89, 1992-2 CB 154* .

Rev Proc 2004-28, 2004-1 CB 984 , describes conditions under which a repurchase agreement (repo) that is collateralized fully can be treated as a government security under *IRC § 851(b)(3)* even if the taxpayer is not treated as the owner of the underlying securities for federal tax purposes.

(n22)Footnote 18. *IRC § 851(b)(3)(A)*. Stock warrants, stock options, stock rights, shareholder voting agreements and convertible debentures do not constitute voting stock for purposes of *IRC § 851(b)*. *Rev Rul 66-339, 1966-2 CB 274* .

Outstanding securities of an issuer include the equity securities of a qualified publicly traded partnership. *IRC § 851(c)(5)*.

(n23)Footnote 19. *IRC § 851(b)(3)(B)*.

(n24)Footnote 20. *IRC § 851(c)(2)*.

(n25)Footnote 21. *Treas Reg § 1.851-2(c)(2) (1957)*. The Regulation is taken from H Rep No 2333, 77th Cong, 2d Sess 122 (1942).

(n26)Footnote 22. *IRC § 851(c)(1)*.

(n27)Footnote 23. *IRC § 851(c)(3)*.

(n28)Footnote 24. See also *Treas Reg § 1.851-5*, Ex (4).

(n29)Footnote 25. *IRC § 851(d)*; *Treas Reg § 1.851-5*, Exs (5) and (6).

IRC § 851(d) applies only to a company that previously has qualified as an RIC. A company seeking to achieve that status cannot rely on the provision as a means of satisfying the asset diversification requirements. *Rev Rul 72-83*, 1972-1 CB 205 .

(n30)Footnote 26. A stock split that caused the portion of an RIC's assets invested in a particular stock to increase to 27 percent was a mere change in the number of shares representing the original investment by the company and not an acquisition for purposes of *IRC § 851(d)*. *Rev Rul 74-133*, 1974-1 CB 165 .

An acquisition includes the receipt of securities of a third party that is the acquiring corporation in a type "C" reorganization with a portfolio company, as well as the receipt of securities of a third party by in-kind distribution from a portfolio company pursuant to an antitrust order. *Rev Rul 63-170*, 1963-2 CB 286 .

(n31)Footnote 27. *IRC § 851(d)*. An RIC may, within the thirty-day period, dispose of the securities of any issuer in order to meet the 5-percent limitation imposed on the ownership of "other securities." *Rev Rul 69-134*, 1969-1 CB 187 .

(n32)Footnote 28. The disallowance provision applies to any RIC that distributes an exempt-interest dividend. The amount of the disallowance is equal to that portion of the otherwise deductible expenses which the exempt income of the company bears to its total income less net capital gains.

(n33)Footnote 29. *IRC § 852(a)(3)*.

(n34)Footnote 30. *Treas Reg § 1.852-1(b)*; *Rev Rul 58-466*, 1958-2 CB 379 .

(n35)Footnote 31. *Rev Rul 65-89*, 1965-1 CB 265 ; *Rev Rul 69-120*, 1969-1 CB 187 .

(n36)Footnote 32. *Cf Rev Rul 69-652*, 1969-2 CB 147 .

(n37)Footnote 33. *Rev Proc 2010-12*, 2010-3 IRB 302, amplifying and superseding *Rev Proc 2009-15*, 2009-1 CB 356, which amplified and superseded *Rev Proc 2008-68*, 2008-52 IRB 1373. The conditions are: (1) that the entire distribution be made by the corporation to its shareholders with respect to its stock; (2) that the stock of the corporation is publicly traded on an established securities market in the United States; (3) that the dividend be declared on or before December 31, 2012, with respect to a taxable year ending on or before December 31, 2011; (4) that shareholders may elect to receive their entire entitlement under the dividend declaration in either stock of the distributing corporation or cash, subject to a "Cash Limitation" on the amount of money that may be distributed in the aggregate to all shareholders which (a) is not less than 10% of the aggregate declared distribution and (b) requires that if too many shareholders elect to receive money, each shareholder electing to receive money will receive a pro rata amount of money corresponding to the shareholder's respective entitlement under the declaration, and in no event less than 10% of the shareholder's entire entitlement under the declaration in money; (5) that the number of shares to be received by any shareholder is determined, over a period of up to two weeks ending as close as practicable to the payment date, based upon a formula utilizing market prices that is designed to equate in value the number of shares to be received with the amount of money that could be received instead; and (6) that, with respect to any shareholder participating in a dividend reinvestment plan ("DRIP"), the DRIP applies only to the extent that, in the absence of the DRIP, the shareholder would have received the distribution in money in accordance with condition (4). *Rev Proc 2010-12*, 2010-3 IRB 302 .

(n38)Footnote 1. *IRC § 851(e)(1)*. The Securities and Exchange Commission must certify that the investment company is a venture capital company.

(n39)Footnote 2. *IRC § 851(e)(1)*.

(n40)Footnote 3. *IRC § 851(e)(2)*.

(n41)Footnote 1. S Rep No 91-552, 91st Cong, 1st Sess 287 (1969).

(n42)Footnote 2. *IRC § 851(f)(1)*, effective for taxable years of unit investment trusts ending after 1968 and for taxable years of holders of interest in these trusts ending with or within the taxable years of such trusts.

(n43)Footnote 3. *IRC § 851(f)(2)*.

(n44)Footnote 4. S Rep No 91-552, 91st Cong, 1st Sess 287, at 288 (1969).



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Taxation of Securities Transactions

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CHAPTER 12 Regulated Investment Companies

1-12 Taxation of Securities Transactions § 12.03

§ 12.03 Taxation of the Regulated Investment Company

[1] Taxation of Ordinary Income

[a] Applicable Rates. The investment company that achieves RIC status and meets the income distribution requirements of *IRC Section 852(a)(1)* is subject to a tax on its investment company taxable income at the rates and in the manner set forth in *IRC Section 11*.ⁿ¹ (RICs that fail to comply with regulations prescribed for the purpose of ascertaining the actual ownership of its stock are taxed at the highest corporate rate.) In other words, the rates applied are the same as those imposed on the taxable income of an ordinary business corporation. The difference in treatment comes with the way in which taxable income is computed.

[b] Computing Investment Company Taxable Income. Investment company taxable income is no more than the corporation's taxable income,^{n1.1} as normally computed, with the following adjustments:

- (1) The amount of net capital gain is excluded.
- (2) The net operating loss deduction provided by *IRC Section 172*, and the dividends received deductions provided by *IRC Sections 243, 244, and 245*, are not allowed.
- (3) The dividends paid deduction, as defined in *IRC Section 561*, is allowed, but the deduction is computed without regard to capital gains dividends and exempt-interest dividends.ⁿ²
- (4) Issue discount on short-term government obligations issued at a discount and redeemable at maturity without interest will be taxable as it accrues, if the company so elects.
- (5) Gross income does not include 50 percent of the interest received by the RIC with respect to a securities acquisition loan.ⁿ³ A securities acquisition loan is (1) any loan to a corporation or to an employee stock ownership plan to the extent that the proceeds are used to acquire employer securities for the plan or are used to refinance such a loan, or (2) any loan to a corporation (other than one with a commitment period that exceeds seven years) to the extent that, within 30 days, employer securities are transferred to the plan in an amount equal to the proceeds of the loan and the securities are allocable to accounts of plan participants within one year of the date of the loan.ⁿ⁴

(6) The taxable income of an RIC to which an election under *IRC Section 4982(e)(4)* does not apply is computed without regard to any net foreign currency loss attributable to transactions after October of the taxable year, and any such loss is treated as arising on the first day of the next taxable year.ⁿ⁵

(7) To the extent provided in regulations, the taxable income of the RIC (other than one to which an election under *IRC Section 4982(e)(4)* applies) is computed without regard to any net reduction in the value of any stock of a passive foreign investment company with respect to which a mark-to-market election under *IRC Section 1296* is in effect occurring after October 31 of the taxable year, and any such reduction is treated as occurring on the first day of the following taxable year.^{n5.1}

In addition, an open-end investment company is entitled to deduct stock issuance expenses incurred after the initial stock issuance period (90 days pursuant to the Securities Act of 1933) on the theory that the circumstances that permit shareholders of the company to withdraw capital on demand also serve to make the continuous capital-raising efforts of the fund an essential part of its day-to-day business operations.ⁿ⁶

[c] Dividends Paid Deduction. As mentioned above, the RIC computes its taxable income by deducting the dividends, other than capital gains dividends and exempt-interest dividends which it pays during the taxable year.ⁿ⁷ Because it may be difficult for an RIC to determine if it has met the income distribution requirement of *IRC Section 852(a)(1)*, Congress added what is now *IRC Section 855(a)* to provide that a dividend paid after the close of the year will be considered as having been paid during the taxable year if the RIC declares the dividend prior to the time it is required to file its return for the taxable year, and then distributes the amount of the dividend to its shareholdersⁿ⁸ in the 12-month period following the close of the taxable year, but not later than the date of the first regular dividend payment made after the declaration.ⁿ⁹

The election to treat dividends as having been paid in the prior year rests exclusively with the RIC. The election must be made in the return filed for the taxable year, and is made by including the dividend to which the election applies in the dividends paid deduction for the taxable year.ⁿ¹⁰ An election, once made, becomes irrevocable after the expiration of time for filing the return for the taxable year for which the election is made.ⁿ¹¹

The election permitted by *IRC Section 855(a)* can be made only to the extent that earnings and profits of the taxable year to which the election relates exceed the total amount of distributions out of earnings and profits actually made during the taxable year.ⁿ¹² For the purpose of determining available earnings and profits, the amount of actual distributions made during the taxable year does not include any distributions made with respect to an *IRC Section 855(a)* election in effect for a prior year.ⁿ¹³

[2] Taxation of Long-Term Capital Gains

A tax is imposed on the RIC's undistributed net capital gain, i.e., on the excess of the corporation's net long-term capital gain over the sum of its net short-term capital loss and the deduction for capital gains dividends paid during the taxable year.ⁿ¹

A capital gain dividend is defined as any dividend, or part thereof, which is designated by the company as a capital gain dividend in a written notice (Form 2439) mailed to shareholders not later than 60 days after the close of the RIC's taxable year.ⁿ² If the amount designated as a capital gain dividend for a taxable year is greater than the net capital gain for the taxable year, the total capital gain dividend for the year is limited to such gain. If more than one distribution made during the taxable year is designated as a capital gain dividend in whole or in part, then only a proportionate part of each such distribution will be considered a capital gain dividend.ⁿ³ For purposes of the capital gain dividend, the amount of net capital gain for a taxable year, to which an election under *IRC Section 4982(e)(4)* (discussed below) does not apply, is determined without regard to any net capital loss or net long-term capital loss attributable to transactions after October 31, and any such loss is treated as arising on the first day of the next taxable year.ⁿ⁴

Just as in the case of an ordinary dividend, an RIC may elect to treat a capital gain dividend declared and paid after the close of the taxable year as having been paid during the taxable year. The rules that govern the election with respect to ordinary dividends apply with equal force to capital gains dividends.ⁿ⁵ The notice designating the post-year dividend as a capital gains dividend must be given not later than 60 days after the close of the taxable year in which the distribution is made.ⁿ⁶

[3] Exempt-Interest Dividends

Prior to the Tax Reform Act of 1976, there was no provision for flow-through treatment of tax-exempt interest earned by an RIC. As a result, distribution of tax-exempt interest by the RIC produced taxable income for its shareholders. *IRC Section 852(b)(5)*, added by the Act, allows an RIC to pay an exempt-interest dividend if, at the close of each quarter of its taxable year, at least 50 percent of the value of its assets consists of tax-exempt interest obligations issued by states and their political subdivisions.ⁿ¹ The term "exempt-interest dividend" is defined as any dividend (other than a capital gain dividend) paid by an RIC and designated by it as an exempt-interest dividend in a written notice mailed to its shareholders not later than 60 days after the close of its taxable year. If the amount so designated is greater than the excess of the amount of tax-exempt interest received over the amounts disallowed as deductions under *IRC Section 265* (relating to expenses incurred in connection with such income) and *IRC Section 171(a)(2)* (relating to deductions for bond premium amortization), the exempt-interest dividend will be limited to such excess. For purposes of the exempt-interest dividend provisions, 50 percent of the amount of any loan of the RIC that qualifies as a securities acquisition loan is treated as a tax-exempt obligation and 50 percent of the interest received on such loan treated as tax-exempt interest.^{n1.1}

[4] Deduction for Deficiency Dividends

The Tax Reform Act of 1976 added a deficiency dividend procedure to prevent the disqualification of real estate investment trusts which failed to meet the income distribution requirements prescribed for such entities. The Revenue Act of 1978 extended this relief to RICs. Indeed, the later legislation made the same provision applicable to both real estate investment trusts and RICs, with the only difference being the type of adjustment required before the procedure can be employed.ⁿ¹ Therefore, this section will not detail the deficiency dividend procedure. Rather, the reader is referred to the chapter on real estate investment trusts for a discussion of the deduction for deficiency dividends.ⁿ²

A procedure similar to the deficiency dividend procedure becomes applicable if it is determined that a corporation failed to qualify as an RIC for any taxable year without regard to any net reduction in the value of any stock of a foreign investment company with respect to which a mark-to-market election under *IRC Section 1296* is in effect occurring after October 31st of that year.ⁿ³ If the company distributes the accumulated earnings and profits attributable to that year, less an interest charge,ⁿ⁴ as a dividend within 90 days after the determination, the RIC rules will apply to such year.ⁿ⁵ The amount distributed cannot be included in the amount of dividends paid for purposes of the dividends paid deduction for any taxable year.ⁿ⁶

[5] Earnings and Profits of Regulated Investment Companies

Earlier discussion has indicatedⁿ¹ that the computation of earnings and profits of an ordinary business corporation takes into account items which do not enter into the corporation's gross income as well as those which the corporation is not permitted to deduct. The determination of earnings and profits of an RIC is subject to one important exception--current earnings and profits (but not accumulated earnings and profits) are not reduced by any amount which is not allowable as a deduction in computing taxable income.ⁿ² Thus, if the RIC has taxable income of \$200,000 and an excess, nondeductible capital loss of \$50,000, its current earnings and profits are \$200,000, and not \$150,000. In order to coordinate the earnings and profits determination with the excise tax on undistributed income imposed by *IRC Section 4982* (see *infra*), the earnings and profits of an RIC for any year are determined without regard to any net capital loss (or

net foreign currency loss) attributable to transactions after October 31st of that year without regard to any net reduction in the value of any stock of a foreign investment company with respect to which a mark-to-market election under *IRC Section 1296* is in effect occurring after October 31st of that year.ⁿ³ The preceding sentence applies only to the extent that the amount distributed by the company during any calendar year does not exceed the sum of 100 percent of the company's ordinary income for the calendar year and 100 percent of its capital gain net income for the one-year period ending on October 31st of such year.

Since only current earnings and profits are affected by this rule, the maximum amount to be carried forward to the following year and added to accumulated earnings and profits is \$150,000, not \$200,000. On the other hand, if the corporation had no accumulated earnings and profits at the beginning of the year and distributed \$200,000, all chargeable against earnings and profits of the current year, it would start the following year, not with a \$50,000 deficit in accumulated earnings and profits, but with its paid-in capital reduced by \$50,000.ⁿ⁴

It is important to note that every RIC, even one which fails to meet the income distribution requirements of *IRC Section 852(a)(1)* and is taxed in the same manner as an ordinary corporation, is subject to the special rule affecting current earnings and profits.ⁿ⁵

IRC Section 852(a)(2)(B) provides that, at the close of the year, the RIC not have earnings and profits accumulated in any non-RIC year. Any distribution made to comply with *IRC Section 852(a)(2)(B)* is treated as made from earnings and profits that, but for the distribution, would result in a failure to meet those requirements (and allocated to such earnings on a first-in, first-out basis), and, to the extent treated as made from accumulated profits, is not considered to be a distribution for purposes of the dividends paid deduction or the election to treat dividends paid after the close of the taxable year as paid during the taxable year.ⁿ⁶

[6] Record-Keeping Requirements

IRC Section 852(b)(1) imposes the highest rate of corporate tax on any RIC that "fails to comply for the taxable year with regulations prescribed ... for the purpose of ascertaining the actual ownership of its stock." Under Regulations promulgated with respect to an earlier provision that made the requirement a condition for the imposition of the special taxing rules applicable to RICs (*IRC Section 852(a)(2)*, repealed by the Tax Reform Act of 1986), the stockholders statements setting forth the stock actually and constructively owned by the shareholder.ⁿ¹ The information received (including the names of persons who fail to comply with the demand) must be maintained as part of the corporation's permanent records.ⁿ²

[7] Excise Tax on Undistributed Earnings

IRC Section 4982(a) imposes a 4 percent nondeductible excise tax on the excess of the "required distribution" for the calendar year over the "distributed amount" for such year.ⁿ¹ The tax is due by March 15 of the following calendar year. The "required distribution" for any calendar year is the sum of (a) 97 percent of the RIC's ordinary income for the year, (b) 98 percent of the company's capital gain net income for the one-year period ending on October 31st, and (c) the excess of the grossed up required distribution for the preceding calendar year over the distributed amount for such year.ⁿ² (The grossed up required distribution for any calendar year is the sum of the taxable income of the RIC for the year, determined without regard to the deduction for dividends paid, and all amounts from earlier years that are not treated as having been distributed.)ⁿ³ The "distributed amount" for any calendar year is the sum of (a) the deduction for dividends paid (as defined by *IRC Section 561*) during the calendar year, (b) any amount of tax imposed on the company's ordinary income and net capital gain for the year, and (c) the excess (if any) of the distributed amount for the preceding calendar year over the required distribution for such year.ⁿ⁴

The RIC's ordinary income for this purposes is its investment company income (as defined in *IRC Section 852(b)(2)*) determined (a) by taking into account the net capital gain of the company and not taking into account the dividends paid

deduction, (b) by not taking into account any gain or loss from the sale of a capital asset, and (c) by treating the calendar year as the RIC's taxable year.ⁿ⁵

Any foreign currency gain or loss attributable to a Section 988 transaction that is properly taken into account for the portion of a calendar year after October 31st is taken into account in determining the amount of ordinary income of the RIC for the following calendar year.ⁿ⁶

Capital gain net income is determined by treating the one-year period ending on October 31st of any calendar year as the company's taxable year, and for this purpose is defined as the excess of the company's capital gains over its capital losses, reduced (but not below the company's net capital gain) by the amount of any net ordinary loss for the calendar year.ⁿ⁷ The net ordinary loss for the calendar year is the amount that would be the company's net operating loss if ordinary income were computed according to the rules described in the preceding paragraph.

If an RIC has a taxable year that ends with the month of November or December, the company can elect to use its taxable year rather than the one-year period ending on October 31st in determining the amount of capital gain net income and the amount of gain or loss from Section 988 foreign currency transactions (including the amount of such income entering into the computation of the required distribution).ⁿ⁸

For the purposes of applying the above provisions, any deficiency dividend is taken into account at the time it is paid, and any income giving rise to the adjustment is treated as arising at the time the dividend is paid.ⁿ⁹

[8] Transfers by a C Corporation to a Regulated Investment Company or Real Estate Investment Trust

In 2000, the Internal Revenue Service issued temporary regulations governing the treatment of a C corporation that qualified as a RIC or REIT, or transferred assets to a RIC or REIT in a transaction in which the C corporation's basis carried over to the RIC or REIT. Under those regulations, the C corporation was treated as having sold all of its assets at their respective fair market values and immediately liquidated.ⁿ¹ The C corporation could avoid the immediate recognition of gain if it elected to be subject to the rules of *IRC Section 1374* (discussed in § 15.02[1]).ⁿ² The regulations became final on March 18, 2003.^{n2.1}

On January 2, 2002, the Service issued two new temporary regulations regarding such transactions, one for transactions occurring after June 9, 1987, and before January 2, 2002,ⁿ³ and one for transactions taking place after January 1, 2002.ⁿ⁴ The regulations became final on March 18, 2003.^{n4.1} A RIC or REIT can apply the 2000 regulations to transactions that occurred after June 9, 1987, and before January 2, 2002, but cannot rely on certain provisions in those regulations if it is subject to *IRC Section 1374* treatment.ⁿ⁵

Under the regulations for pre-2002 transactions, if property owned by a C corporation becomes the property of a RIC or REIT (the converted property) in a conversion transaction (a transaction in which the C corporation qualifies as a RIC or REIT or transfers property to the RIC or REIT), deemed sale treatment will apply unless the RIC or REIT elects to be subject to the built-in gain rules of *IRC Section 1374*.ⁿ⁶ This means that the C corporation recognizes gain or loss as if it sold the converted property to an unrelated party at fair market value on the deemed sale date.ⁿ⁷ If the C corporation recognizes a net gain on the transaction, the converted property has a basis in the hands of the RIC or REIT equal to the fair market value of the property on the deemed sale date. If the deemed sale results in a net loss, the loss is not recognized and the C corporation's basis in the converted property carries over to the RIC or REIT.ⁿ⁸

The deemed sale rule will not apply to a pre-2002 conversion transaction if the RIC or REIT makes an election to be subject to tax on the net built-in gain in the converted property under the rules of *IRC Section 1374*, as modified by the regulations, as if the RIC or REIT were an S corporation.ⁿ⁹ If property subject to the rules of *IRC Section 1374* owned by a RIC, a REIT, or an S corporation (the predecessor) becomes the property of a RIC or REIT (the successor) in a continuation transaction, the rules of *IRC Section 1374* apply to the successor to the same extent that the predecessor

was subject to those rules with respect to the property, and the 10-year recognition period of the successor with respect to the property is reduced by the portion of the 10-year period of the predecessor that expired before the date of the continuation transaction.ⁿ¹⁰

The first modification applies only to REITs. The prelimitation amount of *Regulations Section 1.1374-2(a)(1)* (limiting an S corporation's net recognized built-in gain by computing taxable income using all rules applicable to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover) is reduced by the portion of such amount that is subject to tax under *IRC Section 857(b)(4)* (income from foreclosure property), *857(b)(5)* (imposition of tax for failure to meet certain income requirements), *857(b)(6)* (income from prohibited transactions), or *857(b)(7)* (income from redetermined rents, redetermined deductions, and excess interest).ⁿ¹¹ For this purpose, the amount of a REIT's recognized built-in gain that is subject to tax under *IRC Section 857(b)(5)* is computed as follows:

(1) Where the tax is computed by reference to *IRC Section 857(b)(5)(A)*, the amount of built-in gain that is subject to tax under *IRC Section 857(b)(5)* is the tax imposed by that section multiplied by a fraction the numerator of which is the amount of recognized built-in gain (without regard to recognized built-in loss and recognized built-in gain from prohibited transactions) that is not derived from sources referred to in *IRC Section 856(c)(2)*, and the denominator of which is the gross income (without regard to gross income from prohibited transactions) of the REIT that is not derived from sources referred to in *IRC Section 856(c)(2)*.ⁿ¹²

(2) Where the tax under *IRC Section 857(b)(5)* is computed by reference to *IRC Section 857(b)(5)(B)*, the amount of built-in gain that is subject to tax under *IRC Section 857(b)(5)* is the tax imposed by that section multiplied by a fraction the numerator of which is the amount of recognized built-in gain (without regard to recognized built-in loss and recognized built-in gain from prohibited transactions) that is not derived from sources referred to in *IRC Section 856(c)(3)*, and the denominator of which is the gross income (without regard to gross income from prohibited transactions) of the REIT that is not derived from sources referred to in *IRC Section 856(c)(3)*.ⁿ¹³

The taxable income limitation of *Regulations Section 1.1374-2(a)(2)* (limiting built-in gain to an S corporation's taxable income determined by using all rules applying to C corporations with certain modifications) is reduced by an amount equal to the tax imposed under *IRC Sections 856(b)(5), (6) and (7)*.ⁿ¹⁴

The second modification, applicable to RICs and REITs, allows the use of net operating loss carryforwards and capital loss carryforwards arising in taxable years when the corporation generating the loss was not subject to the rules governing regulated investment companies or real estate investment trusts as a deduction against net recognized built-in gain to the extent allowed under *IRC Section 1374*.ⁿ¹⁵ The loss carryforwards must be used as a deduction against net recognized built-in gain for a taxable year to the greatest extent possible before the losses can be used to reduce investment company taxable income for purposes of *IRC Section 852(b)* or real estate investment trust taxable income for purposes of *IRC Section 857(b)* for that year.

A third modification allows minimum tax credits and business credit carryforwards arising in taxable years for which the corporation generating the credit was not subject to the rules governing regulated investment companies or real estate investment trusts to reduce the tax imposed on net recognized built-in gain.ⁿ¹⁶ The credits and credit carryforwards must be used to reduce the tax on net recognized built-in gain for a taxable year to the greatest extent possible before the credit and credit carryforwards can be used to reduce the tax on investment company taxable income or real estate investment trust taxable income.

If a conversion transaction is a qualification of a C corporation as a RIC or REIT, the 10-year recognition period described in *IRC Section 1374(d)(7)* begins on the first day of the RIC's or REIT's first taxable year.ⁿ¹⁷ In the case of

other conversion transactions, the 10-year period begins on the day the property is acquired by the RIC or REIT.

Recognized built-in gains of a RIC or REIT are included in computing investment company taxable income, real estate investment trust taxable income, capital gains for purposes of *IRC Sections 852(b)(3)* and *857(b)(3)*, gross income derived from sources within any foreign country or possession of the United States for purposes of *IRC Section 853*, and the dividends paid deduction for purposes of *IRC Section 852(b)(2)(D)*, *852(b)(3)(A)*, *857(b)(2)(B)*, and *857(b)(3)(A)*.ⁿ¹⁸ The amount of tax imposed on net recognized built-in gain for a taxable year is treated as a loss sustained by the RIC or REIT during the taxable year.ⁿ¹⁹ The character of the loss is determined by allocating the tax proportionately (based on recognized built-in gain) among the items of recognized built-in gain included in net recognized built-in gain. For RICs, the tax imposed on net recognized built-in gain is treated as attributable to the portion of the RIC's taxable year occurring after October 31.

A RIC or REIT that entered into a conversion transaction before January 2, 2002, can make the *IRC Section 1374* election with any federal income tax return filed by the RIC or REIT on or before September 15, 2003, provided that the RIC or REIT has reported consistently with the election for all periods.ⁿ²⁰ An interim election is not necessary if the RIC or REIT can demonstrate that it informed the Service prior to January 2, 2002, of its intent to make the election.ⁿ²¹

The temporary regulations governing conversion transactions occurring after January 1, 2002, follow the previously discussed regulations. However, they include certain changes that are not included in those regulations because the Service was concerned that the changes, if made retroactively, could have an adverse impact on taxpayers that relied on the 2000 temporary regulations.ⁿ²²

The first change makes *IRC Section 1374* treatment the default rule, unless the C corporation elects deemed sale treatment for the conversion transaction.ⁿ²³ The second is the addition of an anti-stuffing rule that requires the C corporation to disregard converted property in computing gain or loss on the conversion transaction if (1) the converted property was acquired by the C corporation in a transaction to which *IRC Section 351* applied or as a contribution to capital; (2) the converted property had an adjusted basis immediately after its acquisition by the C corporation in excess of its fair market value on the date of acquisition; and (3) the acquisition of the converted property by the C corporation was part of a plan a principal purpose of which was to reduce gain recognized by the C corporation on the conversion transaction.ⁿ²⁴

A partnership with C corporation partners is treated as an aggregate for purposes of applying the temporary regulations governing conversion transactions after January 1, 2002. Thus, the regulations provide that they apply to property transferred to a RIC or REIT to the extent of any C corporation's proportionate share of the partnership property.ⁿ²⁵

FOOTNOTES:

(n1)Footnote 1. *IRC § 852(b)(1)*. An RIC that is also a personal holding company and has investment company taxable income and undistributed personal holding company income is liable for tax on its retained income under both *IRC § 541* and *IRC § 852(b)(1)*. *Rev Rul 88-41, 1988-1 CB 253*.

See § 6.03[1] for a discussion of the treatment of net built-in gain assets of a C corporation that become assets of a RIC.

(n2)Footnote 1.1. Costs incurred in developing and launching new RIC's do not qualify as ordinary and necessary expenses under *IRC § 162(a)*. Rather, the expenditures are capital in nature because they provide the RIC with significant, long-term benefits. *FMR Corp & Subs v Commr, 110 TC 402 (1998)*.

(n3)Footnote 2. *IRC §§ 852(b)(2)(A)-(D)*. In addition, the taxable income for a period of less than twelve months will not be placed on an annual basis even though the short taxable year results from a change of accounting period. *IRC § 852(b)(2)(E)*; *Treas Reg § 1.852-3(e)*.

An RIC with both common and preferred shares is permitted a deduction for ordinary dividends paid on either class of stock, as well as for special distributions made with respect to the preferred shares. *Rev Rul 74-177, 1974-1 CB 165* .

(n4)Footnote 3. *IRC § 133(a)*.

(n5)Footnote 4. *IRC § 133(b)*.

(n6)Footnote 5. *IRC § 852(b)(8)*. See § 12.03[7], *infra*, for a discussion of *IRC § 4982(e)(4)*.

(n7)Footnote 5.1. *IRC § 852(b)(10)*.

(n8)Footnote 6. *Rev Rul 73-463, 1973-2 CB 34* .

(n9)Footnote 7. A dividend distribution can be deducted only if it meets the definition of dividend contained in *IRC § 316. IRC § 562(a)*.

(n10)Footnote 8. A distribution to a trustee for shareholders will satisfy the distribution requirement, *Rev Rul 69-652, 1969-2 CB 147* ; as will a distribution in installments. *Rev Rul 69-445, 1969-2 CB 148* .

(n11)Footnote 9. The dividend distribution is taken into account for two purposes--the dividends paid deduction and the income distribution requirement of *IRC § 852(a)(1)*.

(n12)Footnote 10. *Treas Reg § 1.855-1(b)(1)* See Ltr Rul 9345016 for an example of an instance in which the IRS granted an extension of time to file the election. Shortly before the due date of the return, the advisor hired by the taxpayer to review and file the taxpayer's returns moved its accounting operations to another floor and reassigned responsibility for such review and filing to a different segment of its accounting department.

(n13)Footnote 11. *Treas Reg § 1.855-1(b)(2)*.

(n14)Footnote 12. *Treas Reg § 1.855-1(b)(1)*.

(n15)Footnote 13. *Treas Reg § 1.855-1(b)(1)*. A distribution made pursuant to a valid election is considered as paid out of the earnings and profits of the year to which the election relates, and not out of the earnings and profits of the year of distribution.

(n16)Footnote 1. *IRC § 852(b)(3)(A). IRC § 562(c)* does not consider any part of a distribution as a dividend for purposes of the dividends paid deduction unless the dividend is pro rata with no preference to any share of stock as compared with other shares of the same class. However, in the case of a distribution to a shareholder that made an initial investment of at least \$10 million in the regulated investment company, the distribution is not to be treated as non pro rata or preferential solely by reason of an increase in the distribution attributable to reductions in administrative expenses of the company. For this purpose, the shareholder is the legal owner of the shares. See *Rev Rul 89-79, 1989-1 CB 172* , involving master shareholder accounts that invest in an RIC.

A second exception is made in the case of distributions in redemptions of interests in unit investment trusts issuing periodic payment plan certificates, if the conditions of *IRC § 852(d)* are met. See *Treas Reg § 1.852-10(b)(2)* for an example of the operation of *IRC § 852(d)*.

Variations in distributions to shareholders of different qualified groups that exist solely as a result of a waiver or reimbursement of fees or expenses, or the allocation of expenses, in accordance with criteria set forth in *Rev Proc 99-40, 1999-2 CB 565* , do not prevent the distributions from qualifying as dividends under *IRC § 562(c)*.

(n17)Footnote 2. *IRC § 852(b)(3)(C)*. If the determination of a deficiency results in an increase in the amount of

excess net long-term capital gain, the designation with respect to the increase may be made at any time within 120 days after the date of the determination.

The amount which can be designated as a capital gain dividend is reduced by the amount of any capital loss carried over to the taxable year and deducted in that year. *Rev Rul 76-299, 1976-2 CB 211* .

(n18)Footnote 3. *IRC § 852(b)(3)(C)*.

(n19)Footnote 4. *IRC § 852(b)(3)(C)*. An RIC can elect to compute its taxable income for a taxable year without regard to part or all of any post-October capital loss or post-October currency loss for that year; the loss is treated as arising on the first day of the next taxable year. The election to defer will not affect the amount of the RIC's gross income for purposes of *IRC § 851(b)(2)* or (3). *Treas Reg § 1.852-11(f)(1), (4), (5)*.

The earnings and profits of an RIC for any taxable year are determined without regard to any post-October capital loss or currency loss. If the election to defer the loss for taxable income purposes is made, earnings and profits are computed as if the amount of deferred loss had arisen on the first day of the succeeding taxable year. *Treas Reg § 1.852-11(g)(1), (2)*.

(n20)Footnote 5. *Treas Reg § 1.855-1(b)(1)*.

(n21)Footnote 6. *IRC § 855(c)*.

(n22)Footnote 1. *Rev Proc 2005-20, 2005-1 CB 990* , describes conditions under which a RIC that holds a partnership interest is treated, for purposes of eligibility to pay exempt-interest dividends, as if it directly invested in the assets held by the partnership.

(n23)Footnote 1.1. *IRC § 852(b)(5)(C)*.

(n24)Footnote 1. In the case of an RIC, the term "adjustment" means (a) an increase in investment company taxable income determined without regard to the deduction for dividends paid, (b) an increase in the amount of the excess of net capital gain over the deduction for capital gains dividends paid, or (c) a decrease in the deduction for dividends paid (determined without regard to capital gains dividends). *IRC § 860(d)(1)*.

(n25)Footnote 2. See Ch 13.

(n26)Footnote 3. A determination is a final decision or judgment of a court, a closing agreement, or a determination filed by the company that it failed to qualify as an RIC for the year or a statement by the taxpayer attached to its amendment or supplement to a return of tax for the relevant tax year. *IRC §§ 852(e)(5), 860(e)*.

(n27)Footnote 4. The interest charge is calculated at the underpayment rate imposed by *IRC § 6621* for the period that begins on the due date of the return for the year in question and ends on the date the determination is made. *IRC § 852(e)(3)*.

(n28)Footnote 5. *IRC § 852(e)(1), (2)*. The described procedure is not available if the determination contains a finding that the failure to qualify was due to fraud. *IRC § 852(e)(4)*.

(n29)Footnote 6. *IRC § 852(e)(2)(C)*.

(n30)Footnote 1. See Ch 4.

(n31)Footnote 2. *IRC § 852(c)(1)*. The current earnings and profits of an RIC are not reduced by capital losses carried over to the taxable year. *Rev Rul 76-299, 1976-2 CB 211* .

(n32)Footnote 3. *IRC § 852(c)(2)*.

(n33)Footnote 4. *Treas Reg § 1.852-5(b)*.

(n34)Footnote 5. *Treas Reg § 1.852-5(a)*.

(n35)Footnote 6. *IRC § 852(c)(3)*, applicable for taxable years beginning after Dec 31, 2000.

(n36)Footnote 1. Only those shareholders who are record holders of a specified percentage of the stock of the RIC are required to furnish statements. The percentages vary in relation to the number of record owners of stock. *Treas Reg § 1.852-6(c)*. If the shareholder fails to comply with the company's demand, he must furnish essentially the same information as part of his return. *Treas Reg § 1.852-7*.

(n37)Footnote 2. *Treas Reg § 1.852-6(c)*.

(n38)Footnote 1. The provision does not apply to an RIC for any calendar year if, at all times during the year, each shareholder of the company was a qualified pension, profit-sharing or stock bonus plan trust, a tax-exempt organization, or a segregated asset account of a life insurance company held in connection with variable contracts (as defined in *IRC § 817(d)*). Any shares attributable to an investment in the company (not exceeding \$250,000) made in connection with its organization are not taken into account. *IRC § 4982(f)*.

Regardless of the taxable years of a RIC and any partnership in which the RIC is a partner, for purposes of determining the RIC's required distribution for a calendar year under *IRC § 4982(a)*, the RIC must take into account its share of partnership items of income, gain, loss, and deduction as they are taken into account by the partnership. *Rev Rul 94-40, 1994-1 CB 274*, as modified by *Rev Rul 94-40A, 1994-1 CB 276*.

For purposes of taking partnership items into account in determining an RIC's required distribution under *IRC § 4982(a)*, the Service will not challenge the use of a method to account for items from a partnership if: (1) the method takes the items into account under *IRC § 706*; (2) the RIC meets the RIC asset test; and (3) at all times during the 12-month period ending on the last testing date that is within the taxable year, the RIC holds an aggregate interest in profits and capital of the partnership of no more than 50 percent. The consistency requirement applies on a partnership-by-partnership basis. *Rev Proc 94-71, 1994-2 CB 810*.

The asset test is met if, at each testing date during the calendar year, the RIC has less than 35 percent of the value of its total assets represented by interests in partnerships. In general, the testing dates are the close of each quarter of the taxable year of the RIC. Alternatively, the testing dates are the close of January, April, July, and October, if the RIC uses those dates consistently from year to year to satisfy the asset test.

(n39)Footnote 2. *IRC § 4982(b)*.

(n40)Footnote 3. *IRC § 4982(b)(3)*.

(n41)Footnote 4. *IRC § 4982(c)*.

(n42)Footnote 5. *IRC § 4982(e)(1)*. For purposes of determining the ordinary income of an RIC, *IRC § 1296* (governing the mark-to-market election for marketable passive foreign investment company stock) is applied as if the RIC's taxable year ended on Oct 31, and any ordinary gain or loss from an actual disposition of stock in a passive foreign investment company during the portion of the calendar year after Oct 31 is taken into account in determining the RIC's ordinary income for the following calendar year. *IRC § 4982(e)(6)*. If the RIC makes the election under *IRC § 4982(e)(4)* (see the text at N 8), the preceding sentence is applied by substituting the last day of the RIC's taxable year for Oct 31.

(n43)Footnote 6. *IRC § 4982(e)(5)*.

(n44)Footnote 7. *IRC § 4982(e)(2)*.

(n45)Footnote 8. *IRC § 4982(e)(4)*. The election can be revoked only with the consent of the Service.

(n46)Footnote 9. *IRC § 4982(e)(3)*.

(n47)Footnote 1. Temp Treas Reg § 1.337(d)-5T(a)(1), (3).

(n48)Footnote 2. Temp Treas Reg § 1.337(d)-5T(b)(1).

(n49)Footnote 2.1. *Treas Reg § 1.337(d)-5*.

(n50)Footnote 3. Temp Treas Reg § 1.337(d)-6T.

(n51)Footnote 4. Temp Treas Reg § 1.337(d)-7T.

(n52)Footnote 4.1. *Treas Reg §§ 1.337(d)-6, 1.337(d)-7*.

(n53)Footnote 5. *Treas Reg § 1.337(d)-5(d)*. The RIC using the 2000 regulations must apply *Treas Reg § 1.337(d)-6(c)(1)(i)*, *Treas Reg § 1.337(d)-6(c)(2)(i)*, *Treas Reg § 1.337(d)-6(c)(2)(ii)*, and *Treas Reg § 1.337(d)-6(c)(3)* with respect to built-in gains.

(n54)Footnote 6. *Treas Reg § 1.337(d)-6(a)(1)*, *Treas Reg § 1.337(d)-6(a)(2)(ii)*. If the conversion transaction is a qualification of the C corporation as a RIC, the deemed sale date is the end of the last day of the C corporation's last taxable year before the first taxable year in which it qualifies to be taxed as a RIC. *Treas Reg § 1.337(d)-6(b)(3)(i)*. If the conversion is a transfer of property by the C corporation to the RIC, the deemed sale date is the end of the day before the day of transfer. *Treas Reg § 1.337(d)-6(b)(3)(ii)*.

The deemed sale rule does not apply to any conversion transaction to the extent that gain or loss otherwise is recognized. Temp Treas Reg § 1.337(d)-6T(d)(1). It is inapplicable as well to any corporation that qualified to be a RIC or REIT for at least one taxable year, then failed to so qualify for a period not in excess of two taxable years, and then requalifies as a RIC or REIT. *Treas Reg § 1.337(d)-6(d)(2)*.

(n55)Footnote 7. *Treas Reg § 1.337(d)-6(b)(1)*.

(n56)Footnote 8. *Treas Reg § 1.337(d)-6(b)(1)*. Net loss is the excess of aggregate losses over aggregate gains (including items of income), without regard to character.

(n57)Footnote 9. *Treas Reg § 1.337(d)-6(c)(1)(i)*.

(n58)Footnote 10. *Treas Reg § 1.337(d)-6(c)(1)(ii)*.

(n59)Footnote 11. *Treas Reg § 1.337(d)-6(c)(2)(i)(A)*.

(n60)Footnote 12. *Treas Reg § 1.337(d)-6(c)(2)(i)(A) (1)*.

(n61)Footnote 13. *Treas Reg § 1.337(d)-6(c)(2)(i)(A) (2)*.

(n62)Footnote 14. *Treas Reg § 1.337(d)-6(c)(2)(i)(B)*.

(n63)Footnote 15. *Treas Reg § 1.337(d)-6(c)(2)(ii)(A)*.

(n64)Footnote 16. *Treas Reg* § 1.337(d)-6(c)(2)(ii)(B).

(n65)Footnote 17. *Treas Reg* § 1.337(d)-6(c)(2)(iii).

(n66)Footnote 18. *Treas Reg* § 1.337(d)-6(c)(3)(i).

(n67)Footnote 19. *Treas Reg* § 1.337(d)-6(c)(3)(ii).

(n68)Footnote 20. *Treas Reg* § 1.337(d)-6(c)(4)(ii). The information required for the election, which is irrevocable, is set forth in *Treas Reg* § 1.337(d)-6(c)(4)(i).

(n69)Footnote 21. *Treas Reg* § 1.337(d)-6(c)(4)(i).

(n70)Footnote 22. *TD 8975*, 67 *Fed Reg* 8 (Jan 2, 2002).

(n71)Footnote 23. *Treas Reg* § 1.337(d)-7(a)(1). *IRC* § 1374 is applied with the same modifications applicable to pre-2002 conversion transactions.

A corporation makes the deemed sale election by attaching a statement to the federal income tax return for the taxable year in which the deemed sale occurs. *Treas Reg* § 1.337(d)-7(c)(5). The election is irrevocable.

(n72)Footnote 24. *Treas Reg* § 1.337(d)-7(c)(4).

(n73)Footnote 25. *Treas Reg* § 1.337(d)-7(e).



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Taxation of Securities Transactions

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CHAPTER 12 Regulated Investment Companies

1-12 Taxation of Securities Transactions § 12.04

§ 12.04 Taxation of Regulated Investment Company Shareholders

[1] Dividends Received

[a] Time of Inclusion in Gross Income. Except for the requirement that an investment company stockholder include certain undistributed capital gains in gross income,ⁿ¹ a shareholder generally includes dividends received from an RIC in gross income for the taxable year in which they are actually received.ⁿ² This rule applies even though the distribution is made with respect to a valid *Section 855(a)* election by the corporation to treat the dividend as having been paid in the prior taxable year.ⁿ³

A special rule governs any dividend declared by an RIC in October, November, or December of any calendar year and payable to shareholders of record on a specified date in such month. The dividend is deemed to be paid by the company and received by the shareholder on December 31st, if the dividend is actually paid by the company during January of the following year.ⁿ⁴ The special rule does not apply for purposes of *IRC Section 855(a)*.ⁿ⁵

[b] Character of the Dividends Received. A distribution received by a shareholder will be considered as ordinary income, unless the RIC designates all or part of the dividend as a capital gain dividend or as an exempt-interest dividend in a written notice to its shareholders no later than 60 days after the close of its taxable year.ⁿ⁶ The amount designated as a capital gain dividends will be treated by the shareholder as long-term capital gain.ⁿ⁷ However, if the aggregate amount designated as capital gain dividends for the taxable year is greater than the excess of the company's net capital gain, the aggregate capital gain dividend for the taxable year is limited to such excess.ⁿ⁸ For example, if an investment company, having 100,000 shares outstanding, designated \$300,000 of distributions as capital gain dividends when in fact the excess of net long-term capital gain over net short-term capital loss was only \$200,000, the capital gain dividend would amount to \$2 per share instead of \$3 per share. The amount designated as an exempt-interest dividend will be treated as an item of excludable income for all purposes of the Code.ⁿ⁹ The extent of the dividend is limited here as well, for it cannot exceed the excess of the amount of tax-exempt interest received over the deductions disallowed by *IRC Sections 265* and *171(a)(2)*.ⁿ¹⁰

[c] Effect on the Dividends Received Deduction. *IRC Section 854* limits the extent to which dividends received from RICs qualify for the maximum rate of tax on dividends provided by *IRC Section 1(h)(11)* or for the dividends received deduction of *IRC Section 243*. Capital gain dividends can never qualify as dividends for those purposes.ⁿ¹¹ Ordinary income dividends can be taken into account in full for purposes of the deduction only if the RIC meets the income distribution requirements of *IRC Section 852(a)(1)* for the taxable year in which the dividend is paid.ⁿ¹² The

dividend must be paid by a domestic corporation.ⁿ¹³ However, distributions from tax-exempt corporations, farmers' cooperative associations, and real estate investment trusts do not qualify as dividends for purpose of the deduction.ⁿ¹⁴ In no event can the amount designated as a dividend by the company exceed the aggregate dividends received by the company for the taxable year.ⁿ¹⁵

If a dividend (other than a capital gain dividend) is received from a RIC, the RIC meets the requirements of *IRC Section 852(a)* for the taxable year during which it paid the dividend, and the qualified dividend income received by the RIC during the taxable year is less than 95-percent of its gross income, then, in computing the maximum tax on dividends under *IRC Section 1(h)(11)*, then, in computing qualified dividend income, there is taken into account only that portion of the dividend designated by the RIC.ⁿ¹⁶ For this purpose, gross income from sales or other dispositions of stock or securities includes only the excess of net short-term capital gain over net long-term capital loss from such sales or dispositions.ⁿ¹⁷ The aggregate amount that can be designated as qualified dividend income cannot exceed the sum of (1) the qualified dividend income of the RIC for the taxable year, and (2) the amount of earnings and profits that were distributed by the RIC during the taxable year and accumulated in a taxable year with respect to which rules did not apply.ⁿ¹⁸

A final limitation is imposed by *IRC Section 854(b)(2)*. No portion of any distribution by an RIC can be treated as a qualified dividend or as a dividend for purposes of the dividends received deduction if it exceeds the amount designated as a dividend by the company in a written notice mailed to shareholders within 60 days after the close of the company's taxable year. If the amount designated by the company is greater than the amount correctly ascertained under *IRC Section 854(b)(1)*, the correct amount controls.ⁿ¹⁹

[2] Undistributed Capital Gains

[a] Extent and Time of Inclusion in Gross Income. Although an RIC is taxed on the undistributed excess of net long-term capital gain over net short-term capital loss, a shareholder will be required to include in his gross income as long-term capital gain so much of the undistributed capital gains as the RIC designates in a written notice mailed to shareholders not later than 60 days after the close of the company's taxable year.ⁿ¹ However, in no event can the amount includable exceed the shareholder's proportionate share of the capital gains subject to tax at the corporate level under *IRC Section 852(b)(3)*.ⁿ²

The designated amount of undistributed capital gains is includable in gross income for the taxable year of the shareholder that includes the last day of the taxable year of the RIC in respect of which the designation is made.ⁿ³ To illustrate, undistributed capital gains realized by a company in a fiscal year ending January 31, 1987, would be includable by a calendar year shareholder in his return for 1987, even though all the gains might have been realized between February 1 and December 31, 1986.

[b] Credit for Taxes Paid. The "conduit" theory of taxation that Congress has provided in the case of RICs would be undermined if a tax on undistributed capital gains were imposed both at the corporate and shareholder levels. This problem is eliminated by *IRC Section 852(b)(3)(D)(ii)* which provides that each shareholder is deemed to have paid the tax imposed on the corporate level on the amount of undistributed capital gain required to be included in his gross income, and which allows the shareholder a credit or refund for the tax which he is deemed to have paid.

[c] Effect on Basis of Shareholder's Stock. The inclusion of undistributed capital gain by the shareholder works an increase in the adjusted basis of his shares in the RIC. The amount of the increase is equal to the amount includable as long-term capital gain less the tax imposed on such amount at the corporate level.ⁿ⁴ Thus, for years prior to 1970, basis was increased by 75 percent of the undistributed capital gains includable in such years. For years after 1974 and before 1979, the increase was 70 percent; for years after 1978 and before 1987, it was 72 percent; for years after 1986 and before 1993, it was 66 percent; for years after 1992 and the first taxable year beginning after August 5, 1997, it was 35 percent. For taxable years beginning after August 5, 1997, the adjustment to basis is equal to the difference between the amount of the includable gain and the tax deemed paid by the shareholder.

[d] Effect on Earnings and Profits of a Corporate Shareholder. If the RIC shareholder is a corporation, the amount of undistributed capital gains includable in its gross income will cause a corresponding increase in its earnings and profits for the taxable year.ⁿ⁵ By the same token, the reduction in earnings and profits by reason of the amount of taxes paid by the corporation must take into account the extent of the corporation's tax liability satisfied by the credit for taxes deemed to have been paid by the shareholder with respect to undistributed capital gains.ⁿ⁶

[3] Special Rule Affecting Loss on the Sale or Exchange of Stock Held Less Than Six Months

The combination of a holding period of less than six months,ⁿ¹ and the inclusion in gross income of either a capital gain dividend or a designated amount of undistributed capital gains, will convert a portion of any loss realized on a sale or exchange of the stock from a short-term capital loss into a long-term loss. The amount so affected can never exceed the amount of capital gain which the shareholder was required to include in gross income.ⁿ²

Example:

On December 10, 1985, a person acquired 100 shares of Investment Company X stock for \$2,500. On December 31, 1985, the investment company distributed a capital gain dividend of \$3 a share to stockholders of record on December 20, 1985. On January 5, 1986, the entire 100 shares were sold for \$2,150. Of the total loss of \$350, \$300 (an amount equal to the capital gain dividend received with respect to the stock and included in gross income) will be treated as a long-term capital loss, and the \$50 balance as a short-term capital loss.

The foregoing discussion assumed that the shareholder did not receive any exempt-interest dividend from the company. If the shareholder did receive such a dividend and then sold the stock within six months of acquisition, any loss realized on the disposition would be disallowed to the extent of the exempt-interest dividend.ⁿ³ The amount so disallowed would reduce the amount of loss treated as long-term capital loss under the rules discussed above.

[4] Election to Allow Shareholders to Claim Foreign Tax Credits of Regulated Investment Companies

An RIC which has more than 50 percent of the value of its assets invested in stock or securities of foreign corporations and which meets the income distribution requirement of *IRC Section 852(a)(1)*, may elect to forego any deduction under *IRC Section 164(a)* or any credit under *IRC Section 901* for foreign taxes paid by it during the taxable year.ⁿ¹ If the election is made, the amount of those taxes will be added to the RIC's dividends paid deduction for the taxable year.ⁿ²

The shareholder of an electing RIC must:

- (1) include in gross income his proportionate share of foreign taxes paid by the RIC;ⁿ³
- (2) treat his proportionate share of such taxes and the portion of any dividend paid by the RIC which represents income derived from foreign sources as gross income from foreign sources;ⁿ⁴ and
- (3) treat his proportionate share of the foreign taxes paid by the RIC as having been paid by him.ⁿ⁵ This permits the shareholder to claim his share of such taxes as either a credit under *IRC Section 901* or a deduction under *IRC Section 164(a)*.ⁿ⁶

The shareholder takes these consequences into account in the taxable year in which distribution is made even though the distribution is pursuant to a *IRC Section 855(a)* election validly made by the corporation.ⁿ⁷

The effect of the election, from the standpoint of the shareholder, is to place him in the same position as a person directly owning stock in foreign corporations.

[a] Notice to Shareholders. The amount that a shareholder is required to treat as his proportionate share of foreign taxes paid and as gross income derived from foreign sources can not exceed the amounts so designated in a written notice mailed to shareholders within 60 days after the close of the company's taxable year.ⁿ⁸ The notice must show the taxes paid to each country and the portion of the dividend which represents income derived from sources within each such country.ⁿ⁹ A copy of the notice must be filed with the company's return in order for the election to be valid.ⁿ¹⁰

[b] Manner of Making the Election. A valid election can be made by the RIC only in the manner specified in the Regulations.ⁿ¹¹ In brief, the RIC is required to file a statement as part of its return in which it sets forth, among other things, the total foreign source income received by it, the total taxes paid by it to foreign countries, and the proportionate share of foreign taxes paid and foreign income received attributable to each share of outstanding stock of the RIC.

The election must be made with respect to all qualifying foreign taxes paid during the taxable year and cannot be made any later than the time prescribed for filing the company's return for the taxable year.ⁿ¹² While a new election must be made each year, once an election is made for a given year it becomes irrevocable.ⁿ¹³

[5] Election to Allow Shareholders to Claim Credits on Tax Credit Bonds

IRC Section 853A, added by the American Recovery and Reinvestment Act of 2009 (ARRA), provides a procedure by which a RIC may elect to pass through credits to which it is entitled (in lieu of interest) on any tax credit bond issued under *IRC Sections 54, 54A or 54AA*.ⁿ¹ The RIC must make an election by which it gives up its right to claim credits with respect to its holdings of tax credit bonds.ⁿ² The RIC must also include in gross income for the taxable year, as interest, an amount equal to the amount it would have included in gross income had it not made the election (i.e., an amount equal to the tax credits to which it would have been entitled).ⁿ³ The RIC is entitled to an offsetting increase in its dividends paid deduction for the taxable year equal to this increase in its gross income.ⁿ⁴

The RIC must also provide a notice to its shareholders, not less than 60 days after the close of its taxable year in a manner to be prescribed by the Secretary, advising each shareholder of (1) his or her proportionate share of the RIC's tax credits for such year in respect of its tax credit bonds, and (2) the equivalent amount of gross income such shareholder must include as interest income on his or her return for such year.ⁿ⁵ Each shareholder of an electing RIC is then required to report the income and is allowed the proportionate share of the RIC's credits on his or her return.ⁿ⁶

[6] Treatment of Certain Load Charges

The purchase price of shares in a mutual fund often includes a sales fee commonly called a load charge. In addition, the purchase of shares in one fund often carries with it the right to sell those shares and reinvest the proceeds in the shares of another, related fund. If the change occurs soon after the initial purchase, the sale will often produce a loss measured in part by the amount of the load charge. Thus, even though there is a continuing investment in the same group of funds, the taxpayer will have realized a capital loss that is potentially deductible in the year of sale.

The ability to convert existing basis into a loss or lesser amount of gain is precluded by *IRC Section 852(f)(1)* if:

- (1) the taxpayer incurs a load charge in acquiring stock in an RIC and thereby acquires a reinvestment right--the right to acquire stock in a mutual fund without the payment of a load charge or with the payment of a reduced load charge;
- (2) the original shares are disposed of before the 91st day after their purchase; and
- (3) the taxpayer exercises the reinvestment right by acquiring stock in the same, or in another, RIC.ⁿ¹

This is accomplished by disregarding the amount of the load charge in determining the basis of the original shares and, accordingly, the gain or loss realized upon the disposition. Instead, the load charge is added to the basis of the newly acquired shares.

FOOTNOTES:

(n1)Footnote 1. See § 12.04[2], *infra*.

(n2)Footnote 2. *Treas Reg* § 1.852-4(a)(1), (3). Dividends which are paid in stock or reinvested in stock pursuant to an option on the part of the shareholder will be taxable dividends. *IRC* § 305(b)(1); *Treas Reg* § 1.305-2(c)(2), Ex 2.

A number of rulings have discussed the problem of determining the owner for tax purposes of mutual fund shares held by a life insurance company as part of a "wrap around" annuity under which the premiums are invested in shares of mutual funds. In general, the policyholder will be treated as the owner if he has investment control and the mutual fund is available to the general public without buying an annuity. *Rev Rul* 81-225, 1981-2 CB 12, clarified by *Rev Rul* 82-55, 1982-1 CB 12 and *Rev Rul* 82-54, 1982-1 CB 11, clarified and amplified by *Rev Rul* 2003-92, 2003-2 CB 350. The investor control theory of *Rev Rul* 81-225 was upheld in *Christoffersen v US*, 749 F2d 513 (8th Cir 1984). Compare *Rev Rul* 2003-91, 2003-2 CB 347, where the policyholder did not possess sufficient incidents of ownership over assets in the mutual funds, so that the holder was not required to include earnings on the assets in the funds in income.

Rev Rul 81-225 and *Rev Rul* 2003-92 have been clarified and amplified to provide that the holder of a variable annuity or life insurance contract is not treated as the owner of an interest in a RIC that funds the variable contract solely because interests in the same RIC are also available to investors described in *Treas Reg* § 1.817-(5)(f)(3) (see § 12A.02). *Rev Rul* 2007-7, 2007-1 CB 468.

(n3)Footnote 3. *IRC* § 855(b).

(n4)Footnote 4. *IRC* § 852(b)(7).

(n5)Footnote 5. For example, an RIC that has a taxable year ending on Nov 30th, may treat the dividend as having been paid before December under *IRC* § 855(a).

(n6)Footnote 6. *IRC* § 852(b)(3)(C). A designation by an RIC with more than one class of stock will be effective for federal income tax purposes only to the extent that it does not exceed the class's proportionate share of that type of income. *Rev Rul* 89-81, 1989-1 CB 226.

(n7)Footnote 7. *IRC* § 852(b)(3)(B).

(n8)Footnote 8. *IRC* § 852(b)(3)(C). In making the designations, permitted by *IRC* §§ 852(b)(3)(C), 852(b)(5)(A), 854(b)(1), 871(k)(1)(C), and 871(k)(2)(C), the RIC may designate the maximum amount permitted under each provision even if the aggregate of all the amounts so designated exceeds the total amount of the RIC's dividend distribution. *Rev Rul* 2005-31, 2005-1 CB 1084.

(n9)Footnote 9. *IRC* § 852(b)(5)(B).

(n10)Footnote 10. *IRC* § 852(b)(5)(A). In making the designations, permitted by *IRC* §§ 852(b)(3)(C), 852(b)(5)(A), 854(b)(1), 871(k)(1)(C), and 871(k)(2)(C), the RIC may designate the maximum amount permitted under each provision even if the aggregate of all the amounts so designated exceeds the total amount of the RIC's dividend distribution. *Rev Rul* 2005-31, 2005-21 IRB 1084.

(n11)Footnote 11. *IRC* § 854(a). This applies only to dividends paid out of long-term capital gains.

(n12)Footnote 12. *IRC* § 854(b)(1)(A). An amount is treated as a dividend received by the RIC only if it would

have qualified for the dividends received deduction if the deduction were available to RICs. *IRC § 854(b)(4)*. In making the designations, permitted by *IRC §§ 852(b)(3)(C), 852(b)(5)(A), 854(b)(1), 871(k)(1)(C), and 871(k)(2)(C)*, the RIC may designate the maximum amount permitted under each provision even if the aggregate of all the amounts so designated exceeds the total amount of the RIC's dividend distribution. *Rev Rul 2005-31, 2005-1 CB 1084*.

(n13)Footnote 13. *IRC § 854(b)(3)(A)*.

(n14)Footnote 14. *IRC § 854(b)(3)(B)(i), (ii)*.

A dividend received from an RIC is subject to the same limitations that are imposed on the recipient investment company. *IRC § 854(b)(3)(C)*.

(n15)Footnote 15. *IRC § 854(b)(1)(C)(i)*.

(n16)Footnote 16. *IRC § 854(b)(1)(B)(i)*. An amount is treated as a dividend only if it is qualified dividend income within the meaning of *IRC § 1(h)(11)(B)*, as discussed in § 2.06[2][a][i]. *IRC § 854(b)(5)*.

(n17)Footnote 17. *IRC § 854(b)(1)(B)(ii)*.

(n18)Footnote 18. *IRC § 854(b)(1)(C)(ii)*.

(n19)Footnote 19. *Treas Reg § 1.854-2*.

(n20)Footnote 1. *IRC § 852(b)(3)(D)(i)*. The designation is made on Form 2439. *Treas Reg § 1.852-9(a)(1)*. If notice is given to a nominee of an actual owner, the nominee is, in turn, required to give notice to the actual owner. *Treas Reg § 1.852-9(b)(1)*.

Under *IRC § 897(h)(1)*, a distribution by a RIC to a foreign taxpayer with respect to any class of stock that is regularly traded on an established securities market located in the US is not treated as gain recognized from the sale or exchange of a US real property interest if the foreign taxpayer did not own more than 5% of the class of stock at any time during the one-year period ending on the date of distribution. The amount of such gain is not included in computing the shareholder's long-term capital gains, but is included in the shareholder's gross income as a dividend from the RIC. *IRC § 852(b)(3)(E)*.

(n21)Footnote 2. *IRC § 852(b)(3)(D)(i)*.

(n22)Footnote 3. *Id.* In determining the proper person to be considered the shareholder, the undistributed capital gain is treated as a cash dividend payable to shareholders of record on the last day of the company's taxable year. The person who would be required to include such a dividend in gross income is the one who must include the undistributed capital gain in gross income. *Treas Reg § 1.852-4(b)(2)(iv)*.

(n23)Footnote 4. *IRC § 852(b)(3)(D)(iii)*.

(n24)Footnote 5. *Treas Reg § 1.852-4(b)(5)*. The earnings and profits of the distributing RIC for the taxable year are reduced by the total amount of the undistributed capital gains designated by the company and includable by its shareholders. The capital account is increased by the amount so designated less the taxes imposed on the gains. No reduction in earnings and profits is caused by the payment of taxes which are deemed paid by shareholders. *Treas Reg § 1.852-2(b)(2)(ii)*.

(n25)Footnote 6. *Treas Reg § 1.852-4(b)(5)*.

(n26)Footnote 1. The holding period principles of *IRC § 246(c)*, discussed at § 4.04[2][a][v], *supra*, are applicable in determining the holding period here.

(n27)Footnote 2. *IRC § 852(b)(4)*. The rule does not apply to losses incurred under a periodic liquidation plan. *IRC § 852(b)(4)(D)*.

(n28)Footnote 3. *IRC § 852(b)(4)(B)*.

(n29)Footnote 1. *IRC §§ 853(a), 853(b)(1)(A)*. The election applies only to taxes actually paid pursuant to an income tax convention, and not to taxes deemed paid by *IRC § 902*. *Treas Reg § 1.853-1(a)*.

The provision does not apply to any tax with respect to which the RIC is not allowed a credit because of the application of *IRC § 901(k)*. *IRC § 853(e)*.

(n30)Footnote 2. *IRC § 853(b)(1)(B)*.

(n31)Footnote 3. *IRC § 853(b)(2)(A)*.

(n32)Footnote 4. *IRC § 853(b)(2)(B)*.

(n33)Footnote 5. *IRC § 853(b)(2)(A)*.

(n34)Footnote 6. *Treas Reg § 1.853-1(a)*.

(n35)Footnote 7. *IRC § 855(d)*.

(n36)Footnote 8. *IRC § 853(c)*.

(n37)Footnote 9. *Treas Reg § 1.853-3*. If the amount designated is greater than the correct amount, the shareholder is limited to the amount correctly ascertained.

(n38)Footnote 10. *Treas Reg § 1.853-4(a)(1)(iii)*.

(n39)Footnote 11. *Treas Reg § 1.853-4(a)(1)*.

(n40)Footnote 12. *Treas Reg § 1.853-4(b)*.

(n41)Footnote 13. *Treas Reg § 1.853-4(b)*.

(n42)Footnote 1. See *IRC § 853A(e)(1)(A)*. Tax credit bonds are discussed in §§ 17.03[14][a]et seq and 17.03[15]. Authority to issue tax credit bonds under *IRC § 54* (clean renewable energy bonds), terminated after December 31, 2008; those bonds have been replaced by "new clean renewable energy bonds," a tax credit bond authorized by *IRC §§ 54A and 54C*.

(n43)Footnote 2. *IRC § 853A(b)(1)*. The Treasury is authorized to issue regulations concerning the manner of making the election, *IRC § 853A(d)*. Congress intends that, at least for any year in which the election is in effect, the election will apply to all tax credit bonds held by the RIC and not on an issue-by-issue basis. See HR Conf Rep 111-16, 111th Cong, 1st Sess (February 12, 2009) at 605.

(n44)Footnote 3. *IRC § 853A(b)(2)(A)*.

(n45)Footnote 4. *IRC § 853A(b)(2)(B)*.

(n46)Footnote 5. *IRC § 853A(c)* and *(d)*.

(n47)Footnote 6. *IRC § 853A(b)*.

(n48)Footnote 1. The rule does not apply to any charge incurred because of the reinvestment of a dividend.



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CHAPTER 12A Variable Deferred Annuity Contracts

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CHAPTER 12A Variable Deferred Annuity Contracts

1-12A Taxation of Securities Transactions § 12A.01

§ 12A.01 Introduction

We saw in the previous chapter that although regulated investment companies (RICs) offer investors diversification and expert management of their investments, RICs are required to distribute a specified portion of their income to their shareholders in order to avoid a tax on the entity. The shareholders must include the amount of the distribution in their respective incomes. Moreover, there is no deferral if the investor sells shares in a mutual fund and then reinvests the proceeds in another fund in the same "family;" gain must be reported in the year of sale.

Diversification and expert management can also be achieved with the purchase of a variable deferred annuity. Issuers of such contracts maintain a number of different investment vehicles and will place the purchaser's funds in whichever portfolio the investor chooses. The benefit of such an investment lies in its deferred tax status. The holder of the annuity is not subject to tax until distributions are actually made, even if changes occur in the investment of the funds within the annuity.



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CHAPTER 12A Variable Deferred Annuity Contracts

1-12A Taxation of Securities Transactions § 12A.02

§ 12A.02 Qualification for Tax-Deferred Status

The key to tax deferral for variable annuity contracts lies in the diversification of investments of segregated accounts that underlie the annuity. A variable annuity contract is a contract:ⁿ¹

- (1) that provides for the allocation of all or part of the amounts received under the contract to an account that, pursuant to state law or regulation, is segregated from the general asset accounts of the issuer;
- (2) that provides for the payment of a variable annuity computed on the basis of recognized mortality tables and the investment experience of a segregated asset account or, if the issuing company issues only variable contracts, the company-wide investment experience; and
- (3) under which the amounts paid in, or the amount paid out, reflect the investment return of the segregated asset account. This third requirement is applied without regard to whether there is a guarantee. Obligations under a guarantee that exceed obligations under the contract without regard to the guarantee are accounted for as part of the company's general account.

If a contract ceases to reflect current investment return and current market value, the contract is not treated as meeting the third requirement after such cessation. The investment return and market value of all assets in a segregated account must be allocated in an identical manner to any variable annuity contract invested in any of those assets.ⁿ²

Deferral is further predicated on the condition that each segregated asset account contain investments that are adequately diversified.ⁿ³ This standard is designed to deny annuity treatment for investments that are publicly available to investors and investments that are made, in effect, at the direction of the investor. Thus, annuity treatment is unavailable to variable annuity contracts that (1) are the equivalent to investments in one or a relatively small number of particular assets (eg, stocks, bonds, or certificates of deposits of a single issuer), or (2) invest in one or a relatively small number of publicly available mutual funds or specific properties, or in a nondiversified pool of mortgage type investments.ⁿ⁴

The diversification requirement is tested quarterly on a calendar basis.ⁿ⁵ A segregated asset account that meets the diversification requirement on the last day of the calendar quarter, or within 30 days after the close of the quarter, is adequately diversified for that quarter.ⁿ⁶

A segregated asset account that is not a real property account on its first anniversary (the anniversary of the first date on which an amount is allocated to the account) is considered to be diversified until the first anniversary unless more than 30 percent of the amount allocated as of the last day of a calendar quarter is attributable to contracts entered into more than one year before that date. If the segregated asset account is a real property account, the "start-up period" is five years, with the 30-percent rule applicable if allocated to contracts entered into more than five years before the date.ⁿ⁷

A segregated asset account that satisfies the diversification requirements on the date a plan of liquidation is adopted is considered adequately diversified for the following periods beginning on the date of adoption of the plan: one year if the account is not a real property account; two years if the account is a real property account.ⁿ⁸

Once the diversification requirement is not met, tax deferral is eliminated even if diversification is achieved again in a later period.ⁿ⁹ However, diversification is deemed to exist if the issuer or holder of the variable annuity contract shows the Service that the failure to actually meet the diversification requirement was inadvertent, the investments in the account satisfy the diversification requirements within a reasonable time after discovery of the failure, and the issuer or holder agrees to make such adjustments or pay such amounts as the Service may require with respect to the periods during which the investments in the account were not diversified.ⁿ¹⁰

In addition, a segregated asset account that was diversified at the end of a calendar quarter does not become nondiversified in a subsequent quarter because of a discrepancy between the value of its assets and the diversification requirements, unless the discrepancy exists immediately after the acquisition of any asset and is wholly or partly a result of the acquisition.ⁿ¹¹

The investments of a segregated asset account are considered to be adequately diversified only if no more than 55 percent of the value of the total assets of the account is represented by any one investment, no more than 70 percent is represented by any two investments, no more than 80 percent is represented by any three investments, and no more than 90 percent is represented by any four investments.ⁿ¹² All securities of the same issuer, all interests in the same real property project, and all interests in the same commodity are treated as a single investment. In the case of U.S. government securities, each government agency or instrumentality is treated as a separate issuer.ⁿ¹³

A special rule, applicable in the case of a beneficial interest in a RIC, real estate investment trust, partnership, or grantor trust ("look-through entity"), does not treat the interest as a single investment, but calls for a pro rata portion of each asset of the look-through entity to be treated as an asset of the segregated asset account,ⁿ¹⁴ whenever:

- (1)(a) all of the beneficial interests in the look-through entity are held by one or more segregated asset accounts of one or more insurance companies, and
- (b) public access to the look-through entity is available exclusively through the purchase of a variable contract;
- (2) in the case of a partnership, any interest in the partnership is not registered under federal or state law regulating the offering or sale of securities; or
- (3) in the case of a grantor trust, substantially all of the assets of the trust are represented by Treasury securities.ⁿ¹⁵

Satisfaction of the requirements relating to look-through entities is not prevented by reason of certain beneficial interests in the entity not being held by segregated accounts.ⁿ¹⁶

A safe harbor, provided by *IRC Section 817(h)(2)*, deems diversification adequate if, at the close of the calendar quarter:

- (1) at least 50 percent of value of the assets in the segregated account is represented by:

(a) cash and cash items (including receivables), government securities and securities of RICs, and

(b) other securities limited generally with respect to any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the account and to not more than 10 percent of the outstanding voting securities of the issuer; and

(2) not more than 25 percent of the value of its total assets is invested in the securities (other than government securities and the securities of RICs) of any one issuer, or two or more issuers that the issuing company controls which are engaged in the same, similar, or related trades or businesses.ⁿ¹⁷

A second proviso limits any investments in cash and cash items, government securities, and securities issued by RICs to 55 percent of the value of the assets in the account.

FOOTNOTES:

(n1)Footnote 1. *IRC § 817(d), (g)*.

(n2)Footnote 2. *Treas Reg § 1.817-5(e)*.

(n3)Footnote 3. *IRC § 817(h)(1)*. To the extent any segregated asset account with respect to a variable life insurance contract is invested in US Treasury securities, the investments made by the accounts are treated as adequately diversified. *IRC § 817(h)(1)*.

For purposes of determining whether a segregated asset account held by an insurance company is adequately diversified, a segregated asset account that invests in a regulated investment company that, in turn, holds an interest in a second regulated investment company can look through to the individual assets held by both regulated investment companies. *Rev Rul 2005-7, 2005-1 CB 464*.

On September 29, 2008, in order to stabilize money market share prices at \$1, the U.S. Treasury Department announced a temporary guarantee program for money market funds, a program available to insurance-dedicated money market funds as well as to money market funds sold directly to the general public. In response to concerns that this program could create adverse tax consequences for insurance-dedicated money market funds, the IRS issued *Notice 2008-92, 2008-2 CB 1001*, which stated that participation in the program will not be treated as a violation of the diversification requirement. The Notice also held that a fund's participation in the program will not cause the holder of a variable contract supported by a segregated account that invests in the fund to be treated as an owner of the fund.

(n4)Footnote 4. *HR Rep No 98-861, 98th Cong, 2d Sess 1055 (1984)*.

(n5)Footnote 5. *Treas Reg § 1.817-5(c)*.

(n6)Footnote 6. *Treas Reg § 1.817-5(c)(1)*.

(n7)Footnote 7. *Treas Reg § 1.817-5(c)(2)*. See *Treas Reg § 1.817-5(h)(4)* for the definition of a real property account.

(n8)Footnote 8. *Treas Reg § 1.817-5(c)(3)*.

(n9)Footnote 9. *Treas Reg § 1.817-5(a)(1)*.

(n10)Footnote 10. *Treas Reg § 1.817-5(a)(2)*. The amount required to be paid is based upon the amount that would have been owed by the holders if they were treated as having received income on the contract as defined in *IRC §*

7702(g)(1)(B).

(n11)Footnote 11. *Treas Reg § 1.817-5(d)*.

(n12)Footnote 12. *Treas Reg § 1.817-5(b)(1)*.

(n13)Footnote 13. *Treas Reg § 1.817-5(b)(1)*.

(n14)Footnote 14. *Treas Reg § 1.817-5(f)(1)*. The ratable interest of a partner in a partnership's assets shall be determined in accordance with the partner's capital interest in the partnership.

(n15)Footnote 15. *IRC § 817(l)(4)*; *Treas Reg § 1.817-5(f)(2)*. A Treasury security is one the direct obligor of which is the US Treasury. *Treas Reg § 1.817-5(h)(2)*.

(n16)Footnote 16. *Treas Reg § 1.817-5(f)(3)*. The holder of a variable annuity or life insurance contract is not treated as the owner of an interest in a RIC that funds the variable contract solely because interests in the same RIC are also available to investors described in *Treas Reg § 1.817-5(f)(3)*. *Rev Rul 2007-7, 2007-1 CB 468*.

(n17)Footnote 17. The safe harbor is keyed into the provisions of *IRC § 851(b)(3)*. A security includes a cash item and any partnership interest, whether or not registered under a federal or state law regulating the offering or sale of securities, but does not include any interest in real property or any interest in a commodity. *Treas Reg § 1.871-5(h)(6)*.



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CHAPTER 12A Variable Deferred Annuity Contracts

1-12A Taxation of Securities Transactions § 12A.03

§ 12A.03 Tax Consequences of Payments Under the Contract

The most important tax consequence to any holder of a variable annuity contract who is a natural person is the deferral of tax on any increase in value of the annuity until payment is made. A holder who is not a natural person is required to treat the income on the contract for any taxable year as income received or accrued during the taxable year.ⁿ¹ The income on the contract is the excess of (1) the sum of the net surrender value of the contract as of the close of the taxable year plus all distributions under the contract received during the taxable year or any prior year, reduced by (2) the sum of the net premiums under the contract for the taxable year and prior taxable years and amounts includable in gross income for prior taxable years with respect to the contract. Where necessary to prevent avoidance of *IRC Section 72(u)(1)*, the Service can substitute "fair market value" for "net surrender value."ⁿ²

The nondeferral rule for holders who are not natural persons does not apply to any annuity contract that:

- (1) is acquired by the estate of a decedent by reason of the decedent's death;
- (2) is held by a qualified employee benefit plan or individual retirement plan;
- (3) is a qualified funding asset (an annuity issued by an insurance company as part of a structured personal injury settlement);ⁿ³
- (4) is purchased by an employer upon the termination of a qualified plan and held by the employer until all amounts under the contract are distributed to the employee for whom it was purchased or the employee's beneficiary; or
- (5) is an immediate annuity.ⁿ⁴ An immediate annuity is one that is purchased for a single premium, has an annuity starting date no later than one year following purchase, and provides for a series of substantially equal periodic payments (to be made not less frequently than annually) during the annuity period.ⁿ⁵

[1] Amounts Not Received as an Annuity

The tax treatment of any amount received under the contract that is not "an amount received as an annuity"ⁿ¹ depends

on the time of receipt. Generally, an amount is received as an annuity if it is received after the annuity starting date, is payable in periodic installments at regular intervals over a period of more than one full year from the annuity starting date, and the total of the amounts payable are determinable at the annuity starting date.ⁿ² However, an exception is made for payments to be received for a definite or determinable period of time under a contract that provides either (1) that the amount of periodic payments may vary in accordance with investment experience, cost of living indices, or other fluctuating criteria, or (2) for specified amounts, the value of which may vary for income tax purposes, such as payments to be made in a foreign currency.ⁿ³ The exception gives rise to the ability to treat a variable annuity as an annuity under *IRC Section 72*.

If the contract holder receives a loan under the contract or assigns or pledges (or agrees to assign or pledge) any portion of the value of the contract, the amount or portion is treated as received under the contract as an amount not received as an annuity.ⁿ⁴ The same holds true for dividends or similar distributions.ⁿ⁵

A gratuitous transfer of the contract results in the transferor being deemed to have received an amount equal to the excess of the cash surrender value of the contract over the investment in the contract as an amount not received as an annuity. The rule does not apply to any transfer to a spouse or former spouse to which *IRC Section 1041* applies.ⁿ⁶

If received before the annuity starting date (the first day of the first period for which an amount is received as an annuity under the contract),ⁿ⁷ the amount is includable in gross income to the extent allocable to income on the contract and excludable to the extent allocable to the investment in the contract.ⁿ⁸ An amount is considered allocable to income on the contract to the extent that it does not exceed the excess of the cash value of the contract (determined without regard to any surrender charge) immediately before the amount is received, over the investment in the contract at the time. Any amount not allocated to income is allocable to investment in the contract.ⁿ⁹

Determination of the amount of investment in the contract begins with a calculation of the aggregate amount of premiums or other consideration paid for the contract. There is then subtracted the amount of any premium refunds or dividends received before the annuity starting date, any other amounts received under the contract before that date that were excludable from gross income, and the value of any refund feature.ⁿ¹⁰ An annuity contract has a refund feature if the expected return under the contract depends in whole or in part on life expectancy, the contract provides for payments to be made to a beneficiary on or after the death of the annuitant, and the payments are in the nature of a refund of the consideration paid.ⁿ¹¹ The amount of any loan or pledge treated as an amount not received as an annuity is not taken into account, except to the extent that the amount is included in gross income.ⁿ¹² If the holder of an annuity transfers it without full and adequate consideration, the investment of the transferee in the contract is increased by the amount required to be included in income by the transferor.ⁿ¹³

If an amount not received as an annuity is received after the annuity starting date, the entire amount is includable in gross income.ⁿ¹⁴

[2] Amounts Received as an Annuity

Normally, until cost is fully recovered, an amount received as an annuity contains both an excludable return of capital and an includable element of income. The excludable portion is determined by use of an exclusion ratio that is calculated by dividing the investment in the contract (as of the annuity starting date) by the expected return under the contract (as of that date).ⁿ¹

When it comes to a variable annuity, the amount of inclusion and exclusion is computed somewhat differently. The investment in the contract is considered to be equal to the expected return under the contract, resulting in an exclusion ratio of 100 percent to be applied to all amounts received as an annuity.ⁿ² The amount of any variable annuity payment treated as an amount received as an annuity is determined by dividing the investment in the contract (adjusted for any refund feature) by the number of payments expected to be received during the annuity period (term certain or life

expectancy). For any taxable year, the amount excluded is the sum of all amounts received as an annuity during the year. All additional amounts are includable in gross income. If the total amount of payments received by the annuitant in a taxable year is less than the amount that could be excluded in that year, the taxpayer can elect, in a succeeding year, to redetermine the amounts to be received as an annuity during the current and succeeding taxable years.ⁿ³

The difference between the portion of the investment in the contract allocable to the taxable year and the total payments actually received in the taxable year prior to the election is divided, in the case of an annuity based on life expectancy, by the applicable life expectancy of the annuitant or annuitantsⁿ⁴ or, in the case of an annuity for a term certain, by the remaining years in the term.

The foregoing rules can be illustrated by the following examples:

Example 1:

A 62-year old taxpayer has a life expectancy of 22.5 years on June 1, 1992, the annuity starting date of a variable annuity contract calling for annual payments purchased in 1990 for \$50,000. A \$2,500 payment under the contract is received on June 1, 1993. The excludable portion of the payment in this case amounts to \$2,273.73, determined by dividing the \$50,000 (the investment in the contract) by 22 (the annuitant's life expectancy adjusted for annual payments).ⁿ⁵

Example 2:

Assume that the taxpayer does not receive a payment under the contract in 1994, but that a payment of \$2,800 is received on June 1, 1995. The annuitant can elect in 1995 to redetermine the amounts to be received as an annuity under the contract as of June 1, 1994. This is done by dividing the difference between what was excludable in 1993 and 1994 (\$4,547.46) and what was actually received (\$2,500) by 20.3 (the annuitant's life expectancy on June 1, 1994, the first year of the election, adjusted for annual payments) and adding the result (\$100.86) to the original exclusion amount. If the election is made, the amount excludable in 1995 and subsequent years is \$2,374.59.

The election described in Example 2 is made by filing with the return a statement that the taxpayer elects to make a redetermination of the amounts excludable from gross income under the annuity contract in accordance with the provisions of *Regulations Section 1.72-4(d)(3)*. The statement must also contain the following information:

- (1) the original annuity starting date and the annuitant's age on that date;
- (2) the date of the first day of the first period for which an amount was received in the current taxable year;
- (3) the investment in the contract originally determined and adjusted for any refund feature; and
- (4) the aggregate of all amounts received under the contract between the date indicated in (1) and the day after the date indicated in (2) to the extent these amounts were excludable from gross income.

[3] Surrender of the Annuity Contract

Any amount received on the surrender, redemption, or maturity of an annuity contract that is not received as an annuity must be included in gross income to the extent that it, when added to amounts previously received that were excludable from gross income (amounts allocable to the investment in the contract), exceeds the aggregate of premiums or other consideration paid.ⁿ¹ However, if the payment is received after the first receipt of an amount as an annuity subsequent to the maturity, redemption, or surrender of the contract, the entire amount is includable in gross income.ⁿ²

In addition, any amount received as an annuity because of the surrender, redemption or modification of a contract is treated either as a periodic payment received for a term different from the one set forth in the contract or as a periodic payment received after a lump-sum distribution, whichever is applicable under the facts of the particular case.ⁿ³ Except in the case of a contract transferred for a valuable consideration, it is immaterial whether the recipient of the amount received on the surrender, redemption, or maturity of the contract is the same person who received prior amounts under the contract that were excludable from gross income.ⁿ⁴

See § 12A.04 for a discussion of the tax consequences of transfers of annuity policies.

[4] Death of the Annuitant

A contract will not be treated as an annuity contract unless it provides that (1) if any holder of the contract dies on or after the annuity starting date and before the entire interest in the contract has been distributed, the remaining portion of the interest will be distributed at least as rapidly as under the method of distribution being used at the holder's death, and (2) if any holder dies before the annuity starting date, the entire interest in the contract will be distributed within five years after the date of death.ⁿ¹ However, if any portion of the annuity is payable to a designated beneficiary over the beneficiary's life or life expectancy and payments begin not later than one year after the annuity holder's death, that portion is deemed to be distributed on the date payments commence.ⁿ² If the designated beneficiary is the spouse of the deceased holder, the rules of *IRC Section 72(s)* are applied by treating the spouse as the holder of the annuity contract.ⁿ³

Payments received under the contract after the death of the annuitant are taxed as income in respect of a decedent. Thus, the amount in excess of the basis of the contract in the hands of the decedent is treated as ordinary income; there is no step-up in basis because of the death of the decedent.ⁿ⁴ However, the recipient is permitted a deduction for any estate tax paid in the decedent's estate attributable to the item of income in respect of a decedent.ⁿ⁵

[5] Penalty for Early Withdrawal

If any amount under an annuity contract is paid to an annuitant prior to attaining age 59½, the annuitant's tax for the taxable year of receipt is increased by an amount equal to 10 percent of the portion of the payment includable in gross income.ⁿ¹ The penalty does not apply if the distribution is:

- (1) due to the death or disability of the annuitant;
- (2) part of a series of substantially equal periodic payments (not less frequently than annually) made for the life or life expectancy of the annuitant or the joint lives or joint life expectancies of the annuitant and a designated beneficiary;
- (3) allocable to investment in the contract before August 14, 1982;
- (4) from a qualified retirement plan or individual retirement account;
- (5) from an immediate annuity account; or
- (6) from a qualified funding asset to which compensation for personal injuries was assigned.ⁿ²

Disability for this purpose means that the person is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or to be of long-continued and indefinite duration.ⁿ³

A distribution that is exempt from the penalty tax because it is part of a series of substantially equal periodic payments will become subject to the additional tax if the payments are subsequently modified (other than by reason of death or disability) either before the close of the five-year period beginning on the date of the first payment and after the taxpayer attains age 59½, or before the taxpayer attains age 59½. The increase in tax for the first taxable year in which the modification occurs is equal to the tax that would have been imposed but for the exemption, plus interest for the "deferral period"--the period beginning with the taxable year in which the distribution would have been taxed if there were no exemption and ending with the year of modification.ⁿ⁴

FOOTNOTES:

(n1)Footnote 1. *IRC § 72(u)(1)*.

(n2)Footnote 2. *IRC § 72(u)(2)*.

(n3)Footnote 3. *IRC §§ 72(u)(3), 130(d)*.

(n4)Footnote 4. *IRC § 72(u)(3)*.

(n5)Footnote 5. *IRC § 72(u)(4)*. If an annuity contract is acquired in a tax-free exchange under *IRC § 1035*, the date of purchase of the annuity for purposes of *IRC § 72(u)(4)* is the date of purchase of the original annuity. *Rev Rul 92-95, 1992-2 CB 43*. See § 12A.04 for a discussion of § 1035.

(n6)Footnote 1. *Treas Reg § 1.72-2(b)(2)*.

(n7)Footnote 2. *Treas Reg § 1.72-2(b)(2)*.

(n8)Footnote 3. *Treas Reg § 1.72-2(b)(3)*.

(n9)Footnote 4. *IRC § 72(e)(4)(A)*.

(n10)Footnote 5. *IRC § 72(e)(1)(B)*.

(n11)Footnote 6. *IRC § 72(e)(4)(C)*.

(n12)Footnote 7. *IRC § 72(c)(4)*. The first day of the first period for which an annuity is received as an annuity is the later of the date upon which the obligations under the contract become fixed or the first day of the period (eg, month or quarter) that ends on the date of the first annuity payment. *Treas Reg § 1.72-4(b)*.

(n13)Footnote 8. *IRC § 72(e)(1)(A), (2)(B)*. No dividend is includable in income if it is retained by the issuer as a premium or other consideration paid for the contract. *IRC § 72(e)(4)(B)*.

(n14)Footnote 9. *IRC § 72(e)(3)*.

(n15)Footnote 10. *IRC § 72(c)(1), (2); Treas Reg § 1.72-6(a)(1)*.

(n16)Footnote 11. *IRC § 72(c)(2); Treas Reg § 1.72-7*. Special rules for determining the investment in the contract apply if there are pre-July 1986 and post-June 1986 investments in the contract. See *Treas Reg § 1.72-6(d)*.

(n17)Footnote 12. *IRC § 72(e)(4)(A)*.

(n18)Footnote 13. *IRC § 72(e)(4)(C)*.

(n19)Footnote 14. *IRC § 72(e)(2)(A)*.

(n20)Footnote 1. *IRC § 72(b)(1)*.

(n21)Footnote 2. *Treas Reg* § 1.72-4(d)(3)(i).

(n22)Footnote 3. *Treas Reg* § 1.72-4(d)(3)(i), (ii).

(n23)Footnote 4. See appropriate table in *Treas Reg* § 1.72-9.

(n24)Footnote 5. The annuitant's life expectancy is determined under Table V of *Treas Reg* § 1.72-9--"Ordinary Life Annuities, One Life." The adjustment is mandated by *Treas Reg* § 1.72-5(a)(2).

(n25)Footnote 1. *Treas Reg* § 1.72-11(d)(1).

(n26)Footnote 2. *Treas Reg* § 1.72-11(d)(1). If an annuity contract is exchanged for a new annuity contract in a tax-free transaction governed by *IRC* § 1035, the date of purchase of the annuity, for the purpose of determining whether it is an immediate annuity excepted from the premature distribution penalty, is the date of purchase of the original annuity. *Rev Rul* 92-95, 1992-2 CB 43 . See § 12A.04 for a discussion of *IRC* § 1035.

(n27)Footnote 3. *Treas Reg* § 1.72-11(d)(1), (e), (f).

(n28)Footnote 4. *Treas Reg* § 1.72-11(d)(2).

(n29)Footnote 1. *IRC* § 72(s). *IRC* § 72(s) does not permit a taxpayer to defer the recognition of income, but merely mandates certain terms that must be included in a contract for it to qualify as an annuity contract for purposes of *IRC* § 72. Therefore, a lump-sum distribution to one inheriting the annuity must be included in income in the year received. *Ltr Rul* 9346002 .

(n30)Footnote 2. *IRC* § 72(s)(2).

(n31)Footnote 3. *IRC* § 72(s)(3).

(n32)Footnote 4. *IRC* § 1014(c).

(n33)Footnote 5. *IRC* § 691(c). *IRC* § 691(d) provides the method of determining the deduction where the annuity is a joint and survivor annuity.

(n34)Footnote 1. *IRC* § 72(q)(1).

(n35)Footnote 2. *IRC* § 72(q)(2). If an annuity contract is exchanged for a new annuity contract in a tax-free transaction governed by *IRC* § 1035, the date of purchase of the annuity, for the purpose of determining whether it is an immediate annuity excepted from the premature distribution penalty, is the date of purchase of the original annuity. *Rev Rul* 92-95, 1992-2 CB 43 . See § 12A.04 for a discussion of *IRC* § 1035.

(n36)Footnote 3. *IRC* § 72(m)(7).

(n37)Footnote 4. *IRC* § 72(q)(3).



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CHAPTER 12A Variable Deferred Annuity Contracts

1-12A Taxation of Securities Transactions § 12A.04

§ 12A.04 Transfers and Exchanges of Annuity Contracts

A transfer of an annuity policy for a valuable consideration is a taxable event resulting in the realization of gain or loss. The transferee's investment in the contract is the actual value of the consideration plus premiums and other consideration paid after the transfer, minus any amounts received by the transferee before the annuity starting date to the extent excludable from gross income. The annuity starting date is the first day of the first period for which the transferee receives an amount under the contract.ⁿ¹

On the other hand, *IRC Section 1035* makes an exchange of an annuity contract for another annuity contract a nonrecognition transaction.ⁿ² If the otherwise tax-free exchange is accompanied by the payment to the annuitant of cash or other property ("boot"), any gain ensuing from the transaction is includable in gross income solely to the extent of the boot. No loss is ever recognized.ⁿ³ The taxpayer's basis in the new annuity contract is the same as the basis in the old contract, decreased by the amount of any money received and increased by the amount of any gain recognized.ⁿ⁴

A direct exchange of a portion of an annuity contract will qualify for nonrecognition under *IRC Section 1035*.ⁿ⁵ *Revenue Procedure 2008-24* provided guidelines regarding tax-free exchanges under *IRC Section 1035* in such a situation. Under that Revenue Procedure, the exchange will not qualify for nonrecognition if there is a withdrawal from either annuity within 12 months after the transfer, other than a withdrawal triggered by a life event such as death, divorce, or loss of employment.ⁿ⁶

FOOTNOTES:

(n1)Footnote 1. *IRC § 72(g)*.

(n2)Footnote 2. To the extent provided in regulations, nonrecognition treatment will not extend to any exchange having the effect of transferring property to any person other than a United States person. *IRC § 1035(c)*.

Neither the Code nor the regulations contain a time limit for completion of the exchange. In addition, nonrecognition treatment under *IRC § 1035* is not expressly conditioned upon the relative policy values of the contracts exchanged, so long as no other property or cash is distributed as part of the exchange. *Rev Rul 92-43, 1992-1 CB 288 ; Ltr Rul 9820018*.

An exchange of a fixed annuity contract for a variable annuity contract comes within *IRC § 1035*. *Rev Rul 68-235*,

1968-1 CB 360 . A taxpayer is not entitled to nonrecognition treatment where he surrenders one annuity policy for cash value and then endorses the check to another issuer for another contract at higher interest. *Ltr Rul 8250023* . However, a transfer of a deferred annuity contract issued by a domestic insurance company for one issued by a foreign insurance company qualifies for nonrecognition treatment. *Ltr Rul 9319024* .

A taxpayer, who owned a non-qualified annuity contract, requested the issuer life insurance company to send a check to another life insurance company as consideration for a new annuity to be issued by the second company. The first company refused to do so and, instead, issued the check to the taxpayer who endorsed it to the second company. The Service ruled that the transaction did not constitute a tax-free exchange under *IRC § 1035(a)(3)*. *Rev Rul 2007-24, 2007-1 CB 1283* .

(n3)Footnote 3. *Treas Reg § 1.1035-1(c)*.

(n4)Footnote 4. A taxpayer assigned an entire annuity contract to a second insurance company that deposited the cash surrender value of the assigned contract into a preexisting annuity contract issued by the second company and owned by the same taxpayer. The Service ruled that the assignment was a tax free exchange under *IRC § 1035*. The taxpayer's basis in the preexisting contract issued by the second company included the taxpayer's basis in the assigned contract; the taxpayer's investment in that contract included the taxpayer's investment in the assigned contract. *Rev Rul 2002-75, 2002-2 CB 812* .

(n5)Footnote 5. *Conway v Commr, 111 TC 350 (1998)* , acq 1999-2 CB xvi. See also *Rev Rul 2003-76, 2003-2 CB 355* .

(n6)Footnote 6. *2008-13 IRB 684* .



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CHAPTER 13 Real Estate Investment Trusts

2-13 Taxation of Securities Transactions 13.syn

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§ 13.05 Stapled Real Estate Investment Trusts



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CHAPTER 13 Real Estate Investment Trusts

2-13 Taxation of Securities Transactions § 13.01

§ 13.01 Introduction

The function served by an RIC with regard to investments in stocks and securities is served by a real estate investment trust when the investment medium switches to real estate and real estate mortgages. It follows, then, that approximately the same tax treatment should be provided for real estate investment trusts, and those owning interests therein, as is provided for regulated investment companies and their shareholders. Using this as its premise,ⁿ¹ Congress enacted *IRC Sections 856 through 860* to govern the taxation of real estate investment trusts and their beneficiaries.ⁿ²

FOOTNOTES:

(n1)Footnote 1. HR Rep No 2029, 86th Cong, 2d Sess 3 (1960).

(n2)Footnote 2. See generally, T. Glynn, *Federal Taxes Affecting Real Estate*, Ch 16 (Matthew Bender); Turlington & Humphreys, "Choice of Pass-Through Entity for Large Real Estate Investments: The Virtues and Vices of Real Estate Investment Trusts and Partnerships from a Federal Tax Standpoint," 47 *NYU Inst on Fed Tax* Ch 29 (1989); Kelley, "Real Estate Investment Trusts," *NYU 32nd Inst on Fed Tax* 1637 (1974); Agger, "Tax Problems of Mortgage Real Estate Investment Trusts," *NYU 31st Inst on Fed Tax* 1739 (1973); Rabinowitz, "Real Estate Investment Trusts: Tax Problems of Equity Trusts," *NYU 31st Inst on Fed Tax* 1773 (1973).

For special rules governing the treatment of distributions by a real estate trust to foreign taxpayers, see § 20.06[2][a][ii].



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CHAPTER 13 Real Estate Investment Trusts

2-13 Taxation of Securities Transactions § 13.02

§ 13.02 Real Estate Investment Trust Defined

[1] The Basic Definition.

IRC Section 856(a) defines a real estate investment trust (REIT) as a corporation, trust, or association that (1) is managed by one or more trustees or directors;ⁿ¹ (2) issues transferable shares or transferable certificates of beneficial interest as evidence of beneficial ownership;ⁿ² (3) would otherwise be taxable as a domestic corporation; (4) is neither a bank, building and loan association, small business investment company, or business development corporation (financial institutions as defined in *IRC Section 582(c)(2)*), or a life insurance subject to taxation under Subchapter L of the Code; (5) is beneficially owned by at least 100 persons;ⁿ³ and (6) is not closely held.ⁿ⁴ The first four mentioned conditions must be met at all times during the taxable year.ⁿ⁵ The fifth must exist during at least 335 days of a taxable year of 12 months, or a proportionate number of days of a short taxable year.ⁿ⁶ The last mentioned condition is satisfied if, during the last half of the trust's taxable year, no five individuals own, directly or indirectly, more than 50 percent in value of the outstanding beneficial interests in the trust.ⁿ⁷ The REIT need not meet the ownership requirements mentioned in (5) and (6) for the first taxable year for which it elects to be taxed as a real estate investment trust.ⁿ⁸

[2] Additional Requirements for Qualification.

[a] Election to Be a Real Estate Investment Trust. No corporation, association, or trust will be considered a REIT for any taxable year unless it has elected to be one for that taxable year or for any prior taxable year.ⁿ¹ Only one method of electing is permitted--the entity must compute taxable income in the manner prescribed for REITs in its return for the first taxable year in which it desires to be taxed as a REIT.ⁿ² The year of election need not be the first year in which the taxpayer could qualify as a REIT.ⁿ³ Once made, the election remains in force until terminated or revoked.ⁿ⁴ Termination is automatic, takes effect whenever the REIT ceases to qualify as such, and stays effective for all succeeding taxable years.ⁿ⁵ Revocation is voluntary, and must be made within the first 90 days of the taxable year for which it is to be effective.ⁿ⁶ It, too, continues to be effective for all succeeding taxable years. Requalification is permitted, but only after a five-year period.ⁿ⁷ However, the waiting period requirement is eliminated in the case of termination if (1) the REIT does not willfully fail to file its tax return for the year in which termination occurs, (2) any incorrect information in the return is not the result of fraud, and (3) the REIT establishes that its failure to qualify as a REIT is due to reasonable cause and not to willful neglect.ⁿ⁸

[b] Gross Income Requirements.

2-13 Taxation of Securities Transactions § 13.02

An entity will not be considered a REIT for any taxable year in which it does not meet both of the following gross income requirements:ⁿ⁹

(1) At least 95 percent of the trust's gross income (excluding gross income from prohibited transactions) must be derived from:

- (a) dividends;
- (b) interest;ⁿ¹⁰
- (c) rents from real property;
- (d) gain from the sale or other disposition of stock, securities, and real property (including interests in real propertyⁿ¹¹ and interests in mortgages on real property)ⁿ¹² that is not held primarily for sale to customers in the ordinary course of business;
- (e) abatements and refunds of real property taxes;
- (f) income and gains derived from foreclosure property;
- (g) commitment fees received as consideration for entering into agreements for the purchase or rental of real property or for the making of mortgage loans;ⁿ¹³ and
- (h) gain from the sale of a real estate asset in a transaction that is not deemed to be a prohibited transaction by reason of *IRC Section 857(b)(6)*.ⁿ¹⁴

(2) At least 75 percent of its gross (excluding gross income from prohibited transactions) income must be derived from:

- (a) rents from real property;
- (b) interest on obligations secured by mortgages on real property or interests in real property;ⁿ¹⁵
- (c) gains from dispositions of real property (including gains from dispositions of interests in real property and interests in mortgages on real property) that is not held primarily for sale to customers in the ordinary course of business;
- (d) dividends or other distributions on, and gain (other than gain from a prohibited transaction) from the disposition of, interests in other qualified real estate investment trusts;
- (e) abatements and refunds of real property taxes;
- (f) income and gains derived from foreclosure property;
- (g) commitment fees;
- (h) gain from the sale or other disposition of a real estate asset in a transaction that is not a prohibited transaction because of the application of *IRC Section 857(b)(6)*; and

(i) qualified temporary investment income.ⁿ¹⁶

Any income derived from a shared appreciation provision is treated as gain recognized on a sale of the secured property.ⁿ¹⁷ The REIT is treated as holding the secured property for the period during which it held the shared appreciation provision (or, if shorter, for the period during which the secured property was held by the owner thereof).ⁿ¹⁸

Thus, at least 75 percent of the REIT's gross income must come from the sources described in (2) above, while an additional 20 percent must be derived from such sources, or from the sources mentioned in (1), or from a combination thereof.^{n18.1} The source of the remaining 5 percent is unimportant, although, for this purpose, any income from discharge of indebtedness is not taken into account.ⁿ¹⁹

If the REIT is a partner in a partnership, the trust is deemed to own its proportionate share of each of the assets of the partnership and to be entitled to the income of the partnership attributable to that share.ⁿ²⁰ For purposes of *IRC Section 856*, the interest of a partner in the partnership's assets is determined in accordance with the partner's capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership retain the same character in the hands of the partners for all purposes of *IRC Section 856*.

The failure to meet the 75 percent and 95 percent tests will not prove fatal, and the two requirements will be deemed to have been satisfied, if following the entity's identification of the failure to meet either or both of the requirements for any taxable year, a description of each item of its gross income prescribed by the requirements is set forth in a schedule for the taxable year filed in accordance with regulations, and the failure to meet either or both of the tests is due to reasonable cause and not due to willful neglect.ⁿ²¹ (An excise tax is imposed in lieu of disqualification.ⁿ²²) The failure to meet an income source test will be due to reasonable cause if the REIT exercised ordinary business care and prudence in attempting to satisfy the tests at the time it entered into each transaction.ⁿ²³ However, even if the REIT did exercise such care and prudence, a later determination, that the transaction is producing nonqualified income in sufficient amounts to cause an income test to be failed, will require the REIT to use ordinary business care and prudence in an effort to renegotiate the terms of the transaction or alter its portfolio.ⁿ²⁴

[i] Defining Rents From Real Property. In most cases, the greatest share of qualifying gross income will come from rents from real property, defined by *IRC Section 856(d)(1)* as including rents from interests in real property, charges for services customarily furnished or rendered in connection with the rental of real property, whether separately stated or not,ⁿ²⁵ and rent attributable to personal property leased in connection with a lease of real property if the rent attributable to the personal property is not more than 15 percent of the total rent for the year under the lease.ⁿ²⁶ To insure that such income remains passive investment income and that the REIT does not become actively involved in the operation of the property, the Code excludes certain amounts received by the REIT in the form of rentals from the scope of "rents from real property."ⁿ²⁷

The first category of excluded income looks to the manner in which the rent is computed. If the determination of the amount paid to the REIT depends in any way on the income or profits derived by any person from the property, the amount is not included within the term "rents from real property,"ⁿ²⁸ Clearly, the rule is applicable where the entire amount paid is based on income or profits. But should the entire amount received be disqualified where the lease specifies a fixed minimum rental as well as a percentage of the tenant's income or profits in excess of a stated amount? The Regulations so provide,ⁿ²⁹ and no case has held to the contrary.

IRC Section 856(d)(2)(A) adds parenthetically that any amount received or accrued by the REIT "shall not be excluded from the term 'rents from real property' solely by reason of being based on a fixed percentage or percentages of receipts or sales." Seemingly, what is required is that the percentage of receipts or sales be fixed at the inception of the lease,

and that it not be a subterfuge for a rental based on income or profits.ⁿ³⁰

If a REIT leases to a tenant who subleases for a rental based wholly or partially on the income or profits of the subtenant, only a proportionate part of the amount received by the REIT from the tenant will be excluded from the category of "rents from real property."ⁿ³¹ According to the Regulations, in the given fact pattern, the nonqualifying amount would be the lesser of (a) the contingent rent received by the REIT, or (2) an amount determined by multiplying the total rent received by the REIT from its tenant by the fraction:

$$\frac{\text{rent received by prime tenant based on income or profits}}{\text{total rent received by prime tenant.}}^{\text{n32}}$$

Example:

A REIT owns land underlying a shopping center. The REIT rents the land to the owner of the shopping center for an annual rent of \$1 million plus 2 percent of the gross receipts that the prime tenant receives from subtenants. For the taxable year in question, the prime tenant derives total rent from the shopping center of \$10 million. Of that amount, \$2.5 is received from subtenants whose rent is based, in whole or in part, on the income derived from the property. The REIT will receive \$1.2 in total rent, of which \$200,000 is based on a percentage of gross receipts of the prime tenant. The portion of the rent that is disqualified is the lesser of \$200,000 (the rent based on a percentage of gross receipts), or \$300,000 (\$1.2 million multiplied by the fraction \$2.5 million/\$10 million). Accordingly, \$1 million qualifies as "rents from real property"; \$200,000 does not.

The Tax Reform Act of 1986 further limited *IRC Section 852(d)(2)(A)*. Rents received by a REIT from a tenant that derives substantially all of its income from subletting the property leased from the REIT qualify as rents from real property, to the extent the rents paid by the subtenants would have so qualified had they been received directly by the REIT.ⁿ³³

Further indication of the interpretation given to *IRC Section 856(d)(2)(A)* can be found in *Revenue Ruling 69-107*ⁿ³⁴ and *Revenue Ruling 64-50*.ⁿ³⁵ In the former, the lease called for a stated rental for the first twenty-five years of the term and then for a rental equal to a percentage of the appraised value of the property, the property to be appraised and the rent adjusted, if necessary, every ten years. In the latter, the lease incorporated an "escalator" provision subjecting the tenant to the payment of additional rent in the event the cost of furnishing basic services (e.g., heat, water, window washing) increased. In both cases, the amounts received by the trust were held to constitute "rents from real property." The Service reached this conclusion in each instance by inquiring whether the arrangement conformed with normal business practices or whether it was nothing more than a means of basing the rent on income or profits.

The second exclusion, founded on the relationship between the REIT and its lessee, disqualifies any amount received or accrued directly or indirectly from a corporate lessee, if the REIT owns 10 percent or more of the total combined voting power of all classes of stock of the corporation entitled to vote or 10 percent or more of the total value of shares of all classes of stock of the corporation.ⁿ³⁶ If the lessee is not a corporation, the exclusionary rule applies if the REIT owns an interest of 10 percent or more in the assets or net profits of the lessee.ⁿ³⁷ The specified degree of ownership can be either direct or indirect; the attribution rules of *IRC Section 318(a)* apply with one change--attribution will run between a REIT and a person owning 10 percent of the beneficial interests of the trust, not 50 percent as prescribed by *IRC Sections 318(a)(2)(C)* and *318(a)(3)(C)*.ⁿ³⁸ In other words, rents received from property leased to an individual owning 10 percent of the beneficial interests of the REIT, or to a partnership or corporation in which such person has a 10 percent or greater interest, will not be considered "rents from real property."

Since *IRC Section 856(d)(2)(B)* refers to "any amount received or accrued directly or indirectly," the second exclusion may apply even if the REIT has no ownership interest in the prime tenant. For example, assume that the REIT leases property to a tenant at an annual rental of \$60,000 and that the tenant subleases the property at a total rental of \$75,000, of which \$25,000 is paid by a subtenant in which the REIT does own the specified percentage of stock or interest in

assets or net profits. Only \$40,000 of the total rent paid by the tenant to the REIT will qualify as "rents from real property." The balance of \$20,000 (25,000/75,000ths of \$60,000) will be excluded by virtue of *IRC Section 856(d)(2)(B)*.ⁿ³⁹

IRC Section 856(d)(2)(B) does not apply to any amount paid to a REIT by a taxable REIT subsidiary of the REIT if either (1) at least 90 percent of the leased space of the property is leased to persons other than taxable REIT subsidiaries of the REIT and other 10-percent owned persons, to the extent the amounts paid to the REIT as rents from real property are substantially comparable to rents paid by other tenants of the REIT's property for comparable space, or (2) with respect to property that is a qualified lodging facility leased by the REIT to a taxable REIT subsidiary, if the property is operated on behalf of the subsidiary by an eligible independent contractor.ⁿ⁴⁰ A qualified lodging facility is a hotel, motel or other establishment of which more than one half of the dwelling units are used on a transient basis, provided that no gambling activities are connected at or in connection with the facility.ⁿ⁴¹

An independent contractor is an eligible independent contractor if, at the time the contractor enters into a management agreement or similar service contract with the taxable REIT subsidiary, the contractor (or any related party) is engaged in the trade or business of operating qualified lodging facilities for any person who is not a related person with respect to the REIT or taxable REIT subsidiary.ⁿ⁴² A person will not fail to be treated as an independent contractor with respect to a qualified lodging facility because (a) the taxable REIT subsidiary bears the expenses for the operation of the facility pursuant to the management agreement or similar service contract, (b) the taxable REIT subsidiary receives the revenues from the operation of the facility, net of expenses for the operation and fees payable to the operation under the agreement or contract, or (c) the REIT receives income for the person with respect to another property that is attributable to a lease of such other property to the other person that was in effect as of the later of January 1, 1999, or the earliest date that any taxable REIT subsidiary of the REIT entered into a management agreement or similar service contract with the person with respect to the qualified lodging facility.ⁿ⁴³

The third exclusion, contained in *IRC Section 856(d)(2)(C)*, becomes effective if the REIT receives any impermissible tenant service income, that is, with respect to real or personal property, any amount received or accrued directly or indirectly by the REIT for services furnished or rendered by the trust to the tenants of the property, or for managing or operating the property.ⁿ⁴⁴ If the amount of impermissible tenant service income is greater than 1 percent of all amounts received or accrued during the taxable year directly or indirectly by the REIT from the property, all of the income from the property is treated as impermissible tenant service income and does not qualify as rent from real property.ⁿ⁴⁵

In determining the amount of impermissible tenant service income, services furnished or rendered, or management or operation provided, through an independent contractor from whom the trust itself does not derive or receive any income, or through a taxable REIT subsidiary of the trust, are not treated as furnished, rendered, or provided by the trust, while there is not taken into account any amount that would be excluded from unrelated business income under *IRC Section 512(b)(3)*.ⁿ⁴⁶ *IRC Section 512(b)(3)* provides an exclusion in the computation of unrelated business taxable income of all rents from real property and all rents from personal property leased with the real property, if the rents attributable to the personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service.^{n46.1}

While the Code does not set forth the test to be applied in determining whether services rendered to tenants are being rendered by an independent contractor or an employee of the REIT,ⁿ⁴⁷ it does prevent certain persons related to the REIT from being classified as independent contractors. If the otherwise independent contractor owns more than 35 percent of the shares or beneficial interests of the REIT, or if persons owning more than 35 percent of the shares or beneficial interests of the REIT also own more than 35 percent of the contractor, the contractor will not achieve independent contractor status.ⁿ⁴⁸ The attribution rules of *IRC Section 318(a)*, amended so that attribution runs between the REIT and a 10 percent shareholder, and between the REIT and a partner who owns directly or indirectly a 25 percent or greater interest in a partnership, apply in determining whether the 35 percent test is met.ⁿ⁴⁹

Once the threshold question of independent contractor status has been answered, the crucial inquiry is whether the REIT receives or derives any income from the independent contractor.ⁿ⁵⁰ This can only be determined by looking at the nature of the services rendered to the tenant. If the services are of a type usually or customarily rendered or furnished in connection with the mere rental of real property (e.g., collection of trash, furnishing elevator service, maintenance of public hallways, etc.), and the tenant is not separately charged for these services, no apportionment between rents from real property and compensation for these services is necessary; the entire amount will qualify as "rents from real property."ⁿ⁵¹ Furthermore, the cost of providing such incidental services may be borne by the REIT.ⁿ⁵² However, the services must be rendered or furnished through an independent contractor.ⁿ⁵³

If the services rendered to the tenants are other than those usually rendered in connection with the mere rental of real property, the cost of such services must be borne by the independent contractor, a separate charge made therefor, and the entire amount charged to the tenants received and retained by the independent contractor.ⁿ⁵⁴ If the REIT receives any income attributable to the furnishing of such services, none of the amounts received by the trust from tenants of the property (including lease rentals) will qualify as "rents from real property."ⁿ⁵⁵

[ii] Defining Foreclosure Property. Prior to 1975, no allowance was made for the situation in which a default on the part of a REIT's debtor resulted in the trust taking over real property that yielded nonqualified income. As a consequence, inadvertent disqualification of the trust was a distinct possibility. A desire on the part of Congress to prevent this result led to the passage of rules regarding foreclosure property.

IRC Section 856(e)(1) defines foreclosure property as any real property and any personal property incident to such real property acquired by a REIT as the result of the trust having bid in the property at foreclosure, or having otherwise reduced the property to ownership or possession by agreement or process of law, after there was a default (or default was imminent) on a lease of the property or on an indebtedness which the property secured. Excluded from the definition is property acquired by the REIT as the result of indebtedness arising from the sale or other disposition of property held primarily for sale to customers in the ordinary course of business if the property was not originally acquired as foreclosure property. Foreclosure property ceases to be such as of the close of the third taxable year following the taxable year in which the trust acquired the property,ⁿ⁵⁶ unless prior to that date (1) the REIT enters into a lease of the property which yields income that does not qualify as rent from real property; (2) construction, other than completion of an improvement more than 10 percent of which was completed before default became imminent, takes place on the property; or (3) the property is used in a trade or business conducted by the REIT other than through an independent contractor from whom the REIT does not derive or receive any income.ⁿ⁵⁷

For taxable years beginning after December 31, 2000, foreclosure property includes any qualified health care property acquired by a REIT as the result of the termination of a lease (other than a termination by reason of a default, or the imminence of a default, on the lease).ⁿ⁵⁸ Qualified health care property is any real property (including interests therein), and any personal property incident thereto, that is a hospital, nursing facility assisted living facility, congregate care facility, qualified continuing care facility, or other licensed facility that extends medical or nursing or ancillary services to patients, and that prior to becoming foreclosure property was operated by a provider of services eligible to participate in Medicare.ⁿ⁵⁹

Unlike other foreclosure property, a qualified health care property that becomes foreclosure property ceases to be such as of the close of the second taxable year after the year in which the REIT acquired the property.ⁿ⁶⁰ If the REIT establishes to the satisfaction of the Internal Revenue Service that an extension of the three-year grace period is necessary to the orderly leasing or liquidation of the REIT's interest in the property, the Service can grant one or more extensions. However, an extension cannot extend the grace period beyond the close of the sixth year after the taxable year in which the REIT acquired the property.

Foreclosure property is treated as such only if the REIT so elects in a statement attached to a timely filed income tax return for the year in which the property is acquired.ⁿ⁶¹ The REIT can revoke the election for a taxable year by filing

the revocation on or before the due date for the income tax return for the taxable year.ⁿ⁶² Revocation of the election bars an election for any subsequent taxable year.

Since the foreclosure rules are to provide relief in the case of an inadvertent acquisition of property on foreclosure, the rules do not apply with respect to real property acquired under a mortgage or lease entered into or acquired by a REIT with an intent to foreclose or evict.ⁿ⁶³ Nor are the rules to apply where the REIT acquired a mortgage on property when it knew or had reason to know that default would occur.ⁿ⁶⁴

[iii] Defining Interest. *IRC Section 856(f)* follows the rules governing rents to provide that as used in the gross income requirements imposed on REITs, the term "interest" does not include any amount which depends in whole or in part on the income or profits of any person. As in the case of contingent rents, the exclusion is not applicable to the extent (1) the amount received is based on a fixed percentage of receipts or sales, or (2) the debtor derives substantially all of its gross income from leasing substantially all of its interests in the property securing the debt and the rents received by the debtor would qualify as rents from real property if received by the REIT,ⁿ⁶⁵ while an allocation between qualified and nonqualified income is permitted where the exclusion would result solely from the fact that the person indebted to the REIT receives amounts based on the income or profits of another.ⁿ⁶⁶

[c] Asset Diversification Requirements. At the close of each quarter of the taxable year, at least 75 percent of the value of the total assets of the REIT must be represented by real estate assets,ⁿ⁶⁷ cash and cash items (including receivables),ⁿ⁶⁸ and Government securities,ⁿ⁶⁹ while (i) not more than 25 percent of the value of its total assets can be invested in securities other than those which qualify for the 75 percent requirement, and (ii) not more than 20 percent of the value of its total assets is represented by securities of one or more taxable REIT subsidiaries.ⁿ⁷⁰ Except with respect to a taxable REIT subsidiary and securities includable in the 75 percent requirement, the REIT cannot own the securities of any one issuer in an amount (1) greater in value than 5 percent of the value of the total assets of the REIT or (2) representing more than 10 percent of the outstanding securities (by vote and value) of the issuer.ⁿ⁷¹ A safe harbor provides that the following are not taken into account in determining whether the 10-percent of value test has been met: (a) straight-debt securities,ⁿ⁷² (b) any loan to an individual or estate, (c) any Section 467 rental agreement,^{n72.1} (d) any obligation to pay rents from real property, (e) any security issued by a state or any political subdivision thereof, the District of Columbia, a foreign government or any political subdivision thereof, or the Commonwealth of Puerto Rico, but only if the determination of any payment received or accrued under the security does not depend in any way on the profits of any entity not described herein or payments on any obligation issued by such an entity, (f) any security issued by a REIT, and (g) any other arrangement determined by the Service.^{n72.2} Securities issued by a corporation or partnership will not be considered straight debt securities if the REIT holding the securities and any of its controlled taxable REIT subsidiaries hold any securities of the issuer that are not described in the safe harbor, and have an aggregate value greater than 1 percent of the issuer's outstanding securities determined without regard to the REIT's interest in a partnership holding the issuer's securities.^{n72.3} Operation of the asset diversification provisions may be illustrated by the following:

Example:

At the close of a quarter of its taxable year, a REIT has its assets invested as follows:

Real estate assets	70%
Cash	7%
Government securities	8%
Securities of X Corp.	6%
Securities of Y Corp.	4%
Securities of Z Corp.	5%

The REIT meets the first asset diversification requirement since more than 75 percent of its assets

consists of real estate assets, cash, and government securities. The second test cannot be met although the REIT has less than 25 percent of its assets invested in other securities; the ownership of X Corp. securities exceeds 5 percent of the REIT's total assets. If the distribution of the REIT's investment in other securities were:

Securities of X Corp.	5%
Securities of Y Corp.	5%
Securities of Z Corp.	5%

the 25-percent requirement would be met unless the REIT's investment in the securities of any of the three corporations represented more than 10 percent of the outstanding voting securities of such corporation.

A REIT that meets the asset diversification requirements at the close of any quarter of a taxable year will not suffer a loss of status if a change in the market value of its investments causes it to fail to meet such requirements at the end of a subsequent quarter.ⁿ⁷³ If the discrepancy between the value of the investments and the diversification requirements exists immediately after the acquisition of any security or other property and is due wholly or in part to such acquisition, a loss of status will result unless the discrepancy is eliminated within thirty days after the close of the quarter in question.ⁿ⁷⁴ If the discrepancy is due to an increase in value of the securities of one issuer and the acquisition of securities of another, only the "acquisition discrepancy" need be eliminated. If due both to an increase in value in, and an acquisition of, securities of the same issuer, both discrepancies must be eliminated.ⁿ⁷⁵

IRC Section 856(c)(7) provides a *de minimis* rule under which a corporation, trust, or association that fails to meet the requirement that a REIT cannot own the securities of any one issuer in an amount greater than 5 percent of the value of the total assets of the REIT, or representing more than 10 percent (by vote and value) of the issuer, will be considered to have satisfied the requirement for any quarter of its taxable year if (1) the failure is due to the ownership of assets the total value of which does not exceed the lesser of (a) 1 percent of the total value of the REIT's assets at the end of the quarter for which the measurement is done, and (b) \$10 million, and (2)(i) the corporation, trust, or association, following identification of the failure, disposes of assets in order to meet the requirements within six months after the last day of quarter in which identification of the failure occurred, or such other time period and in the manner prescribed by the Service, or (ii) the requirements are otherwise met during the prescribed time period.

If the failure does not satisfy the *de minimis* test, the corporation, trust, or association can still be treated as having satisfied the asset diversification requirements if, following identification of the failure, (i) a description of each asset that causes the failure is set forth on a schedule filed in accordance with prescribed regulations, (ii) the failure is due to reasonable cause and not to willful neglect, (iii) the entity pays the tax described below, and (iv) the entity disposes of the asset set forth on the schedule within six months after the last day of the quarter in which the identification of the failure occurred or such other time period and in the manner prescribed by the Service. The tax imposed is the greater of \$50,000, or the amount determined by multiplying (1) the net income generated by the assets described in the schedule for the period beginning on the first date that the failure to meet the requirements occurs as a result of ownership of the assets and ending on the earlier of the date on which the REIT disposes of the assets or the end of the first quarter when there is no longer a failure to meet the requirements, by (2) the highest corporate tax rate imposed by *IRC Section 11*.

[d] Income Distribution Requirements. Although a REIT may meet the qualifications contained in *IRC Section 856*, it will be taxed as an ordinary corporation and not as a real estate investment REIT in any taxable year unless the dividends paid deduction for the taxable year (exclusive of capital gains dividends) equals or exceeds (a) the sum of 95 percent of the trust's real estate investment trust taxable income for the taxable year (computed without the deduction for dividends paid and by excluding any net capital gain) and 95 percent of the excess of the net income from foreclosure property over the tax on such income, minus (b) any excess noncash income.ⁿ⁷⁶ Excess noncash income is

defined as the excess of (a) the sum of (i) the amounts which the REIT is required to include in income under *IRC Section 467* over the amounts it would have to include under its regular method of accounting, (ii) any income on the disposition of a real estate asset if there is a determination that such income is not eligible for nonrecognition as resulting from a like-kind exchange (*IRC Section 1031*), and the failure to meet the requirements of *IRC Section 1031* was due to reasonable cause and not willful neglect, over (b) 5 percent of the REIT taxable income for the taxable year determined without regard to the deduction for dividends paid and by excluding any net capital gain, (iii) amounts includable in gross income with respect to instruments to which *IRC Section 860E(a)* (relating residual interests in a REMIC) or 1272 (relating to original issue debt instruments) applies, in excess of the amount of money and the fair market value of other property received during the taxable year under such instruments, and (iv) cancellation of indebtedness income.ⁿ⁷⁷

The Service can waive the distribution requirements for any taxable year if the REIT can establish to the satisfaction of the Service that it was unable to meet them due to distributions previously made to meet the requirements of *IRC Section 4981*, discussed in § 13.03[8].

In addition to the income distribution requirements, the REIT must meet the record-keeping requirements discussed below, and either the provisions governing REITs must apply for all taxable years beginning after February 28, 1986, or, as of the close of the taxable year, the REIT has no earnings and profits from any year in which it was not treated as a REIT.ⁿ⁷⁸

[3] Taxable REIT Subsidiary.

A taxable REIT subsidiary is a corporation that is not a REIT in which the REIT directly or indirectly owns stock, and the REIT and the corporation jointly elect that the corporation shall be treated as a taxable REIT subsidiary of the REIT.ⁿ¹ The election, once made, is irrevocable unless both the REIT and the taxable REIT subsidiary consent to its revocation, but neither the election nor any revocation thereof requires the consent of the Service. The definition extends to a corporation (other than a REIT or a qualified REIT subsidiary) in which a taxable REIT subsidiary owns, directly or indirectly, securities possessing more than 35 percent of either the total voting power or the total value of the outstanding securities of the corporation.ⁿ²

A corporation cannot be a taxable REIT subsidiary if (a) it directly or indirectly operates or manages a lodging facility or health care facility, or (b) it directly or indirectly provides to any other person (under a franchise, license, or otherwise) rights to any brand name under which a lodging facility or health care facility is operated.ⁿ³ However, a corporation can be a taxable REIT if it provides rights to an eligible independent contractor to operate a lodging facility if the rights are held by the corporation as a franchisee, licensee, or in a similar capacity, and the lodging facility is either owned by the corporation or is leased to the corporation by the REIT.

[4] Accounting for the Trust's Interest in a Partnership.

Suppose a REIT holds a 25-percent interest in a partnership owning income producing real property. Is the interest in the partnership and the income derived therefrom to be viewed merely as a partnership interest and partnership income, or will the REIT be deemed to own a proportionate share of the partnership assets and the income produced by the assets? The classification of the interest and the income therefrom clearly has an effect on the ability of the REIT to qualify as a REIT under *IRC Section 856*. Under the regulations,ⁿ¹ the REIT will be deemed to own its proportionate share of each of the assets of the REIT and will be deemed to be entitled to the income of the partnership attributable to such interest. The character of the various assets in the hands of the partnership and the character of the items of gross income of the partnership retain the same character in the hands of the partners for all purposes of *IRC Section 856*.ⁿ² Therefore, the REIT would be treated as the owner of 25 percent of the real property and as being entitled to 25 percent of the rents earned from the property by the partnership. If the partnership sells the real property, or the REIT disposes of its partnership interest, any gain from the disposition will be considered gain from the sale or other disposition of real

property held for the shorter of (1) the period that the partnership held the real property, or (2) the period that the REIT was a member of the partnership.ⁿ³

[5] Record Keeping Requirements.

Prior to the Taxpayer Relief Act of 1997, a REIT was required to keep records which disclosed the actual ownership of its outstanding shares or certificates of beneficial interest. Failure to do so caused the trust to be taxed as an ordinary corporation. The 1997 legislation substituted a requirement that the REIT comply with regulations issued by the Internal Revenue Service for the purpose of ascertaining actual ownership of outstanding shares or certificates of beneficial ownership.ⁿ¹ If a REIT fails to comply with the new requirements for a taxable year, it must pay (on notice and demand in the same manner as a tax) a penalty of \$25,000.ⁿ² The penalty is increased to \$50,000 if the failure is due to intentional disregard of the requirement; there is no penalty if the failure is due to reasonable cause and not to willful neglect.ⁿ³ The Service may require a REIT to take such actions as the Service deems appropriate to ascertain actual ownership if the REIT fails to comply with the ascertainment regulations.ⁿ⁴ If the REIT fails to take those actions, an additional penalty will be due after notice and demand by the Service. Regulations promulgated under the repealed provision provided that the trust had to demand from each shareholder of record owning a specified percentage of the outstanding shares of the REIT, a written statement showing the number of shares actually and constructively owned by each actual owner.ⁿ⁵ These statements, together with a list of all shareholders who failed or refused to comply with the demand, had to be retained by the REIT as part of its permanent records.ⁿ⁶

FOOTNOTES:

(n1)Footnote 1. Under *Treas Reg § 1.856-1(d)(1)*, the trustee must have such rights and powers as will meet the centralization of management requirement of *Treas Reg § 301.7701-2(c)*. In essence, this calls for the trustee to exercise continuing exclusive authority over the management of the trust. This authority will be held to exist even though the trust instrument grants the beneficial owners certain rights and powers, eg, the right to elect and remove trustees, the right to approve a sale, merger, or reorganization of the trust, or the right to terminate the trust. *Treas Reg § 1.856-1(d)(1)*; *Rev Rul 70-569, 1970-2 CB 147* ; *Rev Rul 64-259, 1964-2 CB 180* .

The management requirement is not violated by an agreement under which the trustees delegate authority to a corporation to act as the REIT's advisor under a contract that can be terminated by the trustees or the shareholders of the REIT, or where the trustees delegate authority to an advisory company to make loan commitments and investments within specified limits. *Rev Rul 74-471, 1974-2 CB 198* ; *Rev Rul 72-254, 1972-1 CB 207* .

(n2)Footnote 2. Shares or certificates will be considered transferable even though the trust instrument contains provisions which permit the trustee to redeem shares or to refuse to transfer shares in any case where the trustee, in good faith, believes that a failure to redeem shares or that a transfer of shares would result in a loss of status as a REIT. *Treas Reg § 1.856-1(d)(2)*. Furthermore, the trust may have more than one class of shares of beneficial interest, including a class which gives the beneficial owners a preference as to dividends and a preference on liquidation. *Rev Rul 69-610, 1969-2 CB 149* .

The issuance of two classes of stock, one entitling holders to income and the other entitling holders to capital gains from the sale of trust assets, did not prevent the trust from continuing to qualify as a REIT in *Rev Rul 71-405, 1971-2 CB 263* .

The Service will not rule whether a corporation whose stock is "paired" or "stapled" to that of another corporation will qualify as a REIT if the activities of the corporations are integrated. *Rev Proc 2007-3, 2007-1 IRB 108* .

(n3)Footnote 3. Pension trusts and profit-sharing trusts qualifying under *IRC §§ 401(a) and 501(a)* are considered persons for the purposes of the 100 person requirement. *Rev Rul 65-3, 1965-1 CB 267* . Income from the sale of condominiums on property held in trust for joint venturers was ordinary partnership income and not capital gain from a

dividend received in liquidation of a REIT; only five persons held interests in the trust. *Grove v Commr*, 54 TC 799 (1970).

(n4)Footnote 4. A corporation, trust, or association that meets the requirements of *IRC* § 857(f)(1) (see § 13.02[4]), and does not know, or exercising reasonable diligence would not have known, whether the entity failed to meet the requirement that it not be closely held will be treated as having met that requirement for the taxable year. *IRC* § 856(k).

(n5)Footnote 5. *IRC* § 856(b). In Rev Rul 71-218, 1971-1 CB 209, a calendar year corporation transferred all of its assets to an unincorporated association in exchange for transferable certificates of beneficial interest. The transaction qualified as an "F" reorganization. Because of this, the taxable year of the transferor corporation did not end until the last day of the year in which the transfer occurred. As a result, the trust did not meet the conditions of *IRC* § 856(a)(1)-(4) for the entire taxable year and could not qualify as a REIT.

(n6)Footnote 6. *Id.* The days need not be consecutive. *Treas Reg* § 1.856-1(c).

(n7)Footnote 7. *IRC* §§ 542(a)(2), 856(h)(1). The provisions of *IRC* § 544, other than the partnership attribution rules, apply in determining stock ownership.

In determining whether a REIT is closely held, any stock held by a qualified pension trust (one described in *IRC* § 401(a) and exempt from tax under *IRC* § 501(a)) is treated as held directly by its beneficiaries in proportion to their actuarial interests in the pension trust. This rule does not apply if one or more disqualified persons (as defined in *IRC* § 4975(e)(2), with certain exceptions), with respect to the pension trust, hold, in the aggregate, 5 percent or more in value of the interests in the REIT and the REIT has accumulated earnings and profits attributable to any period for which it did not qualify as a REIT. An entity that qualifies as a REIT because of the pension trust rule is not treated as a personal holding company. *IRC* § 856(h)(3).

(n8)Footnote 8. *IRC* § 856(h)(2).

(n9)Footnote 1. *IRC* § 856(c)(1).

(n10)Footnote 2. *Treas Reg* § 1.856-2(b).

(n11)Footnote 3. *Treas Reg* § 1.856-2(b).

(n12)Footnote 4. *Treas Reg* § 1.856-2(b).

(n13)Footnote 5. *IRC* § 856(g)(1). Termination will not occur if a corporation, trust, or association is not a REIT for the taxable year because it failed to comply with any provision governing REITs (other than *IRC* § 856(c)(6) or (7)), if the failures are due to reasonable cause and not due to willful neglect, and the entity pays a penalty of \$50,000 for each such failure. *IRC* § 856(g)(5).

(n14)Footnote 6. *IRC* § 856(g)(2). Notice of revocation is to be given by filing a statement with the district director for the district in which the REIT maintains its principal office. *Treas Reg* § 1.856-8(a).

(n15)Footnote 7. *IRC* § 856(g)(3).

(n16)Footnote 8. *IRC* § 856(g)(4).

(n17)Footnote 9. *IRC* § 856(c)(2), (3). The income of a 100 percent owned subsidiary of the REIT is treated as the income of the REIT for this purpose. *IRC* § 856(i).

One of the principal purposes for the income restrictions imposed on REITs is to ensure that the vast bulk of a REIT's income is from passive sources and not from the active conduct of a trade or business. HR Rep No 2020, 86th Cong, 2d

Sess 6 (1960).

Gain treated as goodwill gain derived from a sale of a REIT's trade or business will be treated as being derived from the same source as the gain recognized on the sale to which the goodwill relates. *Ltr Rul 200726002* .

Foreign currency gain or loss is qualifying income under *IRC § 856(c)(2)* or *856(c)(3)*. See, eg, *Ltr Rul 200519007* .

Rev Proc 2003-65, 2003-2 CB 336 , sets forth a safe harbor under which interest on a loan made by a REIT that is secured either by a partnership interest in a partnership or by the sole member interest in a disregarded entity will be treated as interest on an obligation secured by a mortgage on real property or an interest in real property for purposes of *IRC § 856(c)(3)*.

(n18)Footnote 10. Interest is defined by the regulations as consisting only of "lawful interest for the loan or forbearance of money." *Treas Reg § 1.856-5(a)*. Usurious interest or fees representing charges for services are not considered interest for this purpose.

Except to the extent provided by regulations, any income of a REIT from a hedging transaction (as defined in *IRC § 1221(b)(2)(A)(ii)* or *(iii)*) that is clearly identified pursuant to *IRC § 1221(a)(7)*, including gain from the sale or disposition of a such a transaction, is not gross income for purposes of the 95-percent test to the extent that the transaction hedges any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets. *IRC § 856(c)(5)(G)*. Hedging transactions are discussed in *§ 2.04[2][a]*.

A commitment fee paid by a borrower to a REIT is not interest for purposes of *IRC § 856(c)*. *Rev Rul 74-258, 1974-1 CB 170* .

(n19)Footnote 11. The term "real property" means land and improvements thereon (eg, buildings or other permanent structures plus structural components thereof). *Treas Reg § 1.856-3(d)*. The term "interests in real property" includes fee ownership and co-ownership of land and improvements and leaseholds and options to acquire the same. It does not include mineral, oil, or gas royalty interests even though such interests might be interests in real property under local law. *IRC § 856(c)(6)(C)*; *Treas Reg § 1.856-3(c)*; *Rev Rul 64-75, 1964-1 (Part 1) CB 228*.

Foreign real estate acquired with foreign funds is real property for purposes of *IRC § 856(c)*. *Rev Rul 74-191, 1974-1 CB 170* . If *Section 988* gain is recognized with respect to income recognized by a REIT, the gain qualifies under *IRC § 856(c)(2)* or *(3)* to the extent that the qualifying income so qualifies. *Rev Rul 2007-33, 2007-1 CB 1281* .

Notice 2007-42, 2007-1 CB 1288 , provides guidance with respect to the circumstances under which *IRC § 856(c)(2)* or *IRC § 856(c)(3)* characterizes gain under *IRC § 987* as qualifying income for purposes of REIT qualification.

Timberlands and the standing timber thereon constitute real property for purposes of *IRC § 856(c)*. *Ltr Rul 199925015* .

(n20)Footnote 12. A deed of trust on real property is considered a mortgage. *Treas Reg § 1.856-3(b)*.

Security interests in foreign property qualify as mortgages on real property provided such interests are legally equivalent to domestic mortgages or deeds of trust. *Rev Rul 74-191, 1974-1 CB 170* .

(n21)Footnote 13. The determination of the amounts cannot depend either wholly or partially on the income or profits of any person.

(n22)Footnote 14. See *§ 13.03[5]* for a discussion of prohibited transactions.

(n23)Footnote 15. Interest on obligations secured by mortgages includes interest on mortgages originated by the trust, *Rev Rul 65-67, 1965-1 CB 269* ; interest on "straight pass-through" mortgage-backed certificates, *Rev Rul 70-544, 1970-2 CB 6* ; income on participation certificates issued by the Federal Home Loan Mortgage Corporation, *Rev Rul 74-300, 1974-1 CB 169* ; interest on notes secured by stock in a cooperative housing corporation, *Rev Rul 76-101, 1976-1 CB 186* ; interest on hypothecation loans (loans secured by assignment of mortgage notes on real property), *Rev Rul 80-280, 1980-2 CB 207* ; and interest from investments in real estate construction mortgages, but not interest received on unsecured notes and debentures of the Federal National Mortgage Association, the Federal Home Loan Banks, or the Federal Land Banks, *Rev Rul 72-171, 1972-1 CB 208* ; or income from warehousing and interim purchasing of mortgages. Special Ruling, June 18, 1963, 7 CCH 1963 *Stand Fed Tax Rep* P 6559. Interest on a mortgage which covers both real property and personal property must be apportioned. *Treas Reg § 1.856-5(c)(1)*.

(n24)Footnote 16. Qualified temporary investment income is income that is derived from the temporary investment of new capital in stock (or certificates of beneficial interests) or a debt instrument (within the meaning of *IRC § 1275(a)(1)*) and is received during the one-year period beginning on the date that the REIT receives the capital. New capital is defined as any amount received by the REIT in exchange for stock in the REIT (other than amounts received pursuant to a dividend reinvestment plan), or in a public offering of debt obligations of the REIT that have maturities of at least five years. *IRC § 856(c)(5)(D)*.

(n25)Footnote 17. *IRC § 856(j)(1)*. A shared appreciation provision is any provision that is in connection with an obligation held by the REIT and secured by an interest in real property, and that entitles the REIT to receive a specified portion of any gain realized on the sale or exchange of the property (or any gain that would be realized if the property were sold on a specified date) or appreciation in value as of any specified date. *IRC § 856(j)(5)*.

(n26)Footnote 18. *IRC § 856(j)(2)(A)*.

(n27)Footnote 18.1. In *PLR 200614024 (2005)* , the Internal Revenue Service ruled that it would not take into account, for purposes of either the 95 percent or 75 percent tests, income received by an REIT in the form of refundable state income tax credits provided by the state as an incentive to promote the cleanup and development of properties in designated areas that have hazardous waste contamination. The Service determined that leaving these credits out of the income calculation would not interfere with nor impede the policy objectives of Congress in enacting the income tests (*viz*, to assure that a REIT's gross income is composed largely of passive income and not income from an active trade or business, and to equate the treatment of REITs and regulated investment companies (RICs). For similar reasons, the IRS held in *PLR 200916014 (2009)* , that it would not take into account the tax refunds receivable from the state in respect of such tax credits for purposes of the asset diversification test in *IRC § 856(c)(4)(A)* (see *§ 13.02[2][c]*).

(n28)Footnote 19. *IRC § 108(e)(9)*.

(n29)Footnote 20. *Treas Reg § 1.856-3(g)*.

(n30)Footnote 21. *IRC § 856(c)(6)*.

(n31)Footnote 22. See *§ 13.03[4]*.

(n32)Footnote 23. S Rep No 938, Pt I, 94th Cong, 2d Sess 471 (1976).

(n33)Footnote 24. S Rep No 938, Pt I, 94th Cong, 2d Sess 471 (1976).

(n34)Footnote 25. With respect to any particular building, services provided to tenants will be regarded as customary if, in the geographic market within which the building is located, tenants in buildings of a similar class are customarily furnished with the service. S Rep No 938, Pt I, 94th Cong, 2d Sess 471 (1976).

Rev Rul 2004-24, 2004-1 CB 550 , provides instances in which amounts received by the REIT for providing parking

facilities at its rental real properties qualify as rents from real property.

(n35)Footnote 26. The rent attributable to personal property is that amount that bears the same ratio to total rent for the taxable year as the average of the fair market values of the personal property at the beginning and end of the year bears to the average of the aggregate fair market values of the real and personal property at the beginning and end of the year. For taxable years prior to Jan 1, 2001, the ratio used adjusted bases of the property instead of fair market values.

The allocation method does not account for personal property leased by a REIT and then subleased to its tenants. In such case, the arm's-length payment by the REIT to the lessor of the personal property is treated as an amount received by the REIT as rent attributable to personal property. Next, the total rent received by the REIT is reduced by the amount of rent attributable to the sublease of personal property, and then multiplied by the ratio determined under the allocation formula specified in the preceding paragraph. *Ltr Rul 9428033*.

(n36)Footnote 27. Also excluded is any revenue derived from a property interest that does not qualify as a real estate asset, as, for example, a royalty payment under leases that constitute mineral royalty interests. *Rev Rul 64-75, 1964-1 (Part 1) CB 228*.

(n37)Footnote 28. *IRC § 856(d)(2)(A)*.

(n38)Footnote 29. *Treas Reg § 1.856-4(b)(3) (1981)*.

(n39)Footnote 30. *Treas Reg § 1.856-4(b)(3) (1981)*.

(n40)Footnote 31. *IRC § 856(d)(4)*.

(n41)Footnote 32. *Treas Reg § 1.856-4(b)(6)*.

(n42)Footnote 33. *IRC § 856(d)(6)*.

(n43)Footnote 34. *1969-1 CB 189*.

(n44)Footnote 35. *1964-1 (Pt 1) CB 231*.

(n45)Footnote 36. *IRC § 856(d)(2)(B)(i)*.

(n46)Footnote 37. *IRC § 856(d)(2)(B)(ii)*. The fact that a corporation's directors are also the directors of a real estate investment trust to which the corporation pays rent does not itself remove the payment from the category of "rents from real property." *Rev Rul 70-542, 1970-2 CB 148*.

(n47)Footnote 38. *IRC § 856(d)(5)*.

(n48)Footnote 39. *Treas Reg § 1.856-4(b)(4)*.

(n49)Footnote 40. *IRC § 856(d)(8)*. The substantially comparability requirement is met if it is met under the terms of the lease (1) at the time the lease is entered into, (2) at the time of each extension of the lease, including a failure to exercise a right to terminate, and (3) at the time of any modification of the lease between the REIT and the taxable REIT subsidiary if the rent under the lease is effectively increased pursuant to the modification. If the taxable REIT subsidiary is a controlled taxable REIT subsidiary, the term "rents from real property" does not in any event include rent under the lease to the extent of the increase in rent on account of the modification. *IRC § 856(d)(8)(A)(iii)*. A taxable REIT subsidiary is a controlled taxable REIT subsidiary if the REIT owns directly or indirectly stock possessing more than 50 percent by vote or value of the outstanding stock of the subsidiary. *IRC § 856(d)(8)(A)(iv)*.

If the substantially comparable requirement is met at any of the specified times, the requirement is treated as met so

long as there is no increase in the spaced leased to any taxable REIT subsidiary or other 10-percent owned persons. *IRC § 856(d)(8)(A)(v)*. If such an increase occurs during any calendar quarter, the requirements will be treated as met during the quarter and the succeeding quarter if they are met at the close of the succeeding quarter. *IRC § 856(d)(8)(A)(vi)*.

The operation of a property includes the management of the property. *IRC § 856(d)(9)(E)*.

(n50)Footnote 41. *IRC § 856(d)(9)(D)*. The term "lodging facility" includes customary amenities and facilities operated as part of, or associated with, the lodging facility so long as such amenities and facilities are customary for other properties of a comparable size and class owned by persons unrelated to the REIT.

For the six month period beginning Aug 28, 2005, the Service will treat a dwelling unit in a lodging facility as being used on a transient basis if the facility is used to provide temporary housing for victims of Hurricanes Katrina and Rita or for workers assisting in relief activities in the covered disaster area. *Notice 2005-89, 2005-49 IRB 1077*.

(n51)Footnote 42. *IRC § 856(d)(9)(A)*.

(n52)Footnote 43. *IRC § 856(d)(9)(B)*. Certain renewals of existing leases are treated as in effect on either Jan 1, 1999, or an applicable later date. *IRC § 856(d)(9)(C)*.

(n53)Footnote 44. *IRC § 856(d)(7)(A)*. The amount received for services, or management or operations, cannot be valued at less than 150 percent of the REIT's direct cost of the services (or of management or operation). *IRC § 856(d)(7)(D)*.

Although the amount of impermissible tenant service income is excluded from the definition of rent from real property, the amount of such income must be included in the gross income of the REIT for purposes of the 95-percent gross income test of *IRC § 856(c)(2)* or the 75-percent gross income test of *IRC § 856(c)(3)*. *IRC § 856(d)(7)(E)*.

A joint venture between a taxable REIT subsidiary of a REIT and a corporation that qualifies as an independent contractor of the REIT may provide noncustomary services to tenants of the REIT without causing the rents paid by the tenants to the REIT to fail to qualify as rents from real property. *Rev Rul 2003-86, 2003-2 CB 290*.

(n54)Footnote 45. *IRC § 856(d)(7)(B)*. Thus, if the REIT received \$197,000 in rent from a property and \$3,000 in impermissible tenant service income from the same property, the entire \$200,000 would be disqualified. If the trust received \$199,000 in rent and \$1,000 in impermissible tenant service income, only the \$1,000 would be disqualified. See *Rev Rul 98-60, 1998-2 CB 751*.

(n55)Footnote 46. *IRC § 856(d)(7)(C)*. A taxable REIT subsidiary of a REIT provides noncustomary housekeeping services to tenants of the REIT's apartment buildings. The REIT does not separately charge for the services. Because the services are rendered by the taxable REIT subsidiary, the services do not give rise to impermissible tenant service income. *Rev Rul 2002-38, 2002-2 CB 4*.

(n56)Footnote 46.1. Payments for the use or occupancy of space where services are also rendered to the occupant do not constitute rents from real property. *Treas Reg § 1.512(b)-1(c)(5)*. Generally, services are considered rendered to the occupant if they are primarily for the occupant's convenience and are other than those customarily rendered in connection with the rental of space for occupancy only.

(n57)Footnote 47. A corporation that acts as an advisor to a REIT cannot qualify as an independent contractor to manage property, *Rev Rul 74-471, 1974-2 CB 198*; but a subsidiary of the corporation can so qualify if it maintains a separate identity. *Rev Rul 76-534, 1976-2 CB 215*; *Rev Rul 75-136, 1975-1 CB 195*. A corporation wholly owned by one who is a trustee and salaried administrator of a REIT can qualify as an independent contractor. *Rev Rul 77-23, 1977-1 CB 197*.

(n58)Footnote 48. *IRC § 856(d)(3)(A), (B)*. For years after Dec 31, 2000, if any class of stock of either the REIT or the contractor is regularly traded on an established securities market, only persons who own, directly or indirectly, more than 5 percent of that class of stock are taken into account as owning any of the stock of the class for purposes of applying the 35-percent limitation (but all of the outstanding stock of the class is considered in order to compute the denominator for purposes of determining the applicable percentage of ownership).

(n59)Footnote 49. *IRC § 856(d)(5)*.

(n60)Footnote 50. The prohibition against the receipt of income from an independent contractor does not apply to amounts received as rent for space occupied by the contractor in the property which it manages for the REIT. *Rev Rul 66-188, 1966-2 CB 276*.

(n61)Footnote 51. *Treas Reg § 1.856-4(b)(5)(i)*.

(n62)Footnote 52. *Treas Reg § 1.856-4(b)(5)(i)*.

(n63)Footnote 53. *Treas Reg § 1.856-4(b)(5)(i)*.

(n64)Footnote 54. *Treas Reg § 1.856-4(b)(5)(i)*. Any amount representing a separate charge for customary services must also be received and retained by the independent contractor.

(n65)Footnote 55. *Rev Rul 66-189, 1966-2 CB 277*.

(n66)Footnote 56. *IRC § 856(e)(2)*. For taxable years beginning on or before August 5, 1997, foreclosure period retained that status for two years after acquisition. One extension (not to exceed three years) may be granted by the Commissioner if it is established that an extension of the grace period is necessary for the orderly liquidation of the REIT's interest in the property. *IRC § 856(e)(3)*. Prior to enactment of the Taxpayer Relief Act of 1997, one or more extensions could be granted, but the grace period could not exceed six years in total.

Generally, in order to establish the necessity of an extension, the REIT must demonstrate that it has made good faith efforts to renegotiate leases with respect to, or dispose of, the foreclosure property. In certain instances, the REIT may be able to show the need for an extension without having made such efforts, as when it can be demonstrated that, for valid business reasons, construction of the property could not be completed before the expiration of the grace period. *Treas Reg § 1.856-6(g)(2)*.

Where state law allows a mortgagor to redeem foreclosed property within a specified period of time and gives the mortgagor the rights of ownership, including income, during that period, a REIT that purchases the property at the foreclosure sale is not deemed to acquire the property until the end of the period. *Rev Rul 78-3, 1978-1 CB 218*.

(n67)Footnote 57. *IRC § 856(e)(4)(A)-(C)*. Real property is not treated as used in a trade or business by reason of any activities of the REIT with respect to the property to the extent that the activities would not result in amounts received or accrued, directly or indirectly, with respect to the property being treated as other than rents from real property.

In the case of qualified health care property that is foreclosure property, income derived or received from an independent contractor is disregarded to the extent the income is attributable to (i) any lease of property in effect on the date the REIT acquired the qualified health care property (without regard to its renewal after that date so long as the renewal is pursuant to the terms of the lease on that date), or (ii) any lease of property entered into after the date the REIT acquired the property if, on that date, a lease of the property from the REIT was in effect, and under the terms of the new lease, the REIT receives a substantially similar or lesser benefit. *IRC § 856(e)(6)(C)*.

(n68)Footnote 58. *IRC § 856(e)(6)(A)*.

(n69)Footnote 59. *IRC § 856(e)(6)(D)*.

(n70)Footnote 60. *IRC § 856(e)(6)(B)*.

(n71)Footnote 61. *IRC § 856(e)(5); Treas Reg § 1.856-6(c)(3)*. The statement must indicate that the election is made under *IRC § 856(e)* and identify the property to which the election relates. In addition the statement must set forth (i) the name, address, and taxpayer identification number of the REIT; (ii) the date the property was acquired by the REIT; and (iii) a brief description of how the real property was acquired, including the name of the person or persons from whom the property was acquired and a description of the lease or indebtedness with respect to which default occurred or was imminent.

(n72)Footnote 62. *IRC § 856(e)(5)*.

(n73)Footnote 63. *Treas Reg § 1.856-6(b)(3)*.

(n74)Footnote 64. *Treas Reg § 1.856-6(b)(3)*.

(n75)Footnote 65. *IRC § 856(f)(1)(A), (B)*.

(n76)Footnote 66. *IRC § 856(f)(2)*. An approach similar to the one described above for the allocation of contingent rents is used to allocate contingent interest. *Treas Reg § 1.856-5(d)*.

(n77)Footnote 67. "The term 'real estate assets' means real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other real estate investment trusts which meet the requirements of this part." *IRC § 856(c)(5)(B)*.

Air rights over real property are considered interests in real property and real property assets. *Rev Rul 71-286, 1971-2 CB 263*.

Stock or debt instruments representing temporary investments of new capital are treated as real estate assets for the one-year period beginning on the date the REIT receives the capital. New capital is defined as any amount received by the REIT (i) in exchange for stock (or certificates of beneficial interest) in the REIT, or (ii) in a public offering of debt obligations of the REIT that have maturities of at least five years.

A regular or residual interest in a REMIC (see Ch 13A) is treated as an interest in real property, and any amount includable in gross income with respect to such an interest is treated as interest on an obligation secured by a mortgage on real property, but if less than 95 percent of the assets of the REMIC are real estate assets (determined as if the REIT held the assets), the interest in the REMIC is treated as an interest in real property only in the proportion that the assets of the REMIC consists of such interests. In determining whether any interest in a REMIC qualifies under the preceding sentence, any interest held by the REMIC in another REMIC is treated as a real estate asset under principles similar to those in the preceding sentence, except that, if the REMICs are part of a tiered structure, they are treated as a single REMIC. *IRC § 856(c)(5)(E)*.

A "straight pass-through" mortgage-backed certificate is considered a real estate asset, *Rev Rul 70-544, 1970-2 CB 6*, as is a note secured by a mobile home unit set on preengineered block foundations. *Rev Rul 71-220, 1971-1 CB 210*. The mobile home would also be a real estate asset.

The REIT, in *Ltr Rul 200705001*, entered into a repurchase agreement patterned after the form of agreement generally employed in the mortgage backed securities industry. Under the agreement, a party agreed to transfer mortgage loans to the REIT against a transfer of funds by the REIT, with a simultaneous agreement by the REIT to transfer the purchased assets on a given date, against a transfer of funds by the other party. The aggregate amount of the

assigned mortgage loans equaled or exceeded the amount transferred by the REIT. The Service held that the repurchase agreement constituted a real estate asset and was not a security.

(n78)Footnote 68. The Service defines "cash" as cash on hand and time or demand deposits with, or withdrawable accounts in, financial institutions. Therefore, a certificate of deposit is a cash item while a banker's acceptance is not. *Rev Rul 77-199, 1977-1 CB 195 ; Rev Rul 72-171, 1972-1 CB 208 .*

(n79)Footnote 69. *IRC § 856(c)(4)(A)*. A list of qualifying Government securities can be found in *Rev Rul 64-85, 1964-1 (Pt 1) CB 230 .*

United States Treasury obligations acquired by a REIT from a bank under an agreement whereby the REIT agrees to resell the obligations to the bank on a fixed date at the purchase price, plus an agreed amount of interest, do not qualify as an asset for the 75 percent asset test. The asset of the trust is the bank's obligation to repay the purchase price to the REIT, not the government obligations. *Rev Rul 77-59, 1977-1 CB 196 .*

Rev Proc 2003-65, 2003-2 CB 336 , sets forth a safe harbor under which a loan made by a REIT that is secured either by a partnership interest in a partnership or by the sole member interest in a disregarded entity will be treated as a real estate asset for purposes of *IRC § 856(c)(4)(A)* and *856(c)(5)(B)*.

(n80)Footnote 70. *IRC § 856(c)(4)(B)*. The assets of a qualified REIT subsidiary (a wholly-owned subsidiary) of the REIT are treated as the assets of the REIT. *IRC § 856(i)*. A taxable REIT subsidiary cannot be a qualified REIT subsidiary.

Although a qualified REIT subsidiary is otherwise not treated as a corporation separate from the REIT, it is treated as a separate corporation for purposes of (1) federal tax liabilities of the subsidiary for any taxable period that it was treated as a separate corporation, (2) federal tax liabilities of any other entity for which the subsidiary is liable, and (3) refunds or credits of federal tax. *Treas Reg § 1.856-9(a)*.

The 20-percent-of-value test is effective generally for taxable years beginning after Dec 31, 2000.

(n81)Footnote 71. *IRC § 856(c)(4)(B)*. A voting security is any security entitling the owner to vote for the election of directors of the issuing corporation. *IRC § 856(c)(5)(F)*; Investment Company Act of 1940, § 2(a)(42), 15 USC § 80A-2(a)(42).

The 10-percent-of-value test is applicable in taxable years beginning after Dec 31, 2000. There are transitional rules that make the test inapplicable to securities of a corporation held by a REIT on July 12, 1999, securities acquired by the REIT pursuant to a binding contract in effect on that date, and to securities of another corporation acquired in tax-free exchanges and reorganizations. With some exceptions, the transitional rules cease to apply to securities of a corporation if the corporation engages in a substantial new line of business or acquires any substantial asset, or the REIT acquires additional securities of the corporation.

(n82)Footnote 72. Straight debt is any written unconditional promise to pay on demand or a specified date a sum certain in money, if (i) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors, (ii) there is no convertibility (directly or indirectly) into stock, and (iii) the creditor is an individual (other than a nonresident alien), an estate, certain trusts as specified in *IRC § 1361(c)(2)*, or a person that is actively and regularly engaged in the business of lending money. *IRC §§ 856(m)(2)(A)* and *1361(c)(5)*. An interest rate (and interest payment dates) are not treated as contingent on profits, the borrower's discretion, or similar factors solely because of the fact that (1) the time of payment of interest or principal is subject to a contingency, but only if (a) the contingency does not have the effect of changing the effective yield to maturity, as determined under *IRC Section 1272*, other than a change that does not exceed the greater of 1/4 of 1 percent or 5 percent of the annual yield to maturity, or (b) neither the aggregate issue price nor the aggregate face amount of the issuer's debt securities held by the REIT

exceeds \$1 million and not more than 12 months of unaccrued interest can be required to be prepaid thereunder, or (2) the time or amount of payment is subject to a contingency upon a default or the exercise of a prepayment right by the issuer of the debt, but only if the contingency is consistent with customary commercial practice. *IRC § 856(m)(2)(B)*.

(n83)Footnote 72.1. A § 467 rental agreement is a rental agreement for the use of tangible personal property under which there is at least one amount allocable to the use of property during a calendar year following the calendar year in which the use occurs, or there are increases in the amount to be paid as rent under the agreement. *IRC § 467(d)*.

(n84)Footnote 72.2. *IRC § 856(m)(1)*. Any debt instrument issued by a partnership and not falling within the safe harbor will not be considered a security (i) to the extent of the REIT's interest as a partner in the partnership, or (ii) if at least 75 percent of the partnership's gross income (excluding gross income from prohibited transactions) is derived from sources described in *IRC § 856(c)(3)* (see § 13.02[2][b]). *IRC § 856(m)(4)*.

(n85)Footnote 72.3. *IRC § 856(m)(2)(C)*. A REIT's interest as a partner in a partnership is not considered a security, and the REIT is deemed to own its proportionate share of each of the assets of the partnership. *IRC § 856(m)(3)(A)*. The REIT's interest in the partnership assets is the trust's proportionate interest in any securities issued by the partnership (determined without regard to the REIT's interest in the partnership or the application of *IRC § 856(m)(4)*), but not including securities falling within the safe harbor, and the value of any debt instrument is the adjusted issue price thereof, as defined in *IRC § 1272(a)(4)* (see § 17.02A[2][a]). *IRC § 856(m)(3)(B)*.

(n86)Footnote 73. *IRC § 856(c)(4)*. The Service has ruled that an increase in a REIT's holdings in a corporation due solely to the corporation's purchase of its stock on the open market should not cause it to lose its status as a REIT. *Ltr Rul 9237022*.

(n87)Footnote 74. *IRC § 856(c)(4)*.

(n88)Footnote 75. *Treas Reg § 1.856-2(d)(4)*, Examples (4) and (5).

(n89)Footnote 76. *IRC § 857(a)(1)*. The distribution percentage will be 90 percent for taxable years beginning after Dec 31, 2000.

Amounts used to amortize mortgages do not reduce the REIT's taxable income for purposes of determining the amount which must be distributed to meet the percentage requirement. Additionally, the requirement will not be satisfied by distribution of a tax-free stock dividend. *Rev Rul 64-292, 1964-2 CB 182*.

(n90)Footnote 77. *IRC § 857(e)*.

(n91)Footnote 78. *IRC § 857(a)(2)*. A distribution made to comply with the requirement that a REIT have no earnings and profits accumulated from any year in which it was not treated as a REIT is treated as made from the earliest earnings and profits accumulated in any taxable year in which the taxpayer was not a REIT rather than the most recently accumulated earnings and profits. *IRC § 857(d)(3)(A)*. Such a distribution is not treated as a distribution in determining the dividends paid deduction allowable to the REIT or the election to treat a dividend paid after the close of the year as made during the taxable year. *IRC § 857(d)(3)(B)*.

For purposes of satisfying *IRC § 857(a)(2)(b)*, an earnings and profits deficit from years in which a trust was taxed as a REIT can be carried forward to offset an earnings and profits surplus in years when the trust was taxed as a C corporation. *Ltr Rul 200403030*.

(n92)Footnote 1. *IRC § 856(l)(1)*.

(n93)Footnote 2. *IRC § 856(l)(2)*. Straight debt is not taken into account in determining the ownership of securities by a taxable REIT subsidiary. Straight debt is defined in *IRC §§ 856(c)(7) and 1361(c)(5)*. See § 13.02[2][c].

(n94)Footnote 3. *IRC § 856(l)(3)*.

(n95)Footnote 1. *Treas Reg § 1.856-3(g)*. The regulations apply where the REIT is a limited partner. *Rev Rul 69-40, 1969-1 CB 188*.

(n96)Footnote 2. Since the character is retained "for all purposes of section 856," the REIT will be deemed to hold real property primarily for sale to customers, and thus not qualify as a REIT, if the partnership holds any property for such purpose.

(n97)Footnote 3. *Treas Reg § 1.856-3(g)*.

(n98)Footnote 1. *IRC § 857(f)(1)*.

(n99)Footnote 2. *IRC § 857(f)(2)(A)*.

(n100)Footnote 3. *IRC § 857(f)(2)(B), (D)*.

(n101)Footnote 4. *IRC § 857(f)(2)(C)*.

(n102)Footnote 5. *Treas Reg § 1.857-8(d)*.

(n103)Footnote 6. *Treas Reg § 1.857-8(e)*.



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Taxation of Securities Transactions

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CHAPTER 13 Real Estate Investment Trusts

2-13 Taxation of Securities Transactions § 13.03

§ 13.03 Taxation of Real Estate Investment Trusts

[1] Taxation of Ordinary Income.

[a] Applicable Rates. The ordinary taxable income of a qualifying REIT is subject to the tax imposed on corporations by *IRC Section 11*.ⁿ¹ Thus, as in the case of a RIC, the benefit derived from being taxed as a REIT comes from the manner in which taxable income of the trust is determined, not from the rate of tax to which the income is subject.ⁿ²

A REIT's net income from foreclosure property is also subject to the rates on corporate income prescribed by *IRC Section 11*, with one exception. The applicable rate is the highest rate specified.ⁿ³

[b] Computing Real Estate Investment Trust Taxable Income. Taxable income, as normally computed, is converted into REIT taxable income through Code imposed adjustments. An exclusion is provided for an amount equal to any net income derived from prohibited transactions and for an amount equal to the REIT's net income from foreclosure property.ⁿ⁴ The dividends received deductions provided in *IRC Sections 243, 244, and 245* are disallowed.ⁿ⁵ (A REIT is denied a net operating loss carryback, but is allowed to carry over net operating losses for a period of eight years.ⁿ⁶) Allowed as deductions are (a) the deduction for dividends paid described in *IRC Section 561*, but computed without regard to the portion of such deduction attributable to the amount excluded from income which is equal to the REIT's income from foreclosure property,ⁿ⁷ and (b) an amount equal to the sum of the excise tax imposed on REITs that fail to meet gross income requirements but are not disqualified because the failure is due to reasonable cause, the excise tax imposed by *IRC Section 856(c)(9)(B)(iii)* when there is more than a *de minimis* failure to meet asset diversification requirements, the tax imposed by *IRC Section 856(g)(1)* in lieu of automatic termination when a failure to meet the requirements for a REIT are due to reasonable cause, and the 100 percent tax imposed on improperly allocated amounts.ⁿ⁸ Finally, the taxable income for a period of less than twelve months need not be placed on an annual basis even though the short taxable year results from a change in accounting period.ⁿ⁹

A REIT's net income from foreclosure property consists of the aggregate of the gains and losses from sales or other dispositions of foreclosure property described in *IRC Section 1221(a)(1)* (property held for sale to customers in the ordinary course of business) and the net gain or loss from operations.ⁿ¹⁰ The latter amount is the difference between (a) the gross income derived from foreclosure property, to the extent such income does not consist of rents from real property; interest on obligations secured by mortgages on real property or interests in real property; gains from dispositions of real property; dividends or other distributions on, and gain from the disposition of interests in other

qualified REITs; and abatements and refunds of real property taxes; and commitment fees; and (b) any deductions that are directly connected with such income.ⁿ¹¹ If there is a net loss from foreclosure property, such loss is taken into account in computing real estate investment trust taxable income under *IRC Section 856(b)(2)*.ⁿ¹²

[c] Dividends Paid Deduction. We have seen that the dividends paid deduction plays a dual role in the taxation of REITs, i.e., as the measuring rod of the income distribution requirement of *IRC Section 857(a)*, and as the vehicle for obtaining the special tax treatment that Congress has granted to qualifying real estate investment trusts. This crucial concept can be simply defined as the amount of dividends paid during the taxable yearⁿ¹³ excluding, for the distribution requirement, any capital gains dividend paid during the year and, for the determination of REIT taxable income, the amount of net income from foreclosure property. But not every dividend can qualify as a dividend paid during the taxable year. This is open only to distributions of property (including money) that meet the definition of dividend found in *IRC Section 316(a)*.ⁿ¹⁴ Thus, since stock in the distributing corporation is excluded from the definition of property as used in *IRC Section 316(a)*, a nontaxable stock dividend distributed by the REIT normally will not enter into the computation of the dividends paid deduction.ⁿ¹⁵ A further limitation requires that no shareholder be given preference over any other shareholder of the same class, and that no class of shares be given preference over any other class except to the extent that a class is entitled to a preference by its terms.ⁿ¹⁶

If the dividends qualifying for the deduction were limited to those actually paid during the taxable year, a faulty estimate of taxable income and the amount to be distributed in order to meet the income distribution requirement would be fatal. To facilitate accurate determination of these amounts, *IRC Section 858(a)* permits a REIT to elect to treat a dividend paid after the close of the year as having been paid during the taxable year,ⁿ¹⁷ provided (1) the dividend is declared prior to the date upon which the trust's return for the taxable year must be filed, and (2) the dividend is distributed to shareholders or holders of beneficial interests within the twelve-month period following the close of the taxable year to which the election relates, but not later than the date of the first regular dividend payment following declaration of the post-year dividend.ⁿ¹⁸

The election must be made in the return filed by the REIT for the prior taxable year and is made by specifying the dollar amount of the dividend and by stating that the post-year dividend is part of the dividends paid for that year.ⁿ¹⁹ However, any distribution made with respect to a valid election for a prior year will be deemed to have been made only in such prior year and not during the payment year.ⁿ²⁰ The election becomes irrevocable after the time for filing the return for the taxable year to which the election relates has expired.ⁿ²¹

The Service in its discretion can grant an extension of time to file the election, provided (1) the time for making such an election is not expressly proscribed by statute; (2) the request for extension is filed with the Service before the time fixed for making the election, or within such time thereafter as the Service may consider reasonable under the circumstances; and (3) it is shown to the satisfaction of the Service that the granting of the extension will not jeopardize the interests of the government.ⁿ²² As a general rule, relief will be granted when the taxpayer acted reasonably and in good faith, and granting relief will not prejudice the interests of the government.ⁿ²³

A taxpayer will have acted reasonably and in good faith if (a) the taxpayer inadvertently failed to make the election because of certain intervening events beyond the taxpayer's control or, because after exercising due diligence (taking into account the taxpayer's experience and the complexity of the return of issue), the taxpayer was unaware of the necessity of the election; (b) the taxpayer reasonably relied on the written advice of the Service; or (c) the taxpayer reasonably relied on a qualified tax professional, and the tax professional failed to make or advise the taxpayer to make the election.ⁿ²⁴ A taxpayer will not be considered to have acted reasonably and in good faith if the taxpayer knew or should have known that the tax professional was not competent to render advice on the election or did not know all of the relevant facts. In addition, good faith and reasonableness will not exist if the taxpayer seeks to alter a tax return position for which an accuracy penalty has been or could have been imposed under *IRC Section 6662* at the time the taxpayer requests relief, and the new position requires the election. A taxpayer also will not have acted reasonably and in good faith if the taxpayer was fully informed of the required election and related tax consequences and chose not to

file the election. Finally, a taxpayer will not have acted reasonably and in good faith if the taxpayer uses hindsight in requesting relief.

The interests of the government are prejudiced if granting relief would result in a taxpayer having a lower tax liability in the aggregate for all years to which the election applies than the taxpayer would have had if the election had been timely made (taking into account the time value of money).ⁿ²⁵ Ordinarily, the Service will not grant relief when the tax years made by the election--had it been timely--are closed by the statute of limitations.

[2] Taxation of Net Long-Term Capital Gains.

The second half of the real estate investment trust taxing scheme concerns the taxation of net capital gains. A REIT is allowed a deduction for capital gain dividends paid,ⁿ¹ so that the REIT is taxed only on net long-term capital gains it does not distribute.

Before a distribution can qualify as a capital gain dividend, it must be so designated by the REIT in a written notice mailed to shareholders or holders of beneficial interests no later than 30 days after the close of the REIT's taxable year (or mailed to its shareholders or holders of beneficial interests with its annual report for the taxable year).ⁿ² If the aggregate amount designated as a capital gain dividend is greater than the excess of net long-term capital gain over net short-term capital loss for the taxable year, the total capital gain dividend for the year will be restricted to such excess and the amount of each distribution designated as a capital gain dividend limited accordingly.ⁿ³ The net capital gain dividend for any taxable year that is not a calendar year must be determined without regard to any net capital loss attributable to transactions after December 31st of such year; the loss is treated as arising on the first day of the next taxable year.ⁿ⁴ If the net capital gain for the taxable year does not exceed the capital gain dividend for the year, the amount of net capital gain is excluded in determining the net operating loss for the year or the amount of any net operating loss for a prior year that is carried through the taxable year to a succeeding year.ⁿ⁵

[3] Deduction for Deficiency Dividends.

We have seen that a REIT is subject to tax as an ordinary corporation if it fails to meet the income distribution requirements for the taxable year. Disqualification is automatic unless the failure results from a post-audit determination that the income of the REIT must be increased or the dividends paid deduction decreased. In such case, the REIT can avail itself of the deficiency dividend procedure permitted by *IRC Section 860* and escape taxation on the amount distributed as a deficiency dividend.

Resort to the relief granted by *IRC Section 860* can be had only after a "determination" resulting in an "adjustment." The first term is defined as a final decision or judgment of a court, a closing agreement under *IRC Section 7121*, or an agreement between the REIT and the Internal Revenue Service relating to the tax liability of the trust, or a statement by the taxpayer attached to its amendment or supplement to a return of tax for the relevant tax year.ⁿ¹ The second is (1) an increase in the REIT's real estate investment trust taxable income, excluding net capital gains and without deduction for dividends paid; (2) an increase in net after-tax income from foreclosure property; (3) an increase in the amount of excess net capital gain over the deduction for capital gains dividends paid; or (4) a decrease in the deduction for dividends paid determined without regard to capital gain dividends.ⁿ²

A distribution qualifies as a deficiency dividend if distributed within ninety days after the determination resulting in the adjustment and before the filing of a claim for deduction.ⁿ³ (The claim for deduction must be filed no later than 120 days after the determination).ⁿ⁴ The amount that can be treated as a deficiency dividend cannot exceed the net adjustment produced by the audit and determination.ⁿ⁵ The distribution relates to the year for which it is paid. It cannot be considered a dividend for the year in which paid or as a post-year dividend paid pursuant to *IRC Section 858*.ⁿ⁶

The interest and penalty provisions attached to the deficiency dividend procedure are designed "to recover lost revenues

to the government as well as to assume that a REIT (1) will be operated as a conduit of income to its shareholders and (2) will not reduce its distributions of income in reliance on the availability of the deficiency dividend procedure."ⁿ⁷ To this end, interest is determined only to the extent the deficiency deduction is allowed, and runs from the due date (without extensions of time) of the return for the year in question until the claim for deduction is filed.ⁿ⁸

If the allowance of the deficiency dividend deduction results in an overpayment tax, the REIT has two years from the date of determination in which to file a claim for refund.ⁿ⁹ The filing of a claim for deduction suspends the running of the statute of limitations on assessments for a period of two years after the date of determination.ⁿ¹⁰ The determination itself stays the collection of the deficiency and of interest and penalties for a period of 120 days except in the case of jeopardy.ⁿ¹¹

There is one final, but very important, note. The procedure is available only if the entire amount of the adjustment is not due to fraud with intent to evade tax or to willful failure to file a return within the required time.ⁿ¹²

[4] Tax Imposed for Failure to Meet Gross Income Requirements.

We have seen that a REIT is not disqualified for failing to meet the gross income source requirements of *IRC Section 856(c)* if the failure is due to reasonable cause and the REIT complies with certain other conditions.ⁿ¹ The cost to the REIT for this is a 100 percent tax on the net income attributable to the greater of the amount by which the REIT failed the 95 percent test or the 75 percent test.ⁿ² To determine such net income, the amount by which the respective test is failed is multiplied by the following fraction:

$$\frac{\text{real estate investment trust taxable income for year in question}}{\text{gross income of REIT for year in question}}$$

The fraction reflects the average profitability of the REIT and provides a simple way to determine the trust's net income from nonqualifying income without requiring an apportionment or allocation of specific deductions.ⁿ⁵

[5] Tax on Income From Prohibited Transactions.

Prior to the Tax Reform Act of 1976, the Code contained a prohibition against a REIT holding property for sale to customers in the ordinary course of business. The Act removed the bar and replaced it with a tax equal to 100 percent of the net income (gain less directly connected deductions) derived from sales or other dispositions of such property.ⁿ¹

The 100 percent penalty tax is inapplicable to the sale of property held primarily for sale if (1) the property has been held by the REIT for at least two years, (2) the total expenditures made by the REIT during the two-year period preceding the sale do not exceed 30 percent of the net selling price, (3) the REIT does not sell more than seven properties (other than sales of foreclosure property or sales to which *IRC Section 1033* (relating to involuntary conversions) applies) during the taxable year, or the aggregate adjusted bases (as determined for the purposes of computing earnings and profits) of property (other than sales of foreclosure property or sales to which *IRC Section 1033* applies) sold during the taxable year does not exceed 10 percent of the aggregate bases of all assets of the REIT at the beginning of the taxable year, or, for sales made after July 30, 2008, the fair market value of property (other than sales of foreclosure property or sales to which *IRC Section 1033* applies) sold during the taxable year does not exceed 10 percent of the fair market value of all assets of the trust as of the beginning of the taxable year,^{n1.1} (4) if not acquired by foreclosure, the property has been held for rental for at least four years, and (5) if the seven-sale requirement is not satisfied, substantially all of the marketing and development expenditures with respect to the property were made through an independent contractor from whom the REIT does not itself derive or receive any income.ⁿ² Failure to meet the requirements of this safe harbor rule does not mean that the sale is automatically deemed to be a prohibited transaction. Rather, the nature of the transaction is to be determined under the facts and circumstances of the case as if

the safe harbor provision had not been enacted.ⁿ³

Each of the four conditions is affected by special rules. For purposes of the four-year holding period requirement, the length of time that the REIT has held property acquired through foreclosure (or deed in lieu of foreclosure), or termination of a lease, includes the period that the REIT held the loan that was foreclosed or was the lessor of the property.ⁿ⁴

The 30 percent expenditure condition is tested by including not only expenditures made directly by the REIT during the four-year period, but also, in the case of property acquired by foreclosure or lease termination, any payment made by or for the mortgagor or lessee after default became imminent.ⁿ⁵ On the other hand, expenditures are not taken into account if they relate to foreclosure property and did not cause the property to lose its status as foreclosure property,ⁿ⁶ or if they are made to comply with governmental standards or regulations or to restore damage caused by fire, storm, or other casualty.ⁿ⁷

For purposes of the seven-sale per year limit, the sale of more than one property to one buyer in one transaction is treated as one sale.ⁿ⁸ In addition, sales with a net selling price (total selling price less related selling expenses) of less than \$10,000 are excluded from the count.ⁿ⁹ If the REIT exceeds the limit, none of the sales is protected by the safe harbor rule.ⁿ¹⁰

For purposes of the rental test, any rental at an insignificant rent or for a use which indicates that the purpose of the rental arrangement was not for the production of rental income is to be disregarded. It is important to note that the "use" test is not overcome by the fact that the rental derived is a fair rent for that use.ⁿ¹¹

Excluded from the definition of prohibited transaction is any sale of property that is a real estate asset if (a) the REIT held the property for at least four years in connection with the trade or business producing timber, (b) the aggregate expenditures made by the REIT, or a partner of the REIT, during the four-year period preceding the sale that (1) are includable in the basis of the property (other than timberland acquisition expenditures), and (2) are directly related to the operation of the property for the production of timber or for the preservation of the property for use as timberland, do not exceed 30 percent of the net selling price of the property, (c) the aggregate expenditures made by the REIT, or a partner of the REIT, during the four-year period preceding the sale that (1) are includable in the basis of the property (other than timberland acquisition expenditures), and (2) are not directly related to the operation of the property for the production of timber, or for the preservation of the property for use as timberland do not exceed 5 percent of the net selling price of the property, (d)(1) during the taxable year the REIT does not make more than seven sales of property (other than sales of foreclosure property or sales pursuant to an involuntary conversion), or (2) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property (other than sales of foreclosure property or sales pursuant to an involuntary conversion) sold during the taxable year does not exceed 10 percent of the aggregate bases of all of the assets of the REIT at the beginning of the taxable year, (e) if the requirement of (d)(1) above is not satisfied, substantially all of the marketing expenditures with respect to the property were made through an independent contractor from whom the REIT does not derive or receive any income, and (f) the sales price of the property sold by the trust is not bases in whole or in part of income or profits, including income or profits derived from the sale or operation of the property.ⁿ¹²

[6] Tax on Income From Foreclosure Property.

IRC Section 857(b)(4)(A) imposes the highest corporate tax rate on the net income from foreclosure property of a REIT. The income base is defined by *IRC Section 857(b)(4)(B)* as (1) the excess of gain from the sale or other disposition of foreclosure property held for sale to customers in the ordinary course of business and gross income derived from foreclosure property other than rents, interest on obligation secured by mortgages on real property, gains from dispositions of real property not held for sale to customers in the ordinary course of business, income derived from interests in other qualified REIT, abatements and refunds of real estate taxes, and commitment fees, over (2) the

deductions that are directly connected with the production of that income.

[7] Earnings and Profits of Real Estate Investment Trusts.

A REIT, including one taxed as an ordinary business corporation because it fails to meet the 95 percent income distribution test of *IRC Section 857(a)*, computes its current earnings and profits (but not its accumulated earnings and profits) in a manner slightly different from the one employed by an ordinary corporation. The latter may reduce current earnings and profits by the amount of deductions that are not allowable in computing taxable income, such as excess capital losses. The REIT is not permitted to reduce its earnings and profits for the taxable year by any amount not allowable as a deduction in computing its taxable income for the year.ⁿ¹

A REIT is treated as having sufficient earnings and profits to treat as a dividend any distribution (other than a redemption to which *IRC Section 302(a)* applies) that is treated as a dividend by the REIT, except to the extent that the amount distributed exceeds the required distribution for the year under the *IRC Section 4981* excise tax on undistributed income.ⁿ²

[8] Excise Tax on Undistributed Income.

IRC Section 4981(a) imposes a 4 percent tax on the REIT for each calendar year to the extent that the "required distribution" for the year exceeds the "distributed amount" for the year.ⁿ¹ The "required distribution" for any calendar year is the sum of (1) 85 percent of the REIT's ordinary income for the year, (2) 95 percent of the REIT's capital gain net income for the year, and (3) the excess of the grossed up required distribution for the preceding calendar year over the distributed amount for such year.ⁿ² The grossed up required distribution for any calendar year is the sum of the taxable income for the year and all amounts from earlier years that are not treated as having been distributed for purposes of the excise tax.ⁿ³

The REIT's ordinary income for purposes of the excise tax is its REIT taxable income determined (1) without taking into account the dividends paid deduction, (2) by not taking into account any gain or loss from the sale of any capital asset, and (3) by treating the calendar year as the REIT's taxable year.ⁿ⁴ The amount of the REIT's capital gain net income is reduced by any net ordinary loss--the amount that would be its net operating loss for the calendar year determined in accordance with the preceding sentence.ⁿ⁵

The "distributed amount" for any taxable year is the sum of (1) the deduction for dividends paid during the year (computed without regard to the portion of the deduction attributable to the exclusion of net income from foreclosure property), (2) any tax imposed on the REIT's real estate investment trust taxable income or net capital gain, and (3) the excess of the distributed amount for the preceding calendar year over the grossed up required distribution for that year.ⁿ⁶ The amount of dividends paid during the year is determined without regard to the provisions of *IRC Section 858*.ⁿ⁷

For purposes of the excise tax, any deficiency dividend is taken into account when paid, and any income giving rise to the adjustment that triggers the dividend is treated as arising when the dividend is paid.ⁿ⁸

[9] 100 Percent Tax on Improperly Allocated Amounts.

A 100 percent tax is imposed for each taxable year of a REIT if the amount of interest, rent, or other deductions of a taxable REIT subsidiary of the REIT is determined to be other than at arm's length ("redetermined rents," "redetermined deductions," and "excess interest").ⁿ¹ The tax is effective for years beginning after December 31, 2000, and applies in lieu of any distribution, apportionment, or allocation under *IRC Section 482*.ⁿ²

Redetermined rents are rents from real property to the extent the amount of the rents would be reduced on distribution,

apportionment, or allocation under *IRC Section 482* to clearly reflect income as a result of services furnished or rendered by a taxable REIT subsidiary to a tenant of the REIT.ⁿ³ However, the following are not treated as redetermined rents:

- (1) *De minimis* amounts (amounts treated as impermissible tenant income with respect to property to the extent the amounts do not exceed 1 percent of amounts received by the REIT with respect to the property);ⁿ⁴
- (2) There is specified evidence that charges to unrelated parties are substantially comparable;ⁿ⁵
- (3) Certain charges by the subsidiary are separately stated;ⁿ⁶ and
- (4) The subsidiary's gross income from the service is not less than 150 percent of the its direct cost in furnishing the service.ⁿ⁷

In addition, the Service can waive the tax if the REIT establishes to the satisfaction of the Service that rents charged to tenants were established on an arm's-length basis even though a taxable REIT subsidiary of the REIT provided services to the tenants.ⁿ⁸

Redetermined deductions are deductions (other than redetermined rents) of a taxable REIT subsidiary to the extent the amount of the deductions would be decreased on distribution, apportionment, or allocation under *IRC Section 482* to clearly reflect income as between the subsidiary and the REIT.ⁿ⁹ Excess interest is any deduction for interest payments by a taxable REIT subsidiary to the REIT to the extent that the interest payments are in excess of a rate that is commercially reasonable.ⁿ¹⁰

The Service is required to prescribe regulations to carry out the purposes of the foregoing rules.ⁿ¹¹ Until such regulations are prescribed, a REIT and any of its taxable REIT subsidiaries can base their allocations on any reasonable method.

FOOTNOTES:

(n1)Footnote 1. *IRC § 857(b)(1)*. See § 6.03[1] for the treatment of net built-in gain assets of a C corporation that become assets of a REIT.

(n2)Footnote 2. The taxation of regulated investment companies is discussed in Ch 12.

(n3)Footnote 3. *IRC § 857(b)(4)(A)*.

(n4)Footnote 4. *IRC § 857(b)(2)(D), (F)*.

(n5)Footnote 5. *IRC § 857(b)(2)(A)*.

(n6)Footnote 6. *IRC § 172(b)(1)(E)*.

(n7)Footnote 7. *IRC § 857(b)(2)(B)*.

(n8)Footnote 8. *IRC § 857(b)(2)(E)*.

(n9)Footnote 9. *IRC § 857(b)(2)(C)*.

(n10)Footnote 10. *IRC § 857(b)(4); Treas Reg § 1.857-3(a)*.

(n11)Footnote 11. *IRC § 857(b)(4); Treas Reg § 1.857-3(a)*. A deduction is directly connected with gross income if

it has a proximate and primary relationship to the earning of such income, e.g., real property taxes and the earning of gross income from real property. *Treas Reg § 1.857-3(b)*.

(n12)Footnote 12. *Treas Reg § 1.857-3(c)*.

(n13)Footnote 13. *IRC § 561(a)(1)*. In determining the amount of dividends under *IRC § 316* for purposes of the dividends paid deduction, the earnings and profits of the REIT are increased by the total amount of gain on the sale or exchange of real property by the trust during the taxable year. *IRC § 562(e)*.

(n14)Footnote 14. *IRC § 562(a)*. The dividend definition of *IRC § 316* applies to distributions by a REIT. *Treas Reg § 1.856-1(e)(7)*.

(n15)Footnote 15. *Cf* Rev Rul 64-292, 1964-2 CB 182 . However, in response to the 2008 crisis in financial markets, which caused potentially catastrophic liquidity problems for many REITs and RICs, the Internal Revenue Service provided temporary administrative relief by devising a procedure by which REITs and RICs may receive a dividends paid deduction for distributions of their stock so long as their shareholders have the option of electing to receive cash instead of stock, even though shareholders' right to receive cash is subject to a "Cash Limitation" which limits the total amount of cash required to be distributed to 10 percent (or more) of the aggregate declared distribution. The procedure is valid for dividend distributions (including deficiency dividend distributions under *IRC § 860*) declared on or after January 1, 2008 and before December 31, 2012 with respect to taxable years ending on before December 31, 2011. See Rev Proc 2010-12, 2010-3 IRB 302, amplifying and superseding *Rev Proc 2009-15*, 2009-4 IRB 356, which amplified and superseded *Rev Proc 2008-68*, 2008-52 IRB 1373; Ch 12, § 12.02[2][d], fn 33.

(n16)Footnote 16. *IRC § 562(c)*; *Treas Reg § 1.562-2*.

(n17)Footnote 17. The dividend is deemed paid during the taxable year both for the purpose of determining whether the REIT has met the 95 percent income distribution requirement and for the purpose of computing real estate investment trust taxable income. *Treas Reg § 1.858-1(a)*.

(n18)Footnote 18. The entire amount of a dividend paid in installments will be deemed paid during the taxable year if all installments are paid prior to the first regular dividend payment after declaration of the post-year dividend. *Rev Rul 64-30*, 1964-1 (Pt 1) CB 232.

(n19)Footnote 19. *Treas Reg § 1.858-1(b)(1)*.

(n20)Footnote 20. *Treas Reg § 1.858-1(b)(1)*.

(n21)Footnote 21. *Treas Reg § 1.858-1(b)(4)*. The election cannot be made unless the return is timely filed or the REIT receives an extension of time to file. *Rev Rul 76-176*, 1976-1 CB 189 .

(n22)Footnote 22. *Treas Reg § 301.9100-1*.

(n23)Footnote 23. *Rev Proc 92-85*, § 5, 1992-2 CB 490 , modified by *Rev Proc 93-28*, 1993-2 CB 344 .

(n24)Footnote 24. *Rev Proc 92-85*, § 5.01, 1992-2 CB 490 , modified by *Rev Proc 93-28*, 1993-2 CB 344 .

(n25)Footnote 25. *Rev Proc 92-85*, § 5.02, 1992-2 CB 490 , modified by *Rev Proc 93-28*, 1993-2 CB 344 .

(n26)Footnote 1. *IRC § 857(b)(3)(A)*.

(n27)Footnote 2. *IRC § 857(b)(3)(C)*. A *IRC § 858* election may be made with respect to capital gain dividends. *Treas Reg § 1.858-1(a)(3)*. The notice designating the dividend as a capital gain dividend must be sent not later than 30 days after the close of the year in which the distribution is made (or mailed to its shareholders or holders of beneficial

interests with its annual report for the taxable year). *IRC § 858(c)*.

If there is an increase in the amount of net capital gain because of a determination leading to a deficiency dividend, the designation notice must be sent within 120 days of the determination producing such increase.

The amount of any capital loss carried over and deducted in the taxable year reduces the amount that can be designated as a capital gain dividend. *Rev Rul 76-299, 1976-2 CB 211* .

(n28)Footnote 3. *IRC § 857(b)(3)(C)*.

(n29)Footnote 4. *IRC § 857(b)(3)(C)*.

(n30)Footnote 5. *IRC § 857(b)(3)(D)*.

(n31)Footnote 1. *IRC § 860(e)*.

(n32)Footnote 2. *IRC § 860(d)(2)*.

(n33)Footnote 3. *IRC § 860(f)(1)*.

(n34)Footnote 4. *IRC § 860(g)*.

(n35)Footnote 5. *IRC § 860(f)(2)*. For example, if the REIT originally reported income of \$10,000 for 1987 and paid a dividend of \$9,000 and it was then determined that the trust had \$12,000 of real estate investment trust income, the deficiency dividend would be limited to 90 percent of \$2,000 or \$1,800.

(n36)Footnote 6. *IRC § 860(f)(3)*. The shareholder reports the dividend as income when received.

(n37)Footnote 7. S Rep No 938, Pt I, 94th Cong, 2d Sess 465 (1976).

(n38)Footnote 8. *IRC § 860(c)(1)(C)*.

(n39)Footnote 9. *IRC § 860(c)(2)*.

(n40)Footnote 10. *IRC § 860(h)(1)*.

(n41)Footnote 11. *IRC § 860(h)(2)*.

(n42)Footnote 12. *IRC § 860(i)*.

(n43)Footnote 1. See § 13.03[2][b], *supra*.

(n44)Footnote 2. *IRC § 857(b)(5)*.

(n45)Footnote 3. For this purpose, REIT taxable income is determined (1) without regard to the deductions for dividends paid or for the tax imposed on the failure to meet income source requirements, (2) without regard to any net operating loss deduction, and (3) by excluding any net capital gain.

(n46)Footnote 4. Gross income is determined by excluding gross income from prohibited transactions, certain gross income and gain from foreclosure property, long-term capital gains, and short-term capital gain to the extent of any short-term capital loss.

(n47)Footnote 5. S Rep No 938, Pt I, 94th Cong, 2d Sess 472 (1976).

(n48)Footnote 1. *IRC § 857(b)(6)*. Losses from prohibited transactions are not taken into account in determining the amount of net income derived from prohibited transactions. *IRC § 857(b)(6)(C)*.

(n49)Footnote 1.1. See Rev Proc 2008-69 for a method for applying the prohibited transactions safe harbor for a taxable year that begins on or before July 30, 2008 and ends on or after July 31, 2008.

(n50)Footnote 2. *IRC § 857(b)(6)(C)*. Property securing a shared appreciation provision is treated as property held for sale to customers in the ordinary course of business if it is such in the hands of the persons holding the property or it would be if held by the REIT. *IRC § 856(j)(2)(B)*. In order to coordinate the shared appreciation rules with the prohibited transactions safe harbor, the REIT will be treated as having sold the secured property when it recognizes any income from the shared appreciation provision, and any expenditures made by the holder of the secured property are treated as made by the REIT. *IRC § 856(j)(3)*.

For purposes of *IRC § 857(b)(6)(C)*, if a REIT is treated as having sold secured property, the trust will be treated as having held the property for at least four years if the secured property is sold or otherwise disposed of pursuant to a Title 11 (bankruptcy) case, the seller is under the jurisdiction of the bankruptcy court in the case, and the disposition is required by the court or is pursuant to a plan approved by the court. The preceding provision does not apply if the secured property was acquired by the seller with the intent to evict or foreclose, or the trust had reason to know that default on the shared appreciation obligation would occur. *IRC § 856(j)(4)*.

(n51)Footnote 3. *IRC § 857(b)(6)(F)*.

(n52)Footnote 4. *IRC § 857(b)(6)(E)(i)*.

(n53)Footnote 5. *IRC § 857(b)(6)(E)(ii)*. Advances made on loans calling for additional advances at various times are not treated as expenditures unless default on the loan is imminent. S Rep No 1263, 95th Cong, 2d Sess 179 (1978).

(n54)Footnote 6. *IRC § 857(b)(6)(E)(iii)*.

(n55)Footnote 7. *IRC § 857(b)(6)(E)(iv), (v)*.

(n56)Footnote 8. *IRC § 857(b)(6)(E)(vi)*.

(n57)Footnote 9. *IRC § 857(b)(6)(E)(vii)*. Unless excluded under the \$10,000 exception, sales are counted regardless of whether the transaction results in gain or loss. S Rep No 1263, 95th Cong, 2d Sess 180 (1978).

(n58)Footnote 10. *IRC § 857(b)(6)(E)(vii)*. Unless excluded under the \$10,000 exception, sales are counted regardless of whether the transaction results in gain or loss. S Rep No 1263, 95th Cong, 2d Sess 180 (1978).

(n59)Footnote 11. *IRC § 857(b)(6)(E)(vii)*. Unless excluded under the \$10,000 exception, sales are counted regardless of whether the transaction results in gain or loss. S Rep No 1263, 95th Cong, 2d Sess 180 (1978).

(n60)Footnote 12. *IRC § 857(b)(6)(C)*.

(n61)Footnote 1. *IRC § 857(d)(1)*; *Treas Reg § 1.857-7*; *Rev Rul 76-299, 1976-2 CB 211*. An example of the operation of a similar provision relating to regulated investment companies can be found in § 12.03[3].

(n62)Footnote 2. *IRC § 857(d)(2)*.

(n63)Footnote 1. The tax must be paid by March 15 of the following year. *IRC § 4981(d)*.

Regardless of the taxable years of a REIT and any partnership in which the REIT is a partner, for purposes of determining the REIT's required distribution for a calendar year under *IRC § 4981(a)*, the REIT must take into account

its share of partnership items of income, gain, loss, and deduction as they are taken into account by the partnership. *Rev Rul 94-40, 1994-1 CB 274*, as modified by *Rev Rul 94-40A, 1994-1 CB 276*.

For purposes of taking partnership items into account in determining an REIT's required distribution under *IRC § 4981(a)*, the Service will not challenge consistent use of a method, if that method takes the items into account under *IRC § 706* and, in addition, the REIT either files income tax returns on a calendar year basis or files on a fiscal year basis and meets an asset test. *Rev Proc 94-71, 1994-2 CB 810*.

The asset test is met if, at all times during the calendar year, the REIT holds an aggregate interest in profits and capital of the partnership of no more than 50 percent, and, at each testing date within the calendar year, the REIT has less than 35 percent of the value of its total assets represented by interests in partnerships that do not have the calendar year as their accounting period for federal income tax purposes. The testing dates are the close of each quarter of the taxable year of the REIT. The REIT can treat an interest in a fiscal year partnership as an interest in a calendar year partnership if the REIT's taxable year did not affect that partnership's taxable year under *IRC § 706(b)* and the REIT maintains adequate books and records to demonstrate this fact.

(n64)Footnote 2. *IRC § 4981(b)(1), (2)*.

(n65)Footnote 3. *IRC § 4981(b)(3)*.

(n66)Footnote 4. *IRC § 4981(e)(1)*.

(n67)Footnote 5. *IRC § 4981(e)(2)*.

(n68)Footnote 6. *IRC § 4981(c)(1), (2)*.

(n69)Footnote 7. *IRC § 4981(c)(3)*.

(n70)Footnote 8. *IRC § 4981(e)(3)*.

(n71)Footnote 1. *IRC § 857(b)(7)(A)*.

(n72)Footnote 2. *IRC § 857(b)(7)(E)*. *IRC § 857(b)(7)(E)* does not preclude allocation under *IRC § 482* on income on which the 100% tax is not imposed. See, eg, *Rev Rul 2002-38, 2002-2 CB 4*.

(n73)Footnote 3. *IRC § 857(b)(7)(B)(i)*.

(n74)Footnote 4. *IRC § 857(b)(7)(B)(ii)*.

(n75)Footnote 5. *IRC § 857(b)(7)(B)(iii)*.

(n76)Footnote 6. *IRC § 857(b)(7)(B)(iv)*.

(n77)Footnote 7. *IRC § 857(b)(7)(B)(v)*. See, eg, *Rev Rul 2002-38, 2002-2 CB 4*.

(n78)Footnote 8. *IRC § 857(b)(7)(B)(vi)*.

(n79)Footnote 9. *IRC § 857(b)(7)(C)*.

(n80)Footnote 10. *IRC § 857(b)(7)(D)*.

(n81)Footnote 11. *IRC § 857(b)(7)(E)*.



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CHAPTER 13 Real Estate Investment Trusts

2-13 Taxation of Securities Transactions § 13.04

§ 13.04 Taxation of Shareholders or Holders of Beneficial Interests

[1] Dividends Received.

[a] Ordinary Income Dividends. Shareholders of REITs generally include ordinary income dividend distributions in income in the year received; this includes distributions made pursuant to an election by the trust to treat the dividend as a dividend paid in the prior taxable year.ⁿ¹ However, any dividend declared by a REIT in October, November, or December of any calendar year, and payable to shareholders of record on a specified date in any of those months are deemed to have been received by the shareholder and paid by the REIT on December 31st (or earlier, if *IRC Section 858* applies), if the REIT actually pays the dividend during January of the following year.ⁿ² It should be noted that the distribution is not considered a dividend for purposes of the dividends received deduction of Section 243.ⁿ³

For purposes of *IRC Section 1(h)(11)* (relating to the maximum rate of tax on dividends), if a dividend (other than a capital gain dividend) is received from a REIT, and the REIT meets the requirements of *IRC Section 856(a)* for the taxable year in which it is paid, then in computing qualified dividend income, there is taken into account only that portion of the dividend designated by the REIT.^{n3.1} The aggregate amount that can be designated as qualified dividend income cannot exceed the sum of (i) the qualified dividend income of the REIT for the taxable year, received from a REIT, under *IRC Section 857(b)(1)* and the application of those regulations, (ii) the excess of the sum of the real estate investment trust taxable income computed under *IRC Section 857(b)(2)* for the preceding taxable year and the income subject to tax by reason of the application of the regulations under *IRC Section 337(d)* for the preceding taxable year over the taxes payable by the REIT under *IRC Section 857(b)(1)* and the application of those regulations for the preceding taxable year, and (iii) the amount of any earnings and profits that were distributed by the REIT for the taxable year and accumulated in a taxable year with respect to which the rules did not apply.^{n3.2} The amount of any distribution by a real estate investment trust that can be taken into account as a qualified dividend cannot exceed the amount so designated by the REIT in a written notice to its shareholders mailed not later than 60 days after the close of its taxable year.^{n3.3}

In the case of a closely held REIT, any person owning at least 10 percent of the vote or value of the REIT is required to accelerate the recognition of year-end dividends attributable to the closely held REIT, for purposes of the person's estimated tax payments.ⁿ⁴ A closely held REIT is one in which at least 50 percent of the vote or value is owned by five or fewer persons.ⁿ⁵

[b] Capital Gain Dividends. A capital gain dividend, including one paid after the close of the taxable year under a

valid *IRC Section 858* election and one paid as part of a deficiency dividend is includable in the shareholder's gross income in the year of actual distribution as long-term capital gain.ⁿ⁶ For a dividend to be treated as a capital gain dividend, it must be designated as such by the trust in a written notice mailed to shareholders not later than 30 days after the close of the REIT's taxable year (or mailed to its shareholders or holders of beneficial interests with its annual report for the taxable year) or, in the case of a deficiency dividend, within 120 days of the date of the determination.ⁿ⁷ If the amount designated in the notice is greater than the net capital gain for the year, the shareholder's capital gain dividend cannot exceed his proportionate share of such excess.ⁿ⁸

For taxable years beginning after August 5, 1997, a REIT can elect to retain and pay income tax on net long-term capital gains it receives during the taxable year. If the election is made, each REIT shareholder must include in income as long-term capital gains for the shareholder's taxable year in which the last day of the trust's taxable year falls, the amount that the trust designates as long-term capital gain in respect of the shareholder's shares.ⁿ⁹ The designation must be made in a written notice mailed to the REIT's shareholders within 60 days after the close of the REIT's taxable year (or mailed to shareholders or holders of beneficial interests with its annual report for the taxable year), but the amount includable by any shareholder cannot exceed that part of the amount subject to tax under *IRC Section 857(b)(3)(A)(ii)* as a capital gain dividend if all of the amount had been distributed to the shareholder as a capital gain dividend at the close of the REIT's taxable year.

In determining the income tax liability of the shareholder for the taxable year, the shareholder is deemed to have paid the capital gain tax imposed by *IRC Section 857(b)(3)(A)(ii)* on the amount required to be included in the shareholder's long-term capital gain for the year; the shareholder is allowed a credit or refund for the tax deemed to have been paid.ⁿ¹⁰ The adjusted basis of the shares with respect to which the undistributed long-term capital gain is included in the shareholder's income is increased by the difference between the amount of the includable gain and the capital gains tax deemed paid by the shareholder.ⁿ¹¹

If a shareholder does not own more than 5 percent of the stock of a publicly traded REIT, so that distributions by the REIT are not treated as gain from the sale or exchange of a United States real property interest, the amount that would be included in computing long-term capital gains for the shareholder is not included in computing the shareholder's long-term capital gain, but is included in the shareholder's gross income as a dividend from the REIT.ⁿ¹²

The earnings and profits of the REIT and any shareholder that is a corporation are to be appropriately adjusted in accordance with regulations to be prescribed.ⁿ¹³

[2] Special Provision Affecting Losses Realized on the Sale of Shares Held for Six Months or Less.

Since the price of shares sold ex-dividend generally decreases in an amount equal to the dividend, an advantageous tax result--long-term capital gain and short-term capital loss--would be achieved if a taxpayer could purchase shares before the ex-dividend date of a capital gain dividend and sell them immediately thereafter. However, *IRC Section 857(b)(8)* makes this result impossible whenever the shares are held for six months or less,ⁿ¹ by treating the loss sustained on their sale as a long-term capital loss to the extent that the shareholder is required to treat any distribution from the trust as a long-term capital gain.ⁿ² Thus, if the capital gain dividend amounted to \$1 per share, the first \$1 of loss per share would be transformed from a short-term capital loss into a long-term capital loss.

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.857-6(a)*; *IRC § 858(b)*. Deficiency dividends are also includable in the year of receipt, and are includable in full even though the trust does not have sufficient earnings and profits at the time of distribution.

Since the current earnings and profits of a REIT are not reduced by any amount not allowed as a deduction in computing taxable income, earnings and profits should always be sufficient to cover the distribution.

IRC § 301 applies to distributions of property by a REIT in the same manner as it does to those of a domestic corporation. *Treas Reg § 1.856-1(e)(1)*.

(n2)Footnote 2. *IRC § 857(b)(9)*.

(n3)Footnote 3. *IRC §§ 243(c)(2); 857(c)(1)*.

(n4)Footnote 3.1. *IRC § 857(c)(2)(A)*.

(n5)Footnote 3.2. *IRC § 857(c)(2)(B)*.

(n6)Footnote 3.3. *IRC § 857(c)(2)(C)*.

(n7)Footnote 4. *IRC § 6655(e)(5)(A)*, applicable to estimated tax payments due on or after Dec 15, 1999.

(n8)Footnote 5. *IRC § 6655(e)(5)(B)*. The attribution rules of *IRC §§ 856(d)(5)* and *856(l)(3)(B)* apply in determining ownership.

(n9)Footnote 6. *Treas Reg § 1.856-4(b); IRC § 858(b); IRC § 857(b)(3)(B)*.

(n10)Footnote 7. *IRC § 857(b)(3)(C)*. The notice designating post-year dividends, paid pursuant to a *IRC § 858* election, as capital gain dividends must be mailed within thirty days after the close of the year in which the distribution is made. *IRC § 858(c)*.

(n11)Footnote 8. *IRC § 857(b)(3)(C)*. A parallel provision affects capital gain dividends of regulated investment companies. See § 12.04[1][b].

(n12)Footnote 9. *IRC § 857(b)(3)(D)(i)*. In the event of a designation, the capital gains tax imposed by *IRC § 857(b)(3)(A)(ii)* must be paid by the REIT within 30 days after the close of its taxable year. *IRC § 857(b)(3)(D)(iv)*.

(n13)Footnote 10. *IRC § 857(b)(3)(D)(ii)*.

(n14)Footnote 11. *IRC § 857(b)(3)(D)(iii)*.

(n15)Footnote 12. *IRC § 857(b)(3)(F)*.

(n16)Footnote 13. *IRC § 857(b)(3)(D)(v)*.

(n17)Footnote 1. The rule applies to actual capital gain dividends governed by *IRC § 857(b)(3)(B)* as well as deemed distributions coming within *IRC § 857(b)(3)(D)*. The holding period principles of *IRC § 246(c)*, discussed at § 4.04[2][a][v] apply in determining the length of time the shares are held.

(n18)Footnote 2. The rule does not apply to losses incurred under a periodic liquidation plan.



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§ 13.05 Stapled Real Estate Investment Trusts

In 1984, Congress enacted *IRC Section 269B(a)(3)* to require that, in applying the tests for REIT status, all stapled entities were to be treated as one entity. A grandfather provision provided that certain then-existing stapled REIT's were not subject to the new provision.ⁿ¹

The IRS Restructuring and Reform Act of 1998 generally changed that result for real property interests acquired after March 26, 1998 (nonqualified real property interests).ⁿ²

The effect of the change is that all of the income and activities of the stapled REIT group with respect to a nonqualified real property interest will be attributed to the REIT under the one-entity rule of *IRC Section 269B(a)(3)*. This may mean that income received by a member of the stapled REIT group will not be treated as qualifying income under the 75- or 95-percent tests, with the result that REIT status might be lost.

The stapled REIT group consists of an exempt REIT (a REIT that, standing alone, would qualify as a REIT), all entities that are stapled entities with respect to the exempt REIT and all entities that are 10-percent subsidiaries of the exempt REIT or any such stapled entity.ⁿ³ A 10-percent subsidiary is an entity in which the exempt REIT or a stapled entity directly or indirectly holds at least a 10-percent interest.ⁿ⁴ However, a C corporation cannot be considered a 10-percent subsidiary of an exempt REIT.ⁿ⁵

The term "nonqualified real property interest" does not include (a) any improvement to land owned or leased by the exempt REIT or any member of the stapled REIT group, and (b) any repair to, or improvement of, any improvement owned or leased by the exempt REIT or a member of the stapled REIT group, if such ownership or leasehold interest is a qualified real property interest.ⁿ⁶ A qualified real property interest is any interest in real property other than a nonqualified property interest. Act, § 7002(b)(6). This rule does not apply to any improvement place in service after December 31, 1999, that is part of a change in use of the property to which the improvement relates unless the cost of the improvement does not exceed 200 percent of the cost of the property, or, if the property is substituted basis property, the fair market value of the property at the time of acquisition.ⁿ⁷ The term "nonqualified real property interest" also does not include (i) any lease of a qualified real property interest, if the lease is not otherwise such an interest, or (ii) any renewal of a lease that is a qualified real property interest, but only if the rent on any such lease or renewal does not exceed an arm's-length rate.ⁿ⁸ Finally, the term does not include any interest in real property acquired solely as a result of a direct or indirect contribution, distribution or other transfer of the interest from the exempt REIT or any member of

the stapled REIT group to the REIT or any member, but only to the extent that the aggregate of the interests of the exempt REIT and all stapled entities in the interest is not increased by reason of the transfer.ⁿ⁹

An exempt REIT or a stapled entity is treated as holding its proportionate share of each interest in real property held by any 10-percent subsidiary of the exempt REIT or stapled entity.ⁿ¹⁰ Generally, this means that any interest in real property held by a 10-percent subsidiary will be treated as a nonqualified real property interest held by the exempt REIT or stapled entity.ⁿ¹¹ However, if the subsidiary was a 10-percent of the exempt REIT or stapled entity on March 26, 1998, and at all times thereafter, an interest held by the subsidiary that would have been treated as a qualified interest if held directly by the exempt REIT will be so treated, but any increase in the ownership interest in the subsidiary after March 26, 1998, will cause the increase in the real property interest held by the exempt REIT or stapled entity to be treated as a nonqualified real property interest.ⁿ¹²

Special rules are provided for Umbrella Partnership Real Estate Investment Trusts (UPREIT's). If, as of March 26, 1998, (i) an exempt REIT or stapled entity held directly or indirectly at least 60 percent of the capital or profits interest in a partnership, and (ii) 90 percent or more of the profits interests in the partnership (other than interests held by the exempt REIT or stapled entity) are, or will be, redeemable or exchangeable for consideration determined by reference to shares in the exempt REIT or stapled entity (or both), 100 percent of the real property interests, mortgages, activities, and gross income of the partnership will be treated as interests, activities, and gross income of the exempt REIT or stapled entity that owns the partnership interest.ⁿ¹³ The provision also applies to an interest in a partnership formed after March 26, 1998, if the partnership was formed to mirror the stapling of an exempt REIT and a stapled entity in connection with an acquisition agreed to or announced on or before March 26, 1998.ⁿ¹⁴

Special rules apply where a member of a stapled REIT group holds a nonqualified obligation that is secured by an interest in real property, where either the exempt REIT or a stapled entity engages in certain activities with respect to the property. In such case, the REIT gross income provisions are applied by treating the exempt REIT as having impermissible tenant service income equal to the sum of the interest income from the nonqualified obligation and all gross income received by a member of the REIT group from the activity.ⁿ¹⁵ Thus, the income will not qualify under the 75- and 95-percent gross income tests, so that REIT status might be lost.

A nonqualified obligation is defined as any obligation secured by an interest in real property if the income of any member of the stapled REIT group for services furnished with respect to the property would be impermissible tenant service income were the property held, and the services furnished by, the exempt REIT.ⁿ¹⁶ An exception is provided for any obligation with interest that does not exceed an arm's-length rate, provided the interest payments would be treated as interest under the REIT rules.ⁿ¹⁷ A further exception applies to mortgages held by a member of the stapled REIT group on March 26, 1998, and the interest payable on the obligation is not changed to a rate that exceeds an arm's-length rate unless the change is pursuant to the terms of the obligation in effect on March 26, 1998.ⁿ¹⁸ The exception for existing mortgages ceases to apply if the mortgage is refinanced and the principal amount of the mortgage is increased.

FOOTNOTES:

(n1)Footnote 1. Deficit Reduction Act of 1984, § 136(c)(3). In a stapled REIT structure, both the shares of a REIT and a C corporation may be traded, but are subject to a provision that they cannot be sold separately. *IRC § 269B(c)(2), (3).*

(n2)Footnote 2. IRS Restructuring and Reform Act of 1998 ("Act"), § 7002(a), (b)(1). Real property interests held by an exempt REIT or stapled entity will not be treated as nonqualified real property interests if the REIT was a real estate investment trust as of March 26, 1998, and at all times thereafter, and the stapled entity was a stapled entity with respect to the REIT on that date and at all times thereafter. Act, § 7002(b)(5).

(n3)Footnote 3. Act, § 7002(e)(3).

(n4)Footnote 4. Act, § 7002(e)(4)(A). A 10-percent interest means (i) in the case of an interest in a corporation, ownership of 10 percent (by vote or value) of the stock of the corporation, (ii) in the case of an interest in a partnership, ownership of 10 percent of the capital or profits in the partnership, and (iii) in any other case, ownership of 10 percent of the beneficial interest in the entity. Act, § 7002(e)(4)(C).

(n5)Footnote 5. Act, § 7002(e)(4)(B).

(n6)Footnote 6. Act, § 7002(b)(3)(A).

(n7)Footnote 7. Act, § 7002(b)(3)(C). See *IRC § 7701(a)(42)* for the definition of substituted basis property.

An improvement is treated as placed in service before Jan 1, 2000, if it is placed in service before Jan 1, 2004, pursuant to a binding contract in effect on Dec 31, 1999, and at all times thereafter.

(n8)Footnote 8. Act, § 7002(b)(3)(B).

(n9)Footnote 9. Act, § 7002(b)(4).

(n10)Footnote 10. Act, § 7002(c)(1).

(n11)Footnote 11. Act, § 7002(c)(2)(A).

(n12)Footnote 12. Act, § 7002(c)(2)(B), (3). Except as provided in guidance, any change in proportionate interest that is solely attributable to fluctuations in the relative fair market values of different classes of stock will not be taken into account. Act, § 7002(c)(4)(C).

(n13)Footnote 13. Act, § 7002(c)(5)(A). If, as of Jan 1, 1999, more than one partnership owned by any exempt REIT or stapled entity meets the requirements for an UPREIT, only the largest such partnership on that date (determined by aggregate asset bases) will be treated as meeting the requirements. Act, § 7002(c)(5)(B).

(n14)Footnote 14. Act, § 7002(c)(5)(C).

(n15)Footnote 15. Act, § 7002(d)(1).

(n16)Footnote 16. Act, § 7002(d)(2).

(n17)Footnote 17. Act, § 7002(d)(3).

(n18)Footnote 18. Act § 7002(d)(4). If an exempt REIT or stapled entity increases its ownership interest in a subsidiary in which it was a 10-percent owner on March 26, 1998, the additional proportion of the subsidiary's mortgages does not qualify for the existing mortgage exception. Act, § 7002(c)(3), (d)(6).



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CHAPTER 13A Real Estate Mortgage Investment Conduits and Taxable Mortgage Pools

2-13A Taxation of Securities Transactions 13A.syn

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CHAPTER 13A Real Estate Mortgage Investment Conduits and Taxable Mortgage Pools

2-13A Taxation of Securities Transactions § 13A.01

§ 13A.01 Introduction

The Tax Reform Act of 1986 added rules governing a new form of entity known as a real estate mortgage investment conduit (REMIC). A REMIC is formed for the purpose of holding a fixed pool of mortgages secured by interests in real property. As a general rule, the REMIC is not treated as a separate taxable entity. Rather, the income of the REMIC is allocated to, and taken into account by, the holders of interests therein.ⁿ¹

An entity that issues multiple class real estate mortgage-backed securities, but does not qualify as a REMIC, is treated as a taxable mortgage pool (TMP), and taxed accordingly.ⁿ²

FOOTNOTES:

(n1)Footnote 1. See I. Faggen, A. Hague, et al, *Federal Taxes Affecting Real Estate*, Ch 16 (Matthew Bender).

(n2)Footnote 2. See generally *RET: Real Estate Financing*, Ch 3G (Matthew Bender); Peaslee & Nirenberg, *The Federal Taxation of Mortgage-Backed Securities* (Probus Publishing).



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CHAPTER 13A Real Estate Mortgage Investment Conduits and Taxable Mortgage Pools

2-13A Taxation of Securities Transactions § 13A.02

§ 13A.02 Real Estate Mortgage Investment Conduit Defined

[1] In General.

A REMIC is defined in *Internal Revenue Code Section 860D(a)* as an entity

- (1) that has made an election to be treated as a REMIC under *Internal Revenue Code Section 860D(b)* that is effective for the taxable year and all prior taxable years;
- (2) that uses the calendar year as its taxable year;
- (3) in which all of the interests are either "regular interests" or "residual interests;"
- (4) that has only one class of residual interests, and all distributions to such interests (if any) are made on a *pro rata* basis;
- (5) that has made reasonable arrangements designed to ensure that none of its residual interests are held by "disqualified organizations" (as defined in *Internal Revenue Code Section 860E(5)*); and
- (6) substantially all the assets of which, from the close of the 3rd month beginning after its "startup day," and at all times thereafter, consist of "qualified mortgages" and "permitted investments."

The first two requirements are discussed in this section 13A.02[1]. Requirements (3) through (5), relating to investor interests, are discussed in the following section 13A.02[2]. Finally, the sixth requirement, the asset test, is discussed in *section 13A.02[3]*.

A REMIC may be a corporation, a partnership, or any other form of entity. A REMIC may also be a segregated pool of assets within an entity.ⁿ¹ Formation of a REMIC as a segregated pool of assets requires that the sponsor first identify the assets constituting the REMIC, (for example, through the execution of an indenture with respect to the assets), and then issue regular and residual interests in the REMIC.ⁿ² A sponsor is a person who directly or indirectly exchanges qualified mortgages and related assets for regular and residual interests in a REMIC.ⁿ³

The election to be a REMIC is made by timely filing, for the first taxable year of its existence, Form 1066, U.S. Real Estate Mortgage Investment Conduit Income Tax Return.ⁿ⁴ The REMIC's first taxable year begins on its "startup day" and, since a REMIC must use the calendar year as its taxable year, ends on the following December 31.ⁿ⁵ Once made, the election is irrevocable for that taxable year and all succeeding taxable years.ⁿ⁶

The term "startup day" means the day on which the REMIC issues all of its regular and residual interests. A sponsor may, however, contribute property to a REMIC in exchange for regular and residual interests over any period of 10 consecutive days, and the REMIC may designate any one of those days as its startup day. The day so designated is the startup day, and all interests are treated as issued on that day.ⁿ⁷

[2] Interests in a REMIC.

A REMIC must have one or more classes of "regular" interests and a single class of "residual" interests.

A "regular" interest in a REMIC must (1) be issued on the startup day with fixed terms; (2) be designated as a regular interest; (3) unconditionally entitle the holder to receive a specified principal amount or other similar amount, and (4) provide that interest or similar payments, if any, are payable at or before maturity, and are based on either (a) a fixed rate of interest (or, to the extent allowed in the Regulations, a variable rate of interest,) or (b) consist of a specified portion of the interest payments on the REMIC's qualified mortgages which does not vary during the period that the interest is outstanding.ⁿ⁸

A regular interest will be considered to have fixed terms on the startup day if the REMIC's organizational documents irrevocably specify on that date (i) the principal amount (or other similar amount) of the regular interest, (ii) the interest rate or rates used to compute any interest payments on the regular interest, and (iii) the latest possible maturity date of the interest.ⁿ⁹

An interest will be deemed to be designated as a regular interest if it is so identified on the REMIC's timely filed first tax return along with the terms and conditions of the interest and other information required by the Regulations.ⁿ¹⁰

Although a regular interest may be issued in the form of debt, stock, an interest in a partnership or trust, or any other form permitted by state law, it must in all events entitle the holder to a specified amount that would, were the regular interest issued in debt form, be identified as the principal amount of the debt.ⁿ¹¹ Moreover, regardless of the form in which it is issued, a regular interest is treated as debt for all Federal income tax purposes.ⁿ¹²

Although the statute provides that a regular interest must "unconditionally" entitle the holder to receive a specified principal amount or similar amount, the Regulations allow some flexibility.ⁿ¹³ The following types of contingencies may be provided for without disqualifying an interest as a regular interest.ⁿ¹⁴

(i) A contingency which affects the timing (but not the right to or amount of) principal payments depending on the extent of prepayments on some or all of the REMIC's qualified mortgages, or the amount of income earned on the REMIC's permitted investments, or the payment of expenses incurred by the REMIC.ⁿ¹⁵

(ii) A contingency which affects the amount or timing of payments of principal or interest on account of defaults on qualified mortgages and permitted investments, unanticipated expenses incurred by the REMIC, or lower than expected returns on permitted investments.

(iii) A contingency which requires a particular interest to bear, before other regular interests or the residual interest, losses resulting from cash flow shortfalls that are due to defaults or delinquencies on qualified mortgages or permitted investments, unanticipated expenses incurred by the REMIC, lower

than expected returns on permitted investments, or prepayment interest shortfalls.

(iv) A contingency which by the terms of the regular interest results in the deferral of interest payments.

(v) A contingency in which the amount of interest payments is affected by prepayments of the underlying mortgages.

(vi) Any contingency affecting the amount or timing of payments of principal or interest if there is only a remote likelihood that the contingency will occur. The Regulations give as an example a provision that makes full payment of principal and interest on an interest contingent upon the absence of significant cash flow shortfalls due to the operation of the Soldiers and Sailors Civil Relief Act, 50 U.S.C. *app.* 526 (1988) (period of military service may not be included computing any limitations period or any period provided by law for the redemption of real property sold or forfeited to enforce an obligation).

The statute itself provides for an additional contingency--an interest will not be disqualified as a regular interest solely because the specified principal amount (or accrued interest) may be reduced as a result of the nonoccurrence of one or more contingent payments with respect to any reverse mortgage loan held by the REMIC, provided that on the startup day the sponsor reasonably believes that all principal and interest due under the regular interest will be paid at or prior to the liquidation of the REMIC.ⁿ¹⁶ The Joint Committee on Taxation's explanation of this provision states that for this purpose a "reverse mortgage loan" is one that (1) is secured by an interest in real property; (2) provides for one or more advances of principal to the obligor (each such advance giving rise to a "balance increase"), provided such advances are principally secured by an interest in the same real property as that which secures the loan; (3) may provide for a contingent payment at maturity based upon the value or appreciation in value of the real property securing the loan; (4) provides for an amount due at maturity that cannot exceed the value, or a specified fraction of the value, of the real property securing the loan; (5) provides that all payments under the loan are due only upon the maturity of the loan; and (6) matures after a fixed term or at the time the obligor ceases to use as a personal residence the real property securing the loan.ⁿ¹⁷

A call premium entitling the holder of an interest to an additional payment contingent on the period of time the interest has been outstanding will disqualify that interest as a regular interest.ⁿ¹⁸ In addition, an interest in a REMIC may not qualify as a regular interest if the amount of interest (or other similar amount) payable to the holder is disproportionately high relative to the principal amount of the interest.ⁿ¹⁹ Interest payments are considered disproportionately high by the Regulations if the issue price of the interest exceeds 125 percent of the principal amount.ⁿ²⁰

The Regulations provide that it is permissible for a regular interest in a REMIC to provide for interest payments based on a variable interest rate provided the rate is either a "qualified floating rate" set at a "current value" (as those terms are defined for purposes of *Internal Revenue Code Section 1275*), or a "weighted average rate."ⁿ²¹ A qualified floating rate is one in which "variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds..."ⁿ²² and the rate is set at a "current value" as long as the rate on any day is set at a value "no earlier than 3 months prior to the first day on which that value is in effect and no later than 1 year following that first day."ⁿ²³ A weighted average rate is a rate based on a weighted average of the interest rates on some or all of the qualified mortgages held by the REMIC, provided that the qualified mortgages taken into account all bear interest either at a fixed rate or at a variable rate as defined above.ⁿ²⁴ The Regulations also permit a "variable interest rate" to be based on any of several specified variations on a qualified floating or weighted average interest rate.ⁿ²⁵

Finally, interest payments may be based on a combination of fixed, variable, or fixed and variable rates. For example, different fixed rates may be applied in different accrual or payment periods, or a fixed rate may be applied in some periods and a variable rate in others, or different variable rates may be applied in different periods.ⁿ²⁶

In addition to being determined by a fixed rate or a permissible variable rate of interest, interest payments to the holder of a regular interest may be based on a specified portion of the interest payments made on the REMIC's qualified mortgages. In that case, two requirements must be satisfied.

First, the specified portion payable to the interest holder can be expressed as (A) a fixed percentage of the interest that is payable at either a fixed or permissible variable rate on some or all of the REMIC's qualified mortgages, or (B) a fixed number of basis points of the interest payable on some or all of the REMIC's qualified mortgages, or (C) the interest payable at a fixed or permissible variable rate on some or all of the REMIC's qualified mortgages in excess of a fixed number of basis points or in excess of a permissible variable rate.ⁿ²⁷

Second, the portion payable to the interest holder is established as of the startup day and cannot vary over the period that begins on the startup day and ends on the day the holder of the regular interest is no longer entitled to receive payments; provided that a portion will not be treated as varying over time solely because an interest holder's entitlement is dependent on the absence of defaults or delinquencies on the REMIC's qualified mortgages.ⁿ²⁸

Example:

A sponsor transferred a pool of fixed rate mortgages to a REMIC in exchange for two classes of certificates. The fixed interest rate payable on the mortgages varies from mortgage to mortgage, but all rates are between 8 and 10 percent. Class A certificate holders are entitled to receive all principal payments on the mortgages and interest on outstanding principal at 7 percent. Class B certificate holders are entitled to receive all interest on the mortgages in excess of the interest paid to the Class A certificates. The Class B certificates are subordinate to the Class A certificates, so that cash flow shortfalls due to defaults or delinquencies on the mortgages will be borne first by the Class B certificate holders. Interest paid to the holders of the Class B certificates qualifies as a "specified portion of the interest payments on qualified mortgages" because, although the portion of the interest payable varies from mortgage to mortgage, the interest payable can be expressed as a fixed percentage of the interest payable on each particular mortgage. Moreover, the portion of the interest payable to the Class B certificate holders is not treated as varying over time solely because payments on the Class B certificates may be reduced as a result of defaults or delinquencies on the mortgages.ⁿ²⁹

A residual interest in a REMIC is defined simply as an interest in a REMIC which is issued on the startup day, which is not a regular interest, and which is designated as a residual interest.ⁿ³⁰ As with regular interests, a REMIC designates its residual interests by identifying them as such in the tax return for its first taxable year along with their terms and conditions and other information required by the Regulations.ⁿ³¹

There are only three definitional requirements that apply specifically to residual interests. First, there may be only one class of residual interests.ⁿ³² Second, all distributions made with respect to residual interests must be pro rata; however, a residual interest need not entitle the holder to any distributions from the REMIC.ⁿ³³ Third, the REMIC must make reasonable arrangements (a) to ensure that its residual interests are not held by "disqualified organizations" listed in *Internal Revenue Code Section 860E(e)(5)* (chiefly, governmental agencies and tax-exempt organizations not subject to the unrelated business income tax), and (b) to provide the IRS and persons subject to the transfer tax imposed by Section 860E(e)(3) with information needed to compute that tax.ⁿ³⁴ The REMIC will be deemed to have made reasonable arrangements to ensure that its residual interests are not held by disqualified organization if: (1) the residual interest is in registered form,ⁿ³⁵ and (2) the REMIC's organizational documents clearly and expressly prohibit a disqualified organization from acquiring beneficial ownership of a residual interest, and notice of the prohibition is provided through a legend on the document that evidences ownership of the residual interest or through a conspicuous statement in a prospectus or private offering document used to offer the residual interest for sale.ⁿ³⁶ The REMIC will

be deemed to have made reasonable arrangements to ensure that the information necessary to compute the Section 860E(e)(3) tax is made available if its organizational documents require it to provide the Internal Revenue Service and persons liable for the Section 860E(e)(3) tax a computation showing the present value of the total "anticipated excess inclusions" with respect to the transferred residual interest for periods after the transfer.

A REMIC may only have regular and residual interests. The Regulations make clear that certain rights are not interests in a REMIC and therefore are not inconsistent with this requirement. The non-exclusive list includes:

- (i) Payments for services. The right to receive payments that represent reasonable compensation for services provided to the REMIC in the ordinary course of its operation is not an interest in the REMIC even if the payments are based on a specified percentage of interest payments due on qualified mortgages or as a specified percentage of earnings from permitted investments.ⁿ³⁷
- (ii) Stripped interests. Stripped bonds or stripped coupons not held by the REMIC are not interests in the REMIC even if they and the REMIC's qualified mortgages were created from the same mortgage obligation. Further, if an obligation with a fixed principal amount provides for interest at a fixed or variable rate and for certain contingent payment rights (e.g., a shared appreciation provision or a percentage of mortgagor profits provision), and the owner of the obligation contributes the fixed payment rights to a REMIC and retains the contingent payment rights, the retained contingent payment rights are not an interest in the REMIC.ⁿ³⁸
- (iii) Reimbursement rights under credit enhancement contracts.ⁿ³⁹ A credit enhancer's right to be reimbursed for amounts advanced to a REMIC pursuant to the terms of a credit enhancement contract is not an interest in the REMIC even if the credit enhancer is entitled to receive interest on the amounts advanced.ⁿ⁴⁰
- (iv) Rights to acquire mortgages. The right to acquire or the obligation to purchase mortgages and other assets from a REMIC pursuant to a clean-up call,ⁿ⁴¹ or a qualified liquidation,ⁿ⁴² or on conversion of a convertible mortgageⁿ⁴³ (as defined in *Treasury Regulation Section 1.860G-2(d)(5)*), is not an interest in the REMIC.ⁿ⁴⁴

In addition, the Regulations disregard any "de minimis" interests in a REMIC, defined as an interest created on the startup day to facilitate the creation of the REMIC, which has a fair market value of less than the lesser of \$1,000 or 1/1,000 of one percent of the aggregate fair market value of all the regular and residual interests in the REMIC, and which is not specifically designated as an interest in the REMIC.ⁿ⁴⁵

[3] The Asset Test.

Substantially all the assets of a REMIC must consist of either "qualified mortgages" or "permitted investments." This test must be met at the close of the third month ending after the REMIC's startup day (the day on which the REMIC issues or is deemed to have issued all of its regular and residual interests)ⁿ⁴⁶ and at all times thereafter. If the REMIC owns assets that are not qualified mortgages or permitted investments, and the aggregate of the adjusted bases of those assets is less than one percent of the aggregate of the adjusted bases of all of the REMIC's assets, those assets will be regarded as "de minimis" and will not prevent the REMIC from satisfying the "substantially all" requirement.ⁿ⁴⁷

[a] Qualified Mortgages.

In general, a "qualified mortgage" is any obligationⁿ⁴⁸ that is principally secured by an interest in real property, provided that the obligation is transferred to the REMIC on the startup day (with two exceptions, noted below) in exchange for regular or residual interests.ⁿ⁴⁹ The term qualified mortgage is also defined to include a "qualified

replacement mortgage," which is an obligation that would have been a qualified mortgage had it been transferred to the REMIC in exchange for a regular or residual interest in the REMIC on the startup day, and is in fact received by the REMIC either (1) in exchange for another obligation within the 3-month period beginning on the startup day, or (2) in exchange for a "defective obligation." within the 2-year period beginning on the startup day.ⁿ⁵⁰ A defective obligation is an obligation with one or more of the following defects:

- (i) The mortgage is in default, or a default with respect to the mortgage is reasonably foreseeable.
- (ii) The mortgage was fraudulently procured by the mortgagor.
- (iii) The mortgage was not in fact principally secured by an interest in real property.
- (iv) The mortgage does not conform to a customary representation or warranty given by the sponsor or prior owner of the mortgage regarding the characteristics of the mortgage, or the characteristics of the pool of mortgages of which the mortgage is a part.ⁿ⁵¹

Finally, a qualified mortgage is defined to include any regular interest in another REMIC, if the REMIC holding such interest acquired it on its startup day in exchange for its own regular or residual interests.ⁿ⁵²

The Regulations provide that for purposes of the requirement that qualified mortgage (other than a regular interest in a REMIC) be principally secured by an interest in real property, the terms "interests in real property" and "real property" have the same meanings in the REMIC provisions that they have in the real estate investment trust (REIT) provisions.ⁿ⁵³ Examples of obligations that are principally secured by an interest in real property include: "mortgages, deeds of trust, and installment land contracts; mortgage pass-thru certificates guaranteed by GNMA, FNMA, FHLMC, or CMHC (Canada Mortgage and Housing Corporation); other investment trust interests that represent undivided beneficial ownership in a pool of obligations principally secured by interests in real property and related assets that would be considered to be permitted investments if the investment trust were a REMIC, and provided the investment trust is classified as a trust [for tax purposes];ⁿ⁵⁴ and obligations secured by manufactured housing treated as single family residences under [the Internal Revenue Code]ⁿ⁵⁵ (without regard to the treatment of the obligations or the properties under state law)."ⁿ⁵⁶ However, obligations (other than regular interests in a REMIC) secured by other obligations are not principally secured by interests in real property even if the underlying obligations are secured by interests in real property, and therefore cannot be qualified mortgages.ⁿ⁵⁷

An obligation is considered "principally secured" by an interest in real property, and therefore to meet the primary qualification for being a "qualified mortgage," only if it meets either the "80-percent test" or an "alternative test."ⁿ⁵⁸ The 80 percent test is met if the fair market value of real property securing the obligation was at least equal to 80 percent of the adjusted issue price of the obligation at the time the obligation originated or at the time the obligation was contributed to the REMIC by its sponsor.ⁿ⁵⁹ The alternative test is met if substantially all of the proceeds of the obligation were used to acquire or improve or protect an interest in real property and, at the origination date, such interest was the only security for the obligation.ⁿ⁶⁰ Under a safe harbor established by the Regulations, an obligation will be deemed to be "principally secured" by an interest in real property if, at the time the sponsor contributed the obligation to the REMIC, the sponsor reasonably believed that the obligation met either the 80 percent test or the alternative test.ⁿ⁶¹ If the REMIC later discovers that the obligation did not in fact meet one or the other of those tests, the obligation becomes a defective obligation and may lose its status as a qualified mortgage.ⁿ⁶²

The status of an obligation as a qualified mortgage may be lost if a "significant modification" is made with respect to the obligation. Adopting the "deemed exchange" approach to significant modifications in a debt instrument taken in the regulations under Code Section 1001,ⁿ⁶³ the REMIC Regulations treat any significant modification to an obligation as an exchange of obligations--the old unmodified obligation for the new modified obligation.ⁿ⁶⁴ As the Regulations point out, this can have two important consequences to the REMIC. First, if the significant modification occurs before the

obligation is transferred to the REMIC, the 80 percent and alternative tests must be applied to the obligation as though it originated not on the date the obligation first came into existence but on the date it was significantly modified.ⁿ⁶⁵ Second, and of potentially greater importance, if a significant modification is made after the obligation is transferred to the REMIC, and the post-modification obligation is not a qualified replacement mortgage,ⁿ⁶⁶ the modified obligation will not be a qualified mortgage (since it will not have been transferred to the REMIC on its startup day in exchange for regular or residual interests) and the disposition of the pre-modification obligation in the deemed exchange will be a prohibited transaction under *Internal Revenue Code Section 860F(a)(2)*.ⁿ⁶⁷

The Regulations ameliorate the potentially draconian consequences of modifying a qualified mortgage by providing that certain common modifications will not be considered significant for purposes of the REMIC rules even if they would be considered significant under the standards of the Section 1001 Regulations.ⁿ⁶⁸ The following changes in the terms of an obligation will not be considered significant and therefore will not trigger the consequences described above on the occurrence of a "deemed exchange."ⁿ⁶⁹

- (i) Changes in the terms of the obligation occasioned by default or a reasonably foreseeable default;
- (ii) Assumption of the obligation;ⁿ⁷⁰
- (iii) Waiver of a due-on-sale clause or a due-on-encumbrance clause;
- (iv) Conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage;
- (v) A modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for, a recourse or nonrecourse obligation, so long as the obligation continues to be principally secured by an interest in real property following the release, substitution, addition, or other alteration as determined under *Treasury Regulation Section 1.860G-2(b)(7)(ii)* or *(iii)*, discussed below; and
- (vi) A change in the nature of the obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), or from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse), so long as the obligation continues to be principally secured by an interest in real property following such a change, also as determined under *Treasury Regulation Section 1.860G-2(b)(7)(ii)* or *(iii)*.ⁿ⁷¹

If a modification alters the security for an obligation as described in (v) above, or changes the recourse or nonrecourse nature of an obligation as described in (vi) above, the obligation must satisfy one of two tests to show that it continues to be principally secured by an interest in real property. Under *Treasury Regulation Section 1.860G-2(b)(7)(ii)*, the fair market value of the interest in real property securing the modified obligation must be at least 80 percent of the adjusted issue price of the modified obligation, both determined as of the modification date. This 80 percent test will be considered satisfied if the servicer reasonably believes it to be satisfied.ⁿ⁷² If this test is not satisfied, the obligation will still be considered principally secured by an interest in real property under *Treasury Regulation Section 1.860G-2(b)(7)(iii)* if the fair market value of the interest in property that secures the obligation immediately after the modification equals or exceeds the fair market value of the interest in real property that secured the obligation immediately before the modification.ⁿ⁷³

The release by a REMIC of a lien on an interest in real property securing a qualified mortgage may also cause the obligation to lose its qualified mortgage status.ⁿ⁷⁴ However, the Regulations provide two ways the REMIC can avoid this result.

First, obligation will retain its qualified mortgage status if the REMIC releases its lien in a

modification that (A) either is not a significant modification under Code Section 1001 and the regulations thereunder or is not considered a significant modification for purposes of the REMIC provisions pursuant to the exceptions listed in *Treasury Regulation Section 1.860G-2(b)(3)*, and (B) following the modification the obligation is considered principally secured by an interest in real property as redefined in *Treasury Regulation Section 1.860G-2(b)(7)(ii)* or (iii) above.

Second, the obligation will retain its qualified mortgage status if (A) the mortgagor pledges substitute collateral that consists solely of government securities; (B) the mortgage documents allow such a substitution; (C) the lien is released to facilitate the disposition of the property or any other customary commercial transaction, and not as part of an arrangement to collateralize a REMIC offering with obligations that are not real estate mortgages; and (D) the release is not made within 2 years of the startup day.ⁿ⁷⁵

Finally, an obligation may lose its qualified mortgage status if the REMIC discovers that it is a defective obligation, and the defect, had it been discovered before the startup day, would have prevented the obligation from being a qualified mortgage. The Regulations give the REMIC 90 days from the date of discovery to either cause the defect to be cured or to dispose of the defective obligation within the 90 day period.ⁿ⁷⁶ If the REMIC does neither, the defective obligation will cease to be a qualified mortgage at the end of the 90 day period.ⁿ⁷⁷

The Regulations treat certain contractual rights associated with qualified mortgages as part of the qualified mortgages to which they relate for purposes of the asset test, and not as separate disqualifying assets.ⁿ⁷⁸ The rights so treated are those held by the REMIC in connection with credit enhancement contracts, purchase agreements with respect to convertible mortgages, and agreements to make up prepayment interest shortfalls.

Credit enhancement contracts are defined as any arrangement whereby a person agrees to guarantee full or partial payment of the principal or interest payable on a qualified mortgage or on a pool of such mortgages, or full or partial payment on one or more classes of regular interests or on the single class of residual interests, in the event of defaults or delinquencies on qualified mortgages, unanticipated losses or expenses incurred by the REMIC, or lower than expected returns on cash flow investments.ⁿ⁷⁹ In addition, any collateral supporting a credit enhancement contract is not treated as a separate asset of the REMIC solely because it supports the guarantee represented by that contract.ⁿ⁸⁰

A purchase agreement is a contract between the holder of a convertible mortgage and a third party under which the holder agrees to sell and the third party agrees to buy the mortgage for an amount equal to its current principal balance plus accrued but unpaid interest if and when the mortgagor elects to convert the terms of the mortgage.ⁿ⁸¹ Under a convertible mortgage, as defined in the Regulations, the obligor has the right at one or more times during the term of the mortgage to elect to convert from one interest rate to another, provided the new rate is determined pursuant to the terms of the instrument and intended to approximate a market rate of interest for newly originated mortgages at the time of the conversion.ⁿ⁸²

The Regulations define a prepayment interest shortfall, with respect to any mortgage that prepays, as an amount which, for the accrual period in which the mortgage prepays, equals the excess of the interest that would have accrued on the mortgage during that accrual period had it not prepaid, over the interest that did accrue from the beginning of that accrual period up to the date of the prepayment.ⁿ⁸³ The agreement by a mortgage servicer or other third party to make payments to the REMIC to make up such prepayment interest shortfalls is not treated as a separate asset of the REMIC.ⁿ⁸⁴

[b] Permitted Investments.

"Permitted investments" fall into three separate categories: (1) "cash flow investments;" (2) "qualified reserve assets;" and (3) "foreclosure properties."ⁿ⁸⁵

A "cash flow investment" means any investment of payments received under qualified mortgages for a temporary period before distribution to holders of interests in the REMIC.ⁿ⁸⁶ The temporary period over which cash flow investments may be held may not exceed 13 months.ⁿ⁸⁷ If the investment is held as part of a commingled fund or account, the REMIC may employ any reasonable method of accounting for purposes of determining the period over which the amount received under qualified mortgages has been held in the account. For example, the first-in, first-out method of accounting is a reasonable method for determining whether all or part of the account satisfies the 13 month limitation.ⁿ⁸⁸

Payments received under qualified mortgages include--

- (A) Payments of interest and principal on qualified mortgages, including prepayments of principal and payments under credit enhancement contracts;ⁿ⁸⁹
- (B) Proceeds from the disposition of qualified mortgages;
- (C) Cash flows from foreclosure property and proceeds from the disposition of such property;
- (D) A payment by a sponsor or prior owner in lieu of the sponsor's or prior owner's repurchase of a defective obligation that was transferred to the REMIC in breach of a customary warranty; and
- (E) Prepayment penalties required to be paid under the terms of a qualified mortgage when the mortgagor prepays the obligation.ⁿ⁹⁰

A "qualified reserve asset" is any intangible asset held for investment as part of a "qualified reserve fund,"ⁿ⁹¹ defined in turn as a reasonably required reserve to (1) provide for the full payment of expenses of the REMIC, or amounts due on regular interests, in the event of defaults on qualified mortgages or lower than expected returns on cash flow investments,ⁿ⁹² or (2) provide a source of funds for the purchase of qualified mortgages that may be purchased by a REMIC after the startup day as provided in *Internal Revenue Code Section 860G(a)(3)(A)(ii)* and *(iii)*.ⁿ⁹³ The aggregate fair market value of the assets held in a qualified reserve fund may not exceed 50 percent of the fair market value of all the assets in the REMIC on the startup day, and the reserve must be promptly and appropriately reduced when the amount held in the reserve is no longer reasonably required for the purposes for which a qualified reserve fund may be held.ⁿ⁹⁴ The Regulations create a presumption that the amount of a reserve is reasonable (and an excessive reserve is presumed to have been promptly and appropriately reduced) if it does not exceed either (1) the amount required by a nationally recognized independent rating agency as a condition of providing the rating for REMIC interests desired by the sponsor, or (2) the amount required by a third party insurer or guarantor as a condition of providing credit enhancement, provided such insurer or guarantor does not own, directly or indirectly (within the meaning of *Internal Revenue Code Section 267(c)*) an interest in the REMIC.ⁿ⁹⁵

In contrast to a qualified reserve fund, an "outside reserve fund" maintained to pay expenses of a REMIC or make payments to REMIC interest holders is not a permitted investment and indeed is not treated as an asset of the REMIC at all. In order to qualify as an outside reserve fund, the REMIC's organizational documents must clearly and expressly provide that the reserve fund is an outside reserve fund and not an asset of the REMIC, identify the owner(s) of the reserve fund, either by name or by description of the class (such as subordinated regular interest holders) whose membership comprises the owners of the fund, and provide that, for Federal tax purposes, amounts transferred by the REMIC to the fund are treated as amounts distributed by the REMIC to the designated owner(s) or transferees of the designated owner(s).ⁿ⁹⁶

A "foreclosure property," the final category of permitted investments, is a property that would be considered foreclosure property in the hands of a REIT,ⁿ⁹⁷ and which is acquired in connection with the default or imminent default of a

qualified mortgage held by the REMIC.ⁿ⁹⁸

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.860D-1(c)(1)*.

(n2)Footnote 2. *Treas Reg § 1.860D-1(c)(2)*.

(n3)Footnote 3. *Treas Reg § 1.860F-2(b)(1)*.

(n4)Footnote 4. *Treas Reg § 1.860D-1(d)(1)(i)*. The REMIC must include the following information on its first return: (i) its own employer identification number (ii) information concerning the terms and conditions of the REMIC's regular and residual interests, (iii) a description of the prepayment and reinvestment assumptions made for purposes of calculating original issue discount on its qualified mortgages and regular interests pursuant to *IRC § 1272(a)(6)* and the regulations thereunder, with a statement supporting the selection of the prepayment assumption, (iv) the form of the entity under State law or, if an election is being made with respect to a segregated pool of assets within an entity, the form of the entity that holds the segregated pool of assets, and (v) any other information required by the form.

(n5)Footnote 5. Thus, unless the REMIC's "startup day" is January 1, its first year will be a short taxable year. See *Treas Reg § 1.860D-1(b)(6)*.

(n6)Footnote 6. *Treas Reg § 1.860D-1(d)*.

(n7)Footnote 7. *Treas Reg § 1.860G-2(k)*.

(n8)Footnote 8. *IRC § 860G(a)(1)*.

(n9)Footnote 9. *Treas Reg § 1.860G-1(a)(4)*.

(n10)Footnote 10. *Treas Reg § 1.860G-1(a)(1)*; see also *Treas Reg §§ 1.860D-1(d)(2); § 13A.02[1], n 3, supra* .

(n11)Footnote 11. *Treas Reg § 1.860G-1(b)(4)*.

(n12)Footnote 12. *Treas Reg § 1.860G-1(b)(6)*. Thus, a regular interest is subject to *IRC §§ 1271 through 1288*, relating to bonds and other debt instruments, including *IRC § 1272(a)(6)*, which relates specifically to accrual of original issue discount on regular interests in a REMIC.

(n13)Footnote 13. *IRC § 860G(a)(1)(A)*. See also *Treas Reg § 1.860G-1(a)(5)* which provides, as a general rule, that neither the principal amount nor the latest possible maturity date of the interest may be contingent.

(n14)Footnote 14. *Treas Reg § 1.860G-1(b)(3)*.

(n15)Footnote 15. See also *IRC § 860G(a)(1)*(flush language).

(n16)Footnote 16. *IRC § 1.860G(a)(1)* (flush language). The Joint Committee on Taxation's "Bluebook" on the Jobs Creation Act of 2004, which added this language to *IRC § 860G(a)(1)*, states that the sponsor's belief will be presumed to be reasonable if, as of the startup day, the regular interest receives an investment grade rating from at least one nationally recognized statistical rating agency. See General Explanation of Tax Legislation Enacted in the 108th Congress (Jt Comm on Taxation May, 2005) (hereafter "Bluebook") at p 396.

(n17)Footnote 17. Bluebook, p. 397. At the same time Congress modified the definition of a regular interest to accommodate reverse mortgage loans, it also modified the definition of qualified mortgage to include reverse mortgage loans in that category. See *IRC § 860G(a)(3)(A)(iii)*; § 13A.02[3][a], note 49. See also *IRC § 860G(a)(7)(B)(ii)*, also modified by the Jobs Creation Act of 2004, which provides that a REMIC may hold as a permitted investment a reserve

to fund balance increases to reverse mortgage loans.

(n18)Footnote 18. *Treas Reg § 1.860G-1(b)(1)*. However, an interest in a REMIC will not fail to qualify as a regular interest solely because the REMIC's organization documents provide that the REMIC must allocate among and pay to its regular interest holders any customary prepayment penalties that the REMIC receives with respect to its qualified mortgages. *Treas Reg § 1.860G-1(b)(2)*.

(n19)Footnote 19. *Treas Reg § 1.860G-1(b)(5)(i)*. If the holder of the regular interest is entitled to interest payments consisting of a specified portion of interest payments on the REMIC's qualified mortgages, as opposed to interest payments computed at a fixed or variable (or combination of the two) interest rate on the interest's principal amount, however, it does not matter whether the interest payments are disproportionately high relative to the specified principal amount. *Treas Reg § 1.860G-1(b)(5)(ii)*.

(n20)Footnote 20. The issue price of an interest in a REMIC is determined under *IRC § 1273(b)* as if the interest were a debt instrument and, if the interest is issued for property, as though the requirements of *IRC § 1273(b)(3)* were met (thus making the fair market value of the property the issue price). *IRC § 860G(a)(10)*; *Treas Reg § 1.860G-1(d)*. Thus, if a class of interests is publicly offered, the issue price of an interest in that class is the initial offering price to the public at which a substantial amount of the class is sold. If initial offering price to the public at which a substantial amount of the class is sold. If the interest is in a class that is not publicly offered, the issue price is the price paid by the first buyer of that interest regardless of the price paid for the remainder of the class. If the interest is in a class that is retained by the sponsor, the issue price is the interest's fair market value on the "pricing date" (as defined in *Treas Reg § 1.860F-2(b)(3)(iii)* (date on which the terms of the REMIC's regular and residual interests, and the prices at which its regular interests will be sold, are fixed), if any, or, if none, the startup day, regardless of whether property exchanged for the interest is publicly traded.

(n21)Footnote 21. *Treas Reg § 1.860G-1(a)(3)*.

(n22)Footnote 22. *Treas Reg § 1.1275-5(b)(1)*; *Treas Reg § 1.860G-1(a)(3)(i)*.

(n23)Footnote 23. *Treas Reg § 1.1275-5(a)(4)*; *Treas Reg § 1.860G-1(a)(3)(i)*.

(n24)Footnote 24. *Treas Reg § 1.860G-1(a)(3)(ii)(A)*. In computing the weighted average rate, the REMIC may make the interest rate on some or all of the qualified mortgages subject to a cap or floor, or reduce the interest rate on one or more qualified mortgages by a number of basis points or a fixed percentage, or calculate a weighted average rate that is net of any servicing spread, credit enhancement fees, or other expenses of the REMIC. *Treas Reg § 1.860G-1(a)(3)(ii)(B)*.

(n25)Footnote 25. A qualified floating rate or weighted average rate may be manipulated by multiplying such a rate by a fixed multiplier, increasing or decreasing the rate by a constant number of basis points, or both. *Treas Reg § 1.860G-1(a)(3)(iii)*. It may also be subject to a cap (ceiling) or floor establishing a maximum or minimum interest rate or the maximum or minimum number of basis points by which the rate may increase or decrease from one accrual or payment period to another, or over the entire term of the interest. *Treas Reg § 1.860G-1(a)(3)(iv)*. The Regulations also permit the use of "funds-available caps," defined as a limit on the total amount of interest payable in any accrual or payment period based on the total amount available for distribution, including both principal and interest received by the REMIC on some or all of its qualified mortgages as well as amounts held in a reserve fund. *Treas Reg § 1.860G-1(a)(3)(v)(A)*. An allowable "funds-available cap" does not include a cap used as a "device to avoid the standards" imposed by the Regulations on variable interest rates employed in regular interests, however. Whether a cap works as such a device is question to be determined by a "facts and circumstances test," including (1) whether the rate of the interest payable to the e regular interest holders is below the rate payable on the REMIC's qualified mortgages on the startup day, and (2) whether, historically, the rate of interest payable to the regular interest holders has been consistently below that payable on the qualified mortgages. *Treas Reg § 1.860G-1(a)(3)(v)(B)*.

The Regulations provide an example in which a REMIC, holding qualified mortgages that are commercial mortgages on which interest payments are based on the gross profits of the mortgagors, issues regular interests with a variable rate set at 400 percent of the one-year LIBOR rate, subject to a cap equal to current funds available for distribution. It is given that, initially, 400 percent of the LIBOR rate exceeds the weighted average rate payable on the mortgages, and that historical data suggest a significant possibility that this will continue to be the case in the future. The Regulations conclude that the cap in these circumstances is being used as a device to pass through to the holders of the regular interests contingent interest based on mortgagor profits. Consequently, the rate paid on such interests is not considered an acceptable "variable rate." *Treas Reg § 1.860G-1(a)(3)(ii)(C)* (Ex 2).

(n26)Footnote 26. *Treas Reg § 1.860G-1(a)(3)(vi)*. Of course, each variable rate used must be permissible under *Treas Reg § 1.860G-1(a)(3)*.

(n27)Footnote 27. *Treas Reg § 1.860G-1(a)(2)(i)*.

(n28)Footnote 28. *Treas Reg §§ 1.860G-1(a)(2)(ii) and (iii)*.

(n29)Footnote 29. See *Treas Reg § 1.860G-1(a)(2)(vi)*(Examples 1 and 3).

(n30)Footnote 30. *IRC § 860G(a)(2)*.

(n31)Footnote 31. *Treas Reg § 1.860G-1(c)*.

(n32)Footnote 32. *IRC § 860D(a)(3)*; *Treas Reg § 1.860G-1(c)*.

(n33)Footnote 33. *Id.*

(n34)Footnote 34. *IRC § 860D(a)(6)*; *Treas Reg § 1.860D-1(b)(4)*. *IRC § 860E(e)(3)* imposes a tax on a transferor that transfers a residual interest in a REMIC to a disqualified organization. See § 13A.05[3] below.

(n35)Footnote 35. See *Treas Reg § 5f.103-1(c)*.

(n36)Footnote 36. *Treas Reg § 1.860D-1(b)(5)(i)*.

(n37)Footnote 37. *Treas Reg § 1.860D-1(b)(2)(i)*.

(n38)Footnote 38. *Treas Reg § 1.860D-1(b)(2)(ii)*.

(n39)Footnote 39. A credit enhancement contract is a guarantee of payment of the REMIC's qualified mortgages or of interests in the REMIC. See *Treas Reg § 1.860G-2(c)(2)* and § 13A.02[3] below.

(n40)Footnote 40. *Treas Reg § 1.860D-1(b)(2)(iii)*.

(n41)Footnote 41. A "clean-up call" is the redemption of a class of regular interests when, by reason of prior payments with respect to those interests, the administrative costs associated with servicing that class outweigh the benefits of maintaining the class. *Treas Reg § 1.860G-2(j)(1)*.

(n42)Footnote 42. A "qualified liquidation" is defined in *IRC § 860F(a)(4)* as the liquidation of a REMIC pursuant to a plan of liquidation in which all the REMIC's assets are sold and the proceeds used to pay claims or distributed within a 90-day period.

(n43)Footnote 43. A convertible mortgage is one which gives the obligor the right to convert from one interest rate to another. *Treas Reg § 1.860G-2(d)(5)*.

(n44)Footnote 44. *Treas Reg § 1.860D-1(b)(2)(iv)*.

(n45)Footnote 45. *Treas Reg § 1.860D-1(b)(1)(ii)*.

(n46)Footnote 46. See § 13A.02[1], *supra*.

(n47)Footnote 47. *Treas Reg § 1.860D-1(b)(3)(ii)*. Since the "less than one percent" test is only a safe harbor, a REMIC that does not meet the safe harbor test is not precluded from demonstrating in some other way that it meets the "substantially all" test. *Id.* See also § 13A.02[3][a] below, discussing certain contractual and other rights of a REMIC that are not considered separate "other assets" for purposes of the asset test.

(n48)Footnote 48. For purposes of the asset test, an obligation may provide for contingent payments as long as it also provides for total noncontingent payments at least equal to the obligation's issue price. Thus, an instrument issued for \$100x that provides for noncontingent principal payments of \$100x, interest payments at a fixed rate, and contingent payments based on a percentage of the mortgagor's gross receipts, is considered an obligation for purposes of the asset test. *Treas Reg § 1.860G-2(a)(7)*.

(n49)Footnote 49. *IRC § 860G(a)(3)(A)*. A qualified mortgage need not be transferred to the REMIC on the startup day if (1) it is purchased by the REMIC pursuant to a fixed-price contract in effect on the startup day within the 3-month period beginning with the startup day, or (2) to the extent it represents an increase in the principal amount of an obligation described in (i) or (ii) above which (I) is attributable to an advance made to the obligor pursuant to the original terms of a reverse mortgage loan or other obligation, (II) occurs after the startup day, and (III) is purchased by the REMIC pursuant to a fixed price contract in effect on the startup day.

(n50)Footnote 50. *IRC § 860G(a)(3)(B)*.

(n51)Footnote 51. *Treas Reg § 1.860G-2(f)(1)*. Note that a defective obligation may still be a qualified mortgage. For example, if a sponsor represented that all mortgages transferred to a REMIC had a 10 percent interest rate but it was later discovered that one mortgage had a 9 percent interest rate, the 9 percent mortgage would be a defective obligation but the defect would not affect the status of that obligation as a qualified mortgage.

(n52)Footnote 52. *IRC § 860G(a)(3)(C)*.

(n53)Footnote 53. See *Treas Reg § 1.860G-2(a)(4)*, incorporating the definitions of "interest in real property" and "real property" found at *Treas Reg §§ 1.856-3(c)* and *(d)*, respectively. See also Chapter 13, § 13.02[2][b], n.11.

(n54)Footnote 54. See *Treas Reg § 301.7701-4(c)*.

(n55)Footnote 55. See *IRC § 25(e)(10)*.

(n56)Footnote 56. *Treas Reg § 1.860G-2(a)(5)*. In addition, an obligation secured by stock held by a person as a tenant-stockholder (as defined in *IRC § 216*) in a cooperative housing association is designated as an interest in real property. *IRC § 860G(a)(3)* (flush language). In addition, if a REMIC acquires obligations originated by the United States or any State (including a political subdivision, agency or instrumentality of the United States or any State), and more than 50 percent of such obligations are principally secured by an interest in real property, then all such obligations are to be treated as principally secured by an interest in real property. *IRC § 860G(a)(3)* (flush language). A stripped bond or stripped coupon (within the meaning of *IRC §§ 1286(e)(2)* and *(3)*) qualifies as an obligation that is principally secured by an interest in real property if the bonds (as defined in *IRC § 1286(e)(1)*) from which such stripped bonds or stripped coupons arose so qualifies. *Treas Reg § 1.860G-2(a)(9)*. See also Chapter 17, § 17.02[4][c].

(n57)Footnote 57. *Treas Reg § 1.860G-2(a)(6)*. Thus, a collateralized mortgage obligation issued by an issuer that is not a REMIC is not an obligation principally secured by an interest in real property. In addition, a residual interest in

a REMIC (as defined in *IRC § 860G(a)(2)*) is not considered an obligation principally secured by an interest in real property. *Id.*

(n58)Footnote 58. *Treas Reg § 1.860G-2(a)(1).*

(n59)Footnote 59. *Treas Reg § 1.860G-2(a)(1)(i).* The fair market value of the real property securing the obligation must be reduced by the amounts of any liens on the property that are senior to or in parity with the real property interest being tested. *Treas Reg § 1.860G-2(a)(2).*

(n60)Footnote 60. *Treas Reg § 1.860G-2(a)(1)(ii).* For purposes of the alternative test, loan guarantees made by the United States or any state (or any political subdivision, agency, or instrumentality thereof) are not treated as additional security for the obligation. In addition, the fact that the borrower is personally liable on the obligation does not mean that the obligation is secured by property other than real property.

(n61)Footnote 61. *Treas Reg § 1.860G-2(a)(3)(i).* A sponsor may base a reasonable belief on representations and warranties made by the originator of the obligation, or on evidence that the originator typically made mortgage loans in accordance with an established set of parameters, and that any mortgage loan originated in accordance with those parameters would have satisfied either the 80 percent or alternative tests. *Treas Reg § 1.860G-2(a)(3)(ii).*

(n62)Footnote 62. *Treas Reg § 1.860G-2(a)(3)(iii).*

(n63)Footnote 63. See *Treas Reg § 1.1001-3(b)*; Chapter 1, § 1.02[3][a][ii].

(n64)Footnote 64. *Treas Reg § 1.860G-2(b)(1).* Except as noted below, the term "significant modification" has the same meaning in the REMIC Regulations as it has for purposes of *IRC § 1001* and the regulations thereunder. *Treas Reg § 1.860G-2(b)(2).*

(n65)Footnote 65. *Treas Reg § 1.860G-2(b)(1)(ii).*

(n66)Footnote 66. See n 45, *supra*. Unless the obligation is modified within 3 months of the startup day, it will not be a qualified replacement mortgage unless, before modification, it was a defective obligation.

(n67)Footnote 67. See § 13A.04[1] below for a discussion of the tax on prohibited transactions of a REMIC.

(n68)Footnote 68. See *Treas Reg § 1.860G-2(b)(3)*. T.D. 9463, 2009-40 IRB 442, adopted final regulations, effective on and after September 16, 2009, expanding the list of permitted exceptions to the "significant modification" rule as explained hereafter to include modifications that are often made to commercial mortgages, including changes in collateral, guarantees and credit enhancement of an obligation, and changes to the recourse nature of an obligation.

(n69)Footnote 69. See *Treas Reg § 1.860G-2(b)(4).*

(n70)Footnote 70. An obligation is considered assumed for this purpose in any of the following circumstances: (i) The buyer of the mortgaged property acquires the property subject to the mortgage, without assuming any personal liability; (ii) The buyer becomes liable for the debt but the seller also remains liable; or (iii) The buyer becomes liable for the debt and the seller is released by the lender. *Treas Reg § 1.860G-2(b)(5).*

(n71)Footnote 71. *Treas Reg § 1.860G-2(b)(3).*

(n72)Footnote 72. The servicer must base the reasonable belief on (i) a current appraisal performed by an independent appraiser, (ii) an appraisal obtained in connection with the origination of the obligation, updated where appropriate for the passage of time and other changes that may have affected the value of the property, (iii) the sales price of the interest in the case of a substantially contemporaneous sale in which the buyer assumed the seller's obligations under the mortgage, or (iv) some other commercially reasonable valuation method. Moreover, the servicer must not

actually know or have reason to know that this 80 percent test has not been satisfied. *Treas Reg § 1.860G-2(b)(7)(ii)*.

(n73)Footnote 73. Fair market value in both cases must be established by a current appraisal, an original (and updated) appraisal, or some other commercially reasonable method, and the servicer must not actually know or have reason to know that this criterion has not been satisfied. *Treas Reg § 1.860G-2(b)(7)(iii)*. The alternative test is consistent with the fact that if an obligation meets the "principally secured" test and otherwise meets the requirements for a "qualified mortgage" on the startup day, it does not lose that status solely because the collateral thereafter declines in value.

(n74)Footnote 74. *Treas Reg § 1.860G-2(a)(8)*.

(n75)Footnote 75. *Id.*

(n76)Footnote 76. See *Treas Reg § 1.860G-2(f)(2)*.

(n77)Footnote 77. *Id.* However, the REMIC may exchange the defective obligation for a qualified replacement mortgage even after the 90 day "cure or sell" period, provided the exchange is made within a two year period following the startup day as prescribed in *IRC § 860G(a)(4)(B)*.

(n78)Footnote 78. See *Treas Reg §§ 1.860G-2(c), (d) and (e)*.

(n79)Footnote 79. *Treas Reg § 1.860G-2(c)(2)*. A credit enhancement contract includes arrangements to make advances to a REMIC to cover delinquent payments on qualified mortgages, to pay taxes, insurance payments, or other expenses with respect to real property securing the REMIC's qualified mortgages if the mortgagor fails to do so, or to level out the stream of cash flows to the REMIC or provide for the orderly administration of the REMIC. *Treas Reg §§ 1.860G-2(c)(3)(i), (ii) and (iii)*. The person agreeing to make such advances may be the REMIC sponsor, a mortgage servicer, or other third party, and may be either required or permitted by the contract to make such advances. *Treas Reg §§ 1.860G-2(c)(2) and (3)*.

(n80)Footnote 80. *Treas Reg §§ 1.860G-2(c)(1)*.

(n81)Footnote 81. *Treas Reg § 1.860G-2(d)(3)*.

(n82)Footnote 82. *Treas Reg § 1.860G-2(d)(4)*.

(n83)Footnote 83. *Treas Reg § 1.860G-2(e)*.

(n84)Footnote 84. *Id.*

(n85)Footnote 85. *IRC § 860G(a)(5)*.

(n86)Footnote 86. *IRC § 860G(a)(6)*. The Regulations add that the investments must be passive investments earning a return in the nature of interest, and that distributions to holders of interests in the REMIC must be made on "regularly scheduled date[s]." *Treas Reg § 1.860G-2(g)(1)(i)*.

(n87)Footnote 87. *Treas Reg § 1.860G-2(g)(1)(iii)*.

(n88)Footnote 88. *Id.*

(n89)Footnote 89. The Regulations provide that a guarantee arrangement does not fail to qualify as a credit enhancement contract solely because the guarantor, in the event of a default on a qualified mortgage, has the option of immediately paying to the REMIC the full amount of mortgage principal due on acceleration of the defaulted mortgage, or paying principal and interest to the REMIC according to the original payment schedule for the defaulted mortgage, or

according to some other deferred payment schedule. In the event that the guarantor elects to make deferred payments, such payments will be treated as received under a qualified mortgage even if the mortgage is foreclosed upon and the guarantor, pursuant to subrogation rights set out in the guarantee arrangement, is entitled to receive immediately the proceeds of foreclosure.

(n90)Footnote 90. *Treas Reg § 1.860G-2(g)(1)(ii)*.

(n91)Footnote 91. *IRC § 860G(a)(7)(A)*. An asset need not generate any income to be a qualified reserve asset. *Treas Reg § 1.860G-2(g)(3)(i)*.

(n92)Footnote 92. *IRC § 860G(a)(7)(B)(i)*. The Regulations expand the purposes for which a qualified reserve fund may be used to include providing for prepayment interest shortfalls (as defined in *Treas Reg § 1.860G-2(e)* and *§ 13A.02[3][a]* above) or any contingency that could be provided for under a credit enhancement contract (as defined in *Treas Reg §§ 1.860G-2(c)(2)* and *(3)* and *§ 13A.02[3][a]* above).

(n93)Footnote 93. *IRC § 860G(a)(7)(B)(ii)*. A qualified mortgage may be purchased after the startup day under *IRC § 860G(a)(3)(A)(ii)* if an obligation, principally secured by an interest in real property, is purchased within 3 months after the startup day pursuant to a fixed price contract in effect on the startup day. A qualified mortgage may also be acquired after the startup day if it is attributable to an advance made to an obligor under a reverse mortgage loan or similar obligation previously acquired by the REMIC as a qualified mortgage.

(n94)Footnote 94. *IRC § 860G(a)(7)(B)* (flush language). In determining whether the amount of a reserve is reasonable, it is appropriate to consider the credit quality of the qualified mortgages, the extent and nature of any guarantees relating to either the qualified mortgages or the regular and residual interests, the expected amount of expenses of the REMIC, and the expected availability of proceeds from qualified mortgages to pay the expenses. *Treas Reg § 1.860G-2(g)(3)(ii)(A)*.

(n95)Footnote 95. *Treas Reg § 1.860G(g)(3)(ii)(B)*. The Regulations dilute the effect of the presumption, however, by providing that it may be rebutted if the reserve amounts required by the rating agency or third party guarantor or insurer are not "commercially reasonable" in light of the factors described in *Treas Reg § 1.860G(g)(3)(ii)(A)* (n. 89 above). *Treas Reg § 1.860G(g)(3)(ii)(C)*.

(n96)Footnote 96. *Treas Reg § 1.860G(h)*.

(n97)Footnote 97. See *IRC § 856(e)*. In general, foreclosure property in the case of a REIT is defined as real property acquired as a result of having bid in such property at foreclosure or having otherwise reduced such property to ownership or possession by agreement or process of law after a default on an indebtedness which such property secured. The requirement in *IRC § 856(e)(5)* that the REIT make an election to have otherwise eligible property treated as foreclosure property is not applicable to a REIT. *IRC § 860G(a)(8)(A)*.

(n98)Footnote 98. *IRC § 860G(a)(8)*. See also *§ 13A.04[3]* below (tax imposed by *IRC § 860G(c)* on REMIC's income from foreclosure property).



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Taxation of Securities Transactions

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CHAPTER 13A Real Estate Mortgage Investment Conduits and Taxable Mortgage Pools

2-13A Taxation of Securities Transactions § 13A.03

§ 13A.03 Transfers of Property to a Real Estate Mortgage Investment Conduit

[1] Treatment of Transferors.

No gain or loss is recognized to the transferor on the transfer of property to a REMIC in exchange for regular or residual interests in the REMIC.ⁿ¹ Upon such a transfer, the adjusted bases of the interests received in the transaction are equal in the aggregate to the adjusted basis of the property transferred, with the aggregate allocated among the regular and residual interests received in proportion to their fair market values.ⁿ² If the issue price of any interest received in the transaction exceeds its adjusted basis in the hands of the transferor immediately after the transfer, such excess is includable currently in the gross income of the holder under rules similar to those governing market discount bonds, if the interest is a regular interest, or ratably over the anticipated period during which the REMIC will be in existence, if it is a residual interest.ⁿ³ If the basis of the interest exceeds its issue price, the excess, in the case of a regular interest, is treated as amortizable bond premium, and, in the case of a residual interest, is deductible ratably over the anticipated period during which the REMIC will be in existence.ⁿ⁴

[2] Basis to the Real Estate Mortgage Investment Conduit.

The basis of any property received by a REMIC in exchange for an interest in the REMIC is its fair market value immediately after the transfer.ⁿ¹

FOOTNOTES:

(n1)Footnote 1. *IRC § 860F(b)(1)(A)*.

(n2)Footnote 2. *IRC § 860F(b)(1)(B)*. The aggregate adjusted basis is increased by the amount of any organizational expenses incurred by the sponsor in the transaction. *Ltr Rul 9141002* .

(n3)Footnote 3. *IRC § 860F(b)(1)(C)*. The treatment of market discount bonds is the subject of *§ 17.02[4][e]*, *infra* .

The issue price of any interest in a REMIC is determined under *IRC § 1273(b)* in the same manner as if the interest were a debt instrument, except that if the interest is issued for property, *IRC § 1273(b)(3)* applies in all events. *IRC § 860G(a)(10)*. The rules of *IRC § 1273(b)* are discussed in *§ 17.02[4][c]*, *infra*.

(n4)Footnote 4. *IRC § 860F(b)(1)(D)*. See § 17.02[5], *infra*, for a discussion of amortization of bond premium.

(n5)Footnote 1. *IRC § 860F(b)(2)*.



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CHAPTER 13A Real Estate Mortgage Investment Conduits and Taxable Mortgage Pools

2-13A Taxation of Securities Transactions § 13A.04

§ 13A.04 Taxation of Real Estate Mortgage Investment Conduits

IRC Section 860A sets forth the general rule that a REMIC is not subject to taxation. Although the REMIC is a pass-through entity with its income taxable to the holders of interests therein, it is not to be treated as a corporation, partnership, or trust for income tax purposes.ⁿ¹

[1] Tax on Prohibited Transactions.

Under *IRC Section 860F(a)(1)*, a REMIC is required to pay a tax equal to 100 percent of its net income from prohibited transactions. The net income derived from prohibited transactions is the excess of the gross income therefrom over the allowable deductions that are directly connected with such transactions, except that no item attributable to a prohibited transaction for which there was a loss is taken into account.ⁿ²

For this purpose, a prohibited transaction is defined as (1) the disposition of any qualified mortgage transferred to the REMIC other than (a) the substitution of a qualified replacement mortgage for a qualified mortgage (or the repurchase in lieu of substitution of a defective obligation), (b) a disposition incident to the foreclosure, default, or imminent default of the mortgage, (c) the bankruptcy or insolvency of the real estate mortgage pool, or (d) a qualified liquidation (a sale of all of the noncash assets of the REMIC pursuant to a plan of complete liquidation within a period beginning on the date of adoption of the plan and ending at the close of the 90th day thereafter, followed by a distribution of the proceeds thereof, less cash retained to meet claims, to the holders of interests in the REMIC within the same time periodⁿ³); (2) the receipt of income from any asset that is not a qualified mortgage or permitted investment; (3) the receipt by the real estate mortgage pool of any compensation for services; and (4) gain from the disposition of any cash flow investment other than pursuant to a qualified liquidation.ⁿ⁴

[2] Distributions of Property.

Gain is recognized to a REMIC on the distribution of property with respect to any regular or residual interest, as if the REMIC had sold the property to the distributee at its fair market value.ⁿ¹ The distributee's basis in the property is its fair market value.ⁿ²

[3] Tax on Income from Foreclosure Property.

IRC Section 860G(c) subjects a REMIC to tax at the highest corporate rate on its net income from foreclosure property,

that is, on the amount that would be the REMIC's net income from foreclosure property under *IRC Section 857(b)(4)(B)* if the REMIC were a REIT.

[4] Tax on Contributions After Startup Date.

A tax equal to 100 percent of any amount contributed to a REMIC after the startup day is imposed by *IRC Section 860G(d)*. The tax does not apply to any contribution that is made in cash and is (a) a contribution to facilitate a clean-up call or a qualified liquidation, (b) a payment in the nature of a guarantee, (c) a contribution during the three-month period beginning on the startup day, (d) a contribution to a qualified reserve fund by any holder of a residual interest in the REMIC, or (e) any other contribution permitted by the regulations. The tax is also inapplicable to a REMIC with a startup day before July 1, 1987.

FOOTNOTES:

(n1)Footnote 1. The REMIC is treated as a partnership for procedure and administration purposes (Subtitle F of the Code). *IRC § 860F(e)*. Any return required because of this must include the amount of daily accruals determined under *IRC § 860E(c)* and be signed by the REMIC.

The Treasury is authorized to prescribe regulations that will require a REMIC to withhold on amounts paid to nonresident aliens and foreign corporations. HR Rep No 841, 99th Cong., 2d Sess. II-229, II-230 (1986).

(n2)Footnote 2. *IRC § 860F(a)(3)*.

(n3)Footnote 3. *IRC § 860F(a)(4)*.

(n4)Footnote 4. *IRC § 860F(a)(2)*. A disposition required to prevent a threatened default on a regular interest resulting from a default on one or more qualified mortgages or to facilitate a clean-up call is not a prohibited transaction. *IRC § 860F(a)(5)*.

A borrower seeking to refinance a mortgage with a new lender on terms substantially different from the old loan asked the company acting as the master servicer for a REMIC to assign the old loan to the new lender. Such an assignment, coupled with a modification of the old loan and its consolidation with the new one, is customary in New York State in order to avoid the mortgage recording tax imposed by New York on new loans. The old mortgagee is paid only the amount of the outstanding principal and interest on the old loan. The Service has held that the transaction does not constitute a disposition of the old loan, but rather is a payment of the mortgage by the borrower. *Ltr Rul 9414014*. Congress did not intend the payment by an obligor on a debt instrument to be a disposition for purposes of the prohibited transaction provisions. Conf Rep No 841, 99th Cong, 2d Sess II-229, at II-231, note 11 (1986).

(n5)Footnote 1. *IRC § 860F(c)(1)*.

(n6)Footnote 2. *IRC § 860F(c)(2)*.



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CHAPTER 13A Real Estate Mortgage Investment Conduits and Taxable Mortgage Pools

2-13A Taxation of Securities Transactions § 13A.05

§ 13A.05 Taxation of Investors' Interests

[1] Taxation of Holders of Regular Interests.

Holders of regular interests in a REMIC are taxed as if the interest were a debt instrument.ⁿ¹ In the case of regular interests that are not debt instruments, the amount of the fixed unconditional payment is treated as the stated principal amount of the instrument, and the periodic payments (the amounts that are basis on the fixed unconditional payment) are treated as stated interest payments.ⁿ²

According to the legislative history, regular interests are to be treated as if they were debt instruments for all purposes of the Code.ⁿ³ For example, regular interests will be treated as market discount bonds when the revised issue price of the regular interest exceeds the holder's basis in the interest,ⁿ⁴ while the REMIC will be subject to the reporting requirements of *IRC Section 1275* with respect to the regular interests. In addition, regular interests, are to be treated as evidences of indebtedness under *IRC Section 582(c)(1)*, so that gain or loss from the sale or exchange of such interests by certain financial institutions is not capital gain or loss.

In determining the amount of income to be reported, the holder of a regular interest is required to account for the income attributable to the interest on the accrual method, regardless of the method of accounting otherwise used by the holder.ⁿ⁵ Thus, holders of regular interests generally take into account that portion of the REMIC's income that would be taken into account by an accrual basis taxpayer holding a debt instrument with terms equivalent to the terms of the regular interest. In the event that the amount so determined exceeds the income of the REMIC, there is no diminution of the required inclusion for such holders.ⁿ⁶

The amount of taxable original issue discount that the holder of a regular interest is required to include in income for an accrual period is based on the increase in the present value of the remaining payments on the debt instrument, taking into account payments includable in the instrument's stated redemption price at maturity received on the regular interest during the period.ⁿ⁷ The present value calculation is made at the beginning of each accrual period (1) using the yield to maturity of the instrument at the time of its issuance (determined on the basis of compounding at the close of each accrual period and properly adjusted for the length of the accrual period), calculated on the assumption that certain prepayment assumptions, specified in the regulations, will occur, and (2) taking into account any prepayments that have occurred before the end of the accrual period.ⁿ⁸

Gain or loss on the disposition of a regular interest is treated as ordinary income to the extent of any unaccrued original issue discount. This amount is equal to the excess (if any) of (a) the amount that would have been includable in gross income of the taxpayer with respect to the interest if the yield thereon were 110 percent of the applicable federal rate (determined under *IRC Section 1274(d)*)ⁿ⁹ as of the beginning of the taxpayer's holding period, over (b) the amount actually includable in gross income with respect to the interest by the taxpayer.ⁿ¹⁰

[2] Taxation of Holders of Residual Interests.

The holder of a residual interest in a REMIC takes into account his daily portion of the taxable income or net loss of the REMIC for each day during the taxable year on which the holder held the interest.ⁿ¹ The amount so taken into account is treated as ordinary income or loss.ⁿ² The daily portion of income or loss is determined by allocating to each day in any calendar quarter a ratable portion of the taxable income or net loss of the REMIC for such quarter, and by allocating the amounts so allocated among the holders of residual interests in proportion to their respective holdings on such day.ⁿ³

The taxable income of the REMIC for this purpose is determined under the accrual method of accounting and except as provided in regulations, in the same manner as for an individual, except that (1) all regular interests in the REMIC are treated as indebtedness of the REMIC, (2) market discount on any market discount bonds is included in gross income for the taxable years to which it is attributable as determined on the basis of a constant rate of accrual rather than a ratable accrual and without the deferral of net direct business expense allocable to accrued market discount, (3) any item of income, gain, loss, or deduction allocable to a prohibited transaction is not taken into account, and (4) the deduction for (a) depletion with respect to oil and gas wells, (b) personal exemptions, (c) state, local and foreign taxes, (d) charitable contributions, (e) net operating losses, and (f) additional itemized deductions for individuals (other than for expenses incurred in the production of income) are not allowed and (5) the amount of any net income from foreclosure property is reduced by the amount of tax imposed by *IRC Section 860(G)(c)*.ⁿ⁴ The net loss of a REMIC is the excess of the deductions allowed in computing the taxable income of the REMIC (determined with the foregoing modifications) over its gross income.ⁿ⁵

A distribution by a REMIC is not included in the gross income of the holder of a residual interest to the extent it does not exceed the adjusted basis of the interest.ⁿ⁶ If a distribution exceeds such basis, the excess is treated as gain from the sale or exchange of the interest.ⁿ⁷

The basis of a residual interest in a REMIC is increased by the amount of taxable income taken into account by the holder of the interest.ⁿ⁸ It is decreased (but not below zero) by any distributions with respect to the interest and by net losses taken into account by the holder.ⁿ⁹

The extent of the holder's basis is important not only to determine if a distribution will result in gain, but also because the amount of loss that can be taken into account with respect to any holder cannot exceed the adjusted basis of the holder's residual interest as of the close of the calendar quarter (determined without regard to the adjustment to basis for the loss).ⁿ¹⁰ The disallowed loss can be carried forward indefinitely.ⁿ¹¹

Under *IRC Section 860E*, the taxable income of any holder of a residual interest in a REMIC for any taxable year cannot be less than the excess inclusion for the taxable year.ⁿ¹² The excess inclusion is the excess of the amount of the net income of the REMIC that the holder takes into account for any calendar quarter, over the sum of the daily accruals for the residual interest.ⁿ¹³ The daily accrual is determined by allocating to each day in a calendar quarter a ratable portion of the product of the adjusted issue price of the residual interest at the beginning of the accrual period, and 120 percent of the long-term federal rate.ⁿ¹⁴ The adjusted issue price of the residual interest is equal to the initial issue price (an amount equal to the money paid for the interest, or the fair market value of the interest if issued in exchange for property) increased by the amount of daily accruals for prior calendar quarters, and decreased (but not below zero) by the amount of any distributions prior to the end of the calendar quarter.ⁿ¹⁵

IRC Section 860E(a)(3) sets forth rules for coordinating the provisions that govern excess inclusions with the net operating loss provisions of *IRC Section 172*. *IRC Section 860E(a)(3)(A)* provides that any excess inclusion for a taxable year is not taken into account in determining the net operating loss for that year.ⁿ¹⁶ Under *IRC Section 860E(a)(3)(B)*, any excess inclusion for a taxable year is not taken into account in determining taxable income for purposes of a net operating loss that is carried back or carried over.ⁿ¹⁷

If the holder of a residual interest is a nonresident alien or foreign corporation, amounts includable in the gross income of the holder are taken into account, for both inclusion and withholding purposes, only when paid (or when the interest is disposed of).ⁿ¹⁸ The Treasury is given authority to issue regulations that will call for the amounts to be taken into account earlier than payment, where necessary to prevent tax avoidance.ⁿ¹⁹

The wash sale rules of *IRC Section 1091* apply to disallow losses realized on the disposition of a residual interest, where the seller of the interest acquires any residual interest in any REMIC, or any interest in a TMP that is comparable to a residual interest, during the period beginning six months before the disposition of the residual interest and ending six months thereafter.ⁿ²⁰

[3] Tax on Transfers of Residual Interests.

A tax is imposed under *IRC Section 860E(e)(1)* on any transfer of a residual interest in a REMIC to a disqualified organization--the United States, a state or political subdivision thereof, a foreign government, an international organization, a tax-exempt organization (other than a farmers' cooperative) not subject to the tax on unrelated business income, or a cooperative engaged in furnishing electric energy, or providing telephone service, to persons in rural areas.ⁿ¹ The amount of tax is equal to the product of the present value of the total anticipated excess inclusions with respect to the transferred interest after the transfer multiplied by the highest corporate tax rate.ⁿ² Liability for the payment of the tax rests upon the transferor, unless the transfer is through an agent for the disqualified corporation, in which case the tax must be paid by the agent.ⁿ³ The person otherwise liable for the tax is relieved of liability if the transferee furnishes to such person an affidavit that it is not a disqualified organization and, as of the time of the transfer, the person does not have actual knowledge that the affidavit is false.ⁿ⁴ The Service can waive the tax if, within a reasonable time after the transfer, steps are taken to end the interest of the disqualified organization, and there is paid to the Service such amounts as it requires.ⁿ⁵

A pass-through entity (regulated investment company, REIT, common trust fund, partnership, trust, estate, or Subchapter T cooperative) is assessed a similar tax under *IRC Section 860E(e)(6)* if a disqualified organization is a record holder of an interest in the entity at any time during its taxable year.ⁿ⁶ Here, however, the tax is imposed solely on the amount of the excess inclusions for the year allocable to the interest held by the disqualified organization, and is deductible against the amount included in the gross income of the entity with respect to the residual interest involved. Relief from payment of the tax is allowed if the record holder of the interest furnishes the pass-through entity with an affidavit that the holder is not a disqualified organization and that the pass-through entity does not have actual knowledge that the affidavit is false.

A transfer of a noneconomic residual interest is disregarded for all federal tax purposes if a significant purpose of the transfer was to enable the transferor to impede the assessment or collection of tax.ⁿ⁷ A significant purpose to impede assessment or collection exists if, at the time of the transfer, the transferor either knew or should have known (had "improper knowledge") that the transferee would be unwilling or unable to pay taxes due on its share of the taxable income of the REMIC. A transferor is presumed not to have improper knowledge if (1) at the time of transfer, the transferor conducted a reasonable investigation of the financial condition of the transferee and, as a result of the investigation, the transferor found that the transferee had historically paid its debts as they came due and found no significant evidence to indicate that the transferee would not continue to do so; (2) the transferee represents to the transferor that it understands that, as the holder of the noneconomic residual interest, the transferee may incur tax

liabilities in excess of any cash flows generated by the interest and that the transferee intends to pay taxes associated with holding the interest as they become due; (3) the transferee represents that it will not cause income from the noneconomic residual interest to be attributable to a foreign establishment or fixed base (within the meaning of an applicable income tax treaty) of the transferee or another United States taxpayer; and (4) the transfer satisfies a formula test or an asset test.ⁿ⁸ Under the formula test, the present value of the anticipated tax liabilities associated with holding the residual interest cannot exceed the sum of (1) the present value of any consideration given to the transferee to acquire the interest, (2) the present value of the expected future distributions on the interest, and (3) the present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.ⁿ⁹ For purposes of this test, the transferee is assumed to pay tax at the highest rate imposed on corporations, and present values are computed using a discount rate equal to the federal short-term rate prescribed by *IRC Section 1274(d)(1)* for the month of transfer and the compounding period used by taxpayer.ⁿ¹⁰

Three requirements must be satisfied in order to meet the asset test. First, at the time of the transfer, and at the close of each of the transferee's two fiscal years preceding the transfer, the transferee's gross assets for financial reporting purposes must exceed \$100 million and its net assets for such purposes must exceed \$10 million.ⁿ¹¹ Second, the transferee must be an eligible corporation that makes a written agreement that any subsequent transfer of the interest will be to another eligible corporation that satisfies the reasonable investigation and representation requirements mentioned above.ⁿ¹² Third, the facts and circumstances known to the transferor on or before the date of transfer must not reasonably indicate that the taxes associated with the residual interest will not be paid.ⁿ¹³ In applying the asset test, (1) the gross assets and net assets of a transferee do not include the obligation of any person related to the transferee (as defined in *IRC Section 860L(g)*) or any other asset if a principal purpose for holding or acquiring the asset is to permit the transferee to satisfy the asset test;ⁿ¹⁴ and (2) a transfer is not to an eligible corporation if there is a direct or indirect transfer of a residual interest to a foreign permanent establishment of a domestic corporation or if the transferor knows, or has reason to know, that the transferee will not honor the restrictions on subsequent transfers of the residual interest.ⁿ¹⁵

A residual interest is a noneconomic residual interest unless, at the time of the transfer (a) the present value of the expected future distributions on the residual interest at least equals the product of the present value of the anticipated excess inclusions and the highest corporate tax rate for the year in which the transfer occurs; and (b) the transferor reasonably expects that, for each anticipated excess inclusion, the transferee will receive distributions from the REMIC at or after the time at which the taxes accrue on the anticipated excess inclusion in an amount sufficient to satisfy the accrued taxes.ⁿ¹⁶

A transfer of a residual interest that has tax avoidance potential is disregarded for all federal tax purposes if the transferee is a foreign person.ⁿ¹⁷ A residual interest has tax avoidance potential for this purpose unless, at the time of the transfer, the transferor reasonably expects that, for each excess inclusion, the REMIC will distribute to the transferee an amount that will equal at least 30 percent of the excess inclusion, and that each such amount will be distributed at or after the time at which the excess inclusion accrues and not late than the close of the calendar year following the calendar year of accrual.ⁿ¹⁸

FOOTNOTES:

(n1)Footnote 1. *IRC § 860B(a)*.

(n2)Footnote 2. HR Rep No 841, 99th Cong, 2d Sess II-231 (1986).

(n3)Footnote 3. *Id.*

(n4)Footnote 4. HR Rep No 841, 99th Cong, 2d Sess II-231 (1986).

(n5)Footnote 5. *IRC § 860B(b)*. According to the legislative history, periodic payments of interest (or similar amounts) are to be treated as accruing pro rata between the dates that the payments are to be made. HR Rep No 841,

99th Cong, 2d Sess II-231 (1986).

(n6)Footnote 6. *IRC 860B(b)*. According to the legislative history, periodic payments of interest (or similar amounts) are to be treated as accruing pro rata between the dates that the payments are to be made. HR Rep No 841, 99th Cong, 2d Sess II-231 (1986).

(n7)Footnote 7. *IRC § 1272(a)(6)(A), (C)*.

(n8)Footnote 8. *IRC § 1272(a)(6)(B)*.

(n9)Footnote 9. The determination of the applicable federal rate is made without regard to *IRC § 1274(d)(2)*, which prescribes the lowest three-month rate for sales and exchanges.

(n10)Footnote 10. *IRC § 860B(c)*.

(n11)Footnote 1. *IRC § 860C(a)(1)*. The holder of REMIC residual interests cannot use an inventory method of accounting under *IRC § 471* to account for such interests. *Rev Rul 95-81, 1995-2 CB 70*.

As a general rule, all taxpayers, regardless of their overall method of accounting must recognize an inducement fee (a fee paid to induce a person to become the holder of a noneconomic residual interest in a REMIC) over the remaining expected life of the REMIC in a manner that reasonably reflects the after-tax costs and benefits of holding the noneconomic residual interest. *Treas Reg § 1.446-6(c)*. Certain safe harbors alter the application of this rule. *Treas Reg § 1.446-6(e)*. If any portion of an inducement fee has not been recognized in full by the holder as of the time the holder transfers, or otherwise ceases to be the holder for federal tax purposes of, the residual interest, the holder must include the unrecognized portion of the inducement fee at that time. *Treas Reg § 1.446-6(d)*.

(n12)Footnote 2. *IRC § 860C(e)(1)*.

(n13)Footnote 3. *IRC § 860C(a)(2)*. See *Temp Treas Reg § 1.67-3T(b)* for the treatment of allocable investment expenses of pass-through interest holders, as defined in *Temp Treas Reg § 1.67-3T(a)(2)*.

(n14)Footnote 4. *IRC § 860C(b)(1)*. A REMIC is not subject to the investment interest limitation of *IRC § 163(d)*. *Treas Reg § 1.860C-2(b)(2)*. In addition, *IRC § 265* (disallowing a deduction for expenditures relating to tax-exempt income) is applied as if the REMIC were a financial institution. *Treas Reg § 1.860C-2(b)(5)*. Discussions of the investment interest limitation and expenses relating to tax-exempt income can be found in Ch 19.

(n15)Footnote 5. *IRC § 860C(b)(2)*.

(n16)Footnote 6. *IRC § 860C(c)(1)*.

(n17)Footnote 7. *IRC § 860C(c)(2)*.

(n18)Footnote 8. *IRC § 860C(d)(1)*.

(n19)Footnote 9. *IRC § 860C(d)(2)*.

(n20)Footnote 10. *IRC § 860C(e)(2)(A)*.

(n21)Footnote 11. *IRC § 860C(e)(2)(B)*.

(n22)Footnote 12. *IRC § 860E(a)(1)*. The excess inclusion for a taxable year is not taken into account in determining the amount of any net operating loss for, or the amount of any net operating loss carryback or carryover from, the year.

The alternative minimum taxable income of any holder of a residual interest in a REMIC for any taxable year cannot be less than the excess inclusion for the taxable year. In addition any excess inclusion is disregarded for purposes of computing the alternative tax net operating loss. *IRC § 860E(a)(6)*.

The provision does not apply to financial institutions to which *IRC § 593* applies. *IRC § 860E(a)(2)*. The financial institution and each qualified subsidiary are treated as a single corporation. A qualified subsidiary is one in which all of the stock, and substantially all of the indebtedness, of which is held by the financial institution, and which is organized and operated exclusively in connection with the organization and operation of one or more REMICs. *IRC § 860E(a)(4)*.

All members of an affiliated group filing a consolidated return are treated as one taxpayer for the purposes of *IRC § 860E(a)*, except that the exception for financial institutions is applied separately with respect to each corporation that is a member of the group and to which *IRC § 593* applies.

If the residual interest is held by a tax-exempt interest, the income is treated as unrelated business income. *IRC § 860E(b)*. If the interest is held by a REIT, a portion of the dividends paid by the REIT will be treated as excess inclusions by the REIT shareholders. *IRC § 860E(d)*. Similar rules apply to interests held by RIC's, common trust funds, or Subchapter T cooperatives.

Excess inclusion income allocated to a charitable remainder trust is not unrelated business taxable income to the trust. *Rev Rul 2006-58, 2006-2 CB 876*.

(n23)Footnote 13. *IRC § 860E(c)(1)*.

(n24)Footnote 14. *IRC § 860E(c)(2)(A)*.

(n25)Footnote 15. *IRC § 860E(c)(2)(B)*.

(n26)Footnote 16. If, during the same taxable year, a taxpayer recognizes an excess inclusion and incurs a net operating loss, the excess inclusion cannot be offset by the net operating loss and is not taken into account in determining the amount of the net operation loss that can be carried to another taxable year. *Rev Rul 2005-68, 2005-42 CB 853*.

(n27)Footnote 17. If a net operating loss is carried back or carried over to a taxable year in which an excess inclusion is recognized, the excess inclusion cannot be offset by the carryback or carryover and is not included in the calculation of taxable income for net operating loss absorption purposes. *Id.*

(n28)Footnote 18. *IRC § 860G(b)*. The legislative history indicates that withholding on the disposition of the interest is to be similar to withholding on disposition of debt instruments that have original issue discount. HR Rep No 841, 99th Cong, 2d Sess II-236 (1986).

If a foreign person transfers a residual interest to a US person or a foreign holder in whose hands the income from a residual interest would be effectively connected income, and if the transfer has the effect of allowing the transferor to avoid tax on accrued excess inclusions, the transfer is disregarded and the transferor continues to be treated as the owner of the interest for tax liability and withholding purposes. *Treas Reg § 1.860G-3(a)(4)*.

(n29)Footnote 19. A domestic partnership must separately state its allocable share of REMIC taxable income or loss. If a domestic partnership allocates all or some portion of its allocable share of REMIC taxable income to a foreign partner, the amount allocated to the foreign partner must be taken into account by that partner for purposes of *IRC §§ 871(a), 881, 1441, and 1442* as if the amount were received on the last day of the partnership's taxable year, except to the extent that some or all of the amount is required to be taken into account by the foreign partner at an earlier time as a

result of a distribution by the partnership to the partner, a disposition of the partnership's residual interest in the REMIC, a disposition of the foreign partner's interest in the partnership, or any other reduction in the foreign partner's allocable share of the portion of the REMIC net income or deduction allocated to the partnership. *Temp Treas Reg § 1.860G-3T(b)(1)*.

A foreign person that is a shareholder of a REIT or RIC, a participant in a common trust fund, or a patron of a Subchapter T cooperative to whom excess inclusion income is allocated by any of those entities must account for REMIC excess inclusions on a similarly accelerated basis. *Temp Treas Reg § 1.860G-3T(b)(2)*.

(n30)Footnote 20. *IRC § 860F(d)*.

(n31)Footnote 1. *IRC § 860E(e)(5)*. A charitable remainder trust is a disqualified organization for purposes of *IRC § 860E*. *Rev Rul 2006-58, 2006-2 CB 876*.

(n32)Footnote 2. *IRC § 860E(e)(2)*. The present value of the anticipated excess inclusions is determined by discounting the anticipated excess inclusions from the end of each remaining calendar quarter in which those excess inclusions are expected to accrue to the date the disqualified organization acquires the residual interest. The discount rate for this present value computation is the applicable federal rate specified in *IRC § 1274(d)(1)* that would apply to a debt instrument that was issued on the date the disqualified organization acquired the residual interest and whose term ended on the close of the last quarter in which excess inclusions were expected to accrue with respect to the residual interest. *Treas Reg § 1.860E-2(a)(4)*.

(n33)Footnote 3. *IRC § 860E(e)(3)*.

(n34)Footnote 4. *IRC § 860E(e)(4)*.

(n35)Footnote 5. *IRC § 860E(e)(7)*.

(n36)Footnote 6. A pass-through entity that has excess inclusion income allocable to a charitable remainder trust is subject to tax under *IRC § 860E(e)(6)*. *Rev Rul 2006-58, 2006-2 CB 876*.

(n37)Footnote 7. *Treas Reg § 1.860E-1(c)(1)*.

(n38)Footnote 8. *Treas Reg § 1.860E-1(c)(4)*.

(n39)Footnote 9. *Treas Reg § 1.860E-1(c)(7)*. A direct or indirect transfer of the residual interest to a foreign permanent establishment or fixed base of a domestic transferee is not eligible for the formula test.

(n40)Footnote 10. *Treas Reg § 1.860E-1(c)(8)*. If the transferee has been subject to the alternative minimum tax in the preceding two years and will compute its taxable income in the current year using the alternative minimum tax, the transferee can use the alternative minimum tax rate applicable to corporations.

(n41)Footnote 11. *Treas Reg § 1.860E-1(c)(5)(i)*.

(n42)Footnote 12. *Treas Reg § 1.860E-1(c)(5)(ii)*. An eligible corporation is any domestic C corporation other than a corporation that is exempt from, or not subject to, tax, a RIC or REIT, a REMIC, or a cooperative. *Treas Reg § 1.860E-1(c)(6)(i)*.

(n43)Footnote 13. The consideration given to the transferee to acquire the noneconomic residual interest is only one factor to be considered. However, if the amount of consideration is so low that under any set of reasonable assumptions a reasonable person would conclude that the taxes associated with holding the residual interest will not be paid, then the transferor is deemed to know that the transferee cannot or will not pay. In determining whether the amount is too low, the specific terms of the formula test need not be used.

(n44)Footnote 14. A related person is any person that bears a relationship to the transferee enumerated in *IRC* § 267(b) or *IRC* § 707(b)(1), using 20% instead of 50% where it appears under those provisions. *Treas Reg* § 1.860E-1(c)(6)(ii).

(n45)Footnote 15. *Treas Reg* § 1.860E-1(c)(5)(ii).

(n46)Footnote 16. *Treas Reg* § 1.860E-1(c)(2). The computation of the present values in this situation follows the procedure outlined in N 29, *supra*.

(n47)Footnote 17. *Treas Reg* § 1.860G-3(a)(1). The provision does not apply if the transferee's income is effectively connected with a US trade or business. *Treas Reg* § 1.860G-3(a)(3).

(n48)Footnote 18. *Treas Reg* § 1.860G-3(a)(2)(i). A safe harbor regarding reasonable expectation is contained in *Treas Reg* § 1.860G-3(a)(2)(ii).



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Taxation of Securities Transactions

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CHAPTER 13A Real Estate Mortgage Investment Conduits and Taxable Mortgage Pools

2-13A Taxation of Securities Transactions § 13A.06

§ 13A.06 Compliance and Reporting Requirements

[1] Information Required to be Furnished to the Internal Revenue Service.

Every REMIC (other than one whose regular interests are all owned by another REMIC) and every issuer of a collateralized debt obligation must file Form 8811 with the Service on or before the 30th day after (1) the startup date in the case of a REMIC, or (2) the issue date in the case of a collateralized debt obligation.ⁿ¹ A new form must be filed on or before the 30th day after any change in the information previously provided. In addition, every REMIC must file an annual tax return on Form 1066.ⁿ²

[2] Information Required to be Furnished to Holders of Interests in the REMIC.

Amounts includable in the gross income of the holder of a regular interest in a REMIC are treated as interest that is paid when it is includable in gross income under *IRC Section 860B(b)* for purposes of the reporting requirements imposed by *IRC Section 6049*.ⁿ¹ The rules normally applicable to the reporting of interest and original issue discount are expanded to require reporting to corporations, registered dealers in commodities and securities, REITs, common trust funds, entities registered under the Investment Company Act of 1940, and certain tax-exempt charitable trusts.ⁿ² In addition to reporting interest and original issue discount, the REMIC is required to report sufficient information to allow holders to compute the accrual of any market discount or amortization of any premium.ⁿ³

A REMIC must report the following information quarterly to each person who held a residual interest in the REMIC during the quarter: (1) the residual holder's share of income or loss of the REMIC for the calendar quarter; (2) the amount of excess inclusion with respect to the holder's residual interest; (3) for the holder of a residual interest that is also a pass-through interest holder, the allocable investment expenses for the quarter;ⁿ⁴ and (4) the percentage of the REMIC's assets that consist of loans that are qualifying real property loans under *IRC Section 593*, assets described in *IRC Section 7701(a)(19)(C)* (describing assets that must be held by domestic savings and loan associations), and real estate assets defined in *IRC Section 856(c)(6)(B)* (real estate assets of an REIT).ⁿ⁵

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.6049-7(b)(1)*. Any REMIC in existence prior to July 1, 1989, was required to file the form by July 31, 1989.

(n2)Footnote 2. *Treas Reg § 1.860F-4(b)*. The due date of the return is determined by treating the REMIC as a

partnership filing on a calendar year basis.

(n3)Footnote 1. *IRC § 6049(d)(7)(A)*. The information must be reported on Form 1099. *Treas Reg § 1.6049-7(b)(2)*.

(n4)Footnote 2. *IRC § 6049(d)(7)(B)*.

(n5)Footnote 3. *IRC § 6049(d)(7)(C)*.

(n6)Footnote 4. A pass-through interest holder is defined as (1) an individual (other than a nonresident alien whose income with respect to the interest in the REMIC is not effectively connected with the conduct of a trade or business in the US), (2) a person, including a trust or estate, that computes its income in the same manner as an individual, or (3) a pass-through entity (such as a partnership or S corporation) if one or more of its partners, shareholders or other interest holders is (i) a pass-through entity, or (ii) a person described in (1) or (2). *Temp Treas Reg § 1.67-3T(a)(2)(i)(A)(1)-(3)*.

(n7)Footnote 5. *Treas Reg § 1.860F-4(e)(1)*. The information is provided on Schedule Q attached to Form 1066.



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Taxation of Securities Transactions

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CHAPTER 13A Real Estate Mortgage Investment Conduits and Taxable Mortgage Pools

2-13A Taxation of Securities Transactions § 13A.07

§ 13A.07 Taxable Mortgage Pools

Congress intends that REMICs are to be the exclusive means of issuing multiple class real estate mortgage-backed securities without the imposition of two levels of taxation.ⁿ¹ To this end, the 1986 legislation provides that a taxable mortgage pool (TMP) is a taxable corporation that is not an includable corporation for purposes of filing consolidated returns.ⁿ²

A TMP is defined as any entity other than a REMIC if (1) substantially all of the assets of the entity consist of debt obligations (or interests in debt obligations) and more than 50 percent of such obligations (or interests) consist of real estate mortgages (asset composition test), (2) the entity is the obligor under debt instruments with two or more maturities, and (3) the terms of the debt instruments on which the entity is the obligor provide for payments that bear a relationship to the debt obligations (or interests) held by the entity.ⁿ³ Whether substantially all of the assets of an entity consist of debt obligations (or interests therein) is based on all the facts and circumstances.ⁿ⁴ However, if less than 80 percent of the assets of an entity consist of debt obligations (or interests therein), then less than substantially all of the assets of the entity consist of debt instruments (or interests therein).ⁿ⁵

The equity interest of an entity in a partnership, S corporation, trust, REIT, or other pass-through arrangement is deemed to have the same composition as the assets of the pass-through arrangement.ⁿ⁶ Thus, if an entity's interest in a REIT has a basis of \$100,000, and the assets of the REIT consist of equal portions of real estate mortgages and other real estate assets, the entity is treated as holding \$50,000 of real estate mortgages and \$50,000 of other real estate assets.

A credit enhancement contract (or any collateral supporting it) is not treated as a separate asset for purposes of the asset composition test, but, rather, is treated as part of the asset to which it relates.ⁿ⁷ A credit enhancement contract is any arrangement whereby a person agrees to guarantee full or partial payment of the principal or interest payable (1) on a debt obligation (or interest therein) or on a pool of such obligations (or interests), or (2) on one or more of the classes of debt obligations under which an entity is the obligor, because of defaults or delinquencies on debt obligations, unanticipated losses or expenses incurred by the entity, or lower than expected returns on investments.ⁿ⁸

Real estate mortgages that are seriously impaired are not treated as debt obligations for purposes of the asset composition test.ⁿ⁹ Whether a mortgage is seriously impaired is based on all the facts and circumstances including, but not limited to: the number of days delinquent, the loan-to-value ratio, the debt service coverage (based on the operating income from the property), and the debtor's financial position and stake in the property. Generally, no single factor is

determinative of whether a loan is seriously impaired, but, unless an entity is receiving or anticipates receiving payments with respect to a mortgage, a single family residential real estate mortgage is seriously impaired if payments on the mortgage are more than 89 days delinquent, while a multi-family or commercial real estate mortgage is seriously impaired if payments on the mortgage are more than 59 days delinquent.ⁿ¹⁰

For purposes of the asset composition test, real estate mortgages (or interests therein) include all: (1) obligations (including participations or certificates of beneficial ownership therein) that are principally secured by an interest in real property; (2) regular or residual interests in a REMIC; and (3) stripped bonds and stripped coupons, if the bonds from which the stripped bonds or stripped coupons arose would have qualified as real estate mortgages or interests therein.ⁿ¹¹ The concept of real property and interests in real property that apply in the case of a REIT apply here as well.ⁿ¹²

An interest is principally secured by an interest in real property if it satisfies one of two tests.ⁿ¹³ Under the first--the 80-percent test, an obligation is principally secured by an interest in real property if the fair market value of the interest in real property securing the obligation was at least 80 percent of the adjusted issue price of the obligation on the issue date of the obligation.ⁿ¹⁴ For purposes of the 80-percent test, the fair market value of the real property interest is first reduced by the amount of any lien on the interest that is senior to the obligation being tested, and is reduced further by a proportionate amount of any lien that is in parity with the obligation being tested.ⁿ¹⁵

Under the second--the alternative test, an obligation is principally secured by an interest in real property if substantially all of the proceeds of the obligation were used to acquire, improve, or protect an interest in real property that, at the issue date, is the only security for the obligation.ⁿ¹⁶ For this purpose, loan guarantees made by federal, state, local governments, or agencies, or other third-party credit enhancement, are not viewed as additional security. An obligation is not considered to be secured by property other than real property solely because the obligor is personally liable on the obligation.

An obligation secured only by real estate mortgages (or interests therein) is treated as an obligation secured by an interest in real property to the extent of the value of the real estate mortgages or interests therein.ⁿ¹⁷ An obligation secured by both real estate mortgages (or interests therein) and other assets is treated as an obligation secured by an interest in real property to the extent of both the value of the real estate mortgages (or interests therein) and the value of so much of the other assets that constitute real property. Thus, a collateralized mortgage obligation may be an obligation principally secured by an interest in real property.

Debt obligations have two or more maturities if they have different stated maturities or if the holders of the obligations possess different rights concerning the acceleration of, or delay in, the maturities of the obligation.ⁿ¹⁸ Debt obligations that are allocated credit risk unequally do not have, for that reason alone, two or more maturities.ⁿ¹⁹

Payments on debt obligations on which an entity is the obligor (liability obligations) bear a relationship to payments on debt obligations an entity holds as assets (asset obligations) if, under the terms of the liability obligations (or underlying arrangement), the timing and amount of payments on the liability obligations are, in large part, determined by the timing and amount of payments (or projected payments) on the asset obligations.ⁿ²⁰ For purposes of the relationship test, any payment arrangement that achieves a substantially similar result is treated as satisfying the test.ⁿ²¹ Payments on liability obligations of an entity do not bear a relationship to payments on asset obligations of the entity if: (1) the entity's organizational documents manifest clearly that the entity is formed for the primary purpose of liquidating its assets and distributing proceeds of liquidation; (2) the entity's activities are all reasonably necessary to and consistent with the accomplishment of liquidating assets; (3) the entity plans to satisfy at least 50 percent of the total issue price of each of its liability obligations having a different maturity with proceeds from liquidation and not with scheduled payments on its asset obligations; and (4) the terms of the entity's liability obligations (or underlying arrangements) provide that, within three years of the time it first acquires assets to be liquidated, the entity either liquidates, or begins to pass through without delay all payments it receives on its asset obligations (less reasonable allowances for expenses)

as principal payments on its liability obligations in proportion to the adjusted issue prices of the liability obligations.ⁿ²²

An entity that otherwise would be treated as a TMP may elect to be a REIT, if it can meet the requirements for such entities.ⁿ²³ If it does, a portion of the income of the REIT will be treated in the same manner as income subject to the special rules governing excess inclusions by holders of a residual interest in a REMIC.ⁿ²⁴ In addition, the dividends paid to the shareholders of the REIT will be subject to the same rules.ⁿ²⁵

A portion of an entity that meets the definition of a TMP can be treated as such.ⁿ²⁶ A portion of an entity includes all assets that support one or more of the same issues of debt obligations.ⁿ²⁷ An asset supports a debt obligation if, under the terms of the debt obligation (or underlying arrangement), the timing and amount of payments on the debt obligation are, in large part, determined, directly or indirectly, by the timing and amount of payments (or projected payments) on the assets or group of assets that includes the asset. A portion does not include assets that are unlikely to produce any significant cash flows for the holders of the debt obligations.ⁿ²⁸

An asset that qualifies as a credit enhancement contract (or an asset that serves the same function as a credit enhancement contract) is not included in a portion as a separate asset.ⁿ²⁹ An asset is not included in a portion solely because the holders of the debt obligations have recourse to the holder of the asset.ⁿ³⁰

A portion of an entity is treated as the obligor of all debt obligations supported by the assets in that portion.ⁿ³¹

FOOTNOTES:

(n1)Footnote 1. HR Rep No 841, 99th Cong, 2d Sess II-239 (1986). The regulations state that the purpose of the TMP provisions is to prevent income generated by a pool of real estate mortgages from escaping federal income taxation when the pool is used to issue multiple class mortgage-backed securities. *Treas Reg § 301.7701(i)-1(a)*.

(n2)Footnote 2. *IRC § 7701(i)(1)*. The TMP provisions apply to entities or portions of entities that qualify for REMIC status but do not elect to be taxed as REMICs, as well as to certain entities or portions of entities that do not qualify for REMIC status. *Treas Reg § 301.7701(i)-1(a)*.

An entity that is classified as a TMP may not elect to be an S corporation or maintain S corporation status. *Treas Reg § 301.7701(i)-4(c)(1)*.

(n3)Footnote 3. *IRC § 7701(i)(2)(A)*. An entity must use the federal income tax basis of an asset in determining whether it meets the asset composition test. *Treas Reg § 301.7701(i)-1(c)(1)*.

An entity is classified as a TMP on the first testing day that it meets the definition of a TMP. Once an entity is so classified, that classification continues through the day the entity retires its last related debt obligation. *Treas Reg § 301.7701(i)-3(c)(1)*. A testing day is any day on or after Sept 6, 1995, on which an entity issues a related debt obligation (an obligation whose payments bear a relationship to payments on debt obligations that the entity holds as assets) that is significant in amount. *Treas Reg § 301.7701(i)-3(b)(3), (c)(2)*.

For purposes of determining whether an entity meets the definition of a TMP, the Commissioner can disregard or make adjustments to a transaction (or series of transactions) if the transaction (or series) is entered into with a view to achieving the same economic effect of an arrangement subject to the provisions of *IRC § 7701(i)* while avoiding the application of that section. *Treas Reg § 301.7701(i)-1(g)(1)*.

An entity cannot be classified as a TMP if (i) the entity is a state, territory, possession of the US, the District of Columbia, or any political subdivision thereof, or is empowered to issue obligations on behalf of one of the foregoing; (2) the entity issues the debt obligations in the performance of a governmental purpose; and (iii) the entity holds the remaining interests in all assets that support those debt obligations until the debt obligations issued by the entity are

retired. *Treas Reg* § 301.7701-4(a)(1).

(n4)Footnote 4. *Treas Reg* § 301.7701(i)-1(c)(2)(i).

(n5)Footnote 5. *Treas Reg* § 301.7701(i)-1(c)(2)(ii).

(n6)Footnote 6. *Treas Reg* § 301.7701(i)-1(c)(3).

(n7)Footnote 7. *Treas Reg* § 301.7701(i)-1(c)(4)(i).

(n8)Footnote 8. *Treas Reg* § 301.7701(i)-1(c)(4)(ii).

(n9)Footnote 9. *Treas Reg* § 301.7701(i)-1(c)(5)(i).

(n10)Footnote 10. *Treas Reg* §§ 301.7701(i)-1(c)(5)(i), 301.7701(i)-1(c)(5)(ii)(A). Whether an entity anticipates receiving payments with respect to a mortgage is based on all the facts and circumstances. *Treas Reg* § 301.7701(i)-1(c)(5)(ii)(A). However, an entity is treated as not having anticipated receiving payments on the mortgage if 180 days after the testing day, and despite making reasonable efforts to resolve the mortgage, the entity is not receiving payments and has not entered into any agreement to receive payment. *Treas Reg* § 301.7701(i)-1(c)(5)(ii)(C).

(n11)Footnote 11. *Treas Reg* § 301.7701(i)-1(d)(1). Stripped bonds and stripped coupons are discussed in § 17.02[4][c].

(n12)Footnote 12. *Treas Reg* § 301.7701(i)-1(d)(2)(i). Manufactured housing is treated as real property provided the properties qualify as single family residences, without regard to the treatment of the properties under state law. *Treas Reg* § 301.7701(i)-1(d)(2)(ii).

(n13)Footnote 13. *Treas Reg* § 301.7701(i)-1(d)(3)(i).

(n14)Footnote 14. *Treas Reg* § 301.7701(i)-1(d)(3)(ii)(A).

(n15)Footnote 15. *Treas Reg* § 301.7701(i)-1(d)(3)(i).

(n16)Footnote 16. *Treas Reg* § 301.7701(i)-1(d)(3)(ii)(B).

(n17)Footnote 17. *Treas Reg* § 301.7701(i)-1(d)(3)(ii)(A). The provisions of the regulation apply only to obligations issued after Dec 31, 1991.

(n18)Footnote 18. *Treas Reg* § 301.7701(i)-1(e)(1).

(n19)Footnote 19. *Treas Reg* § 301.7701(i)-1(e)(2). Credit risk is the risk payments of principal or interest will be reduced or delayed because of a default on an asset that supports the debt obligation.

(n20)Footnote 20. *Treas Reg* § 301.7701(i)-1(f)(1). Payments on asset obligations include: (i) a payment of principal or interest on an asset obligation, including a prepayment of principal under a credit enhancement contract and a payment from a settlement at a discount that is not substantial; (ii) a payment from a settlement at a substantial discount, if the settlement is arranged prior to the issuance of the liability obligations; and (iii) a payment from the foreclosure on, or sale of, an asset obligation, if arranged prior to the issuance of the liability obligations. *Treas Reg* § 301.7701(i)-1(f)(2).

(n21)Footnote 21. *Treas Reg* § 301.7701(i)-1(f). An example of such an arrangement is one where the timing and amount of payments on liability obligations are determined assets (or an index or other type of model) that have an expected payment by reference to a group of experience similar to that of the asset obligations.

(n22)Footnote 22. *Treas Reg § 301.7701(i)-1(f)(3)*.

(n23)Footnote 23. HR Rep No 841, 99th Cong, 2d Sess II-240 (1986).

(n24)Footnote 24. *IRC § 7701(i)(3)*.

(n25)Footnote 25. *IRC § 7701(i)(3)*.

(n26)Footnote 26. *IRC § 7701(i)(2)(B)*.

(n27)Footnote 27. *Treas Reg § 301.7701(i)-2(a)*.

(n28)Footnote 28. *Treas Reg § 301.7701(i)-2(b)(2)*.

(n29)Footnote 29. *Treas Reg § 301.7701-2(b)(1)*.

(n30)Footnote 30. *Treas Reg § 301.7701-2(b)(3)*.

(n31)Footnote 31. *Treas Reg § 301-7701(i)-2(c)*.



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CHAPTER 13B Financial Asset Securitization Investment Trusts

2-13B Taxation of Securities Transactions 13B.syn

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CHAPTER 13B Financial Asset Securitization Investment Trusts

2-13B Taxation of Securities Transactions § 13B.01

§ 13B.01 Introduction

Securitization is the process of converting one type of asset into another and generally involves the use of an entity separate from the underlying assets. In the case of securitization of debt instruments, the instruments created in the securitization generally have different maturities and characteristics than the debt instruments that are securitized. In 1996, Congress created a new type of statutory entity, a financial asset securitization investment trust ("FASIT"), to facilitate the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans.ⁿ¹ A FASIT generally will not be taxable;ⁿ² its taxable income and net loss will flow through to the owner of the FASIT.

FOOTNOTES:

(n1)Footnote 1. The legislation was contained in § 1621 of the Small Business Job Protection Act of 1996. It took effect on Sept 1, 1997. See generally, Nirenberg, Burke & Kopp, "FASITS--The Small Business Act's New Securitization Vehicle," *85 J Tax'n* 278 (1996) .

(n2)Footnote 2. *IRC § 860H(a)* provides that "a FASIT as such shall not be subject to taxation... (and shall not be treated as a trust, partnership, corporation, or taxable mortgage pool)."



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CHAPTER 13B Financial Asset Securitization Investment Trusts

2-13B Taxation of Securities Transactions § 13B.02

§ 13B.02 Financial Asset Securitization Investment Trust Defined

A FASIT is any entity (a) for which an election to be treated as a FASIT applies for the taxable year, (b) all of the interests in which are regular interests or the ownership interest, (c) that has only one ownership interest and that interest is held by an eligible corporation (the "owner"), (d) as of the close of the third month beginning after the day of its formation and at all times thereafter, substantially all of the assets of which (including assets treated as held by the entity under *IRC Section 860I(b)(2)*) consist of permitted assets, and (e) that is not a regulated investment company.ⁿ¹ A segregated pool of assets can be a FASIT if the initial assets of the pool are clearly identified, such as through an indenture, and changes in the assets of the pool are clearly identified, such as through instruments of conveyance or release.ⁿ² Notwithstanding the foregoing, a FASIT cannot be an entity created or organized under the law of a foreign country or a possession of the United States, an entity any of the income of which is or ever has been subject to net tax by a foreign country or a possession of the United States, or a segregated pool of assets any of the income of which at any time is subject to net tax by a foreign country or possession of the United States.ⁿ³

Any entity or segregated pool of assets meeting the requirements of the preceding paragraph can elect to be treated as a FASIT.ⁿ⁴ The election applies to the taxable year for which it is made and all subsequent taxable years unless revoked with the consent of the Service.ⁿ⁵ If an entity ceases to be a FASIT at any time during the taxable year, it will not be treated as a FASIT after the date of cessation.ⁿ⁶ Rules similar to the rules of *IRC Section 860D(b)(2)(B)* (governing the inadvertent termination of a REMIC) will apply to inadvertent failures to qualify or remain qualified as a FASIT.ⁿ⁷

[1] Permitted Assets

The permitted assets of a FASIT consist of (1) cash or cash equivalents, (2) any debt instrument (bond, debenture, note, or certificate or other evidence of indebtedness) under which interest payments (or other similar amounts), if any, at or before maturity (a) are payable on a fixed rate (or to the extent provided in regulations, at a variable rate), or (b) consist of a specified portion of the interest payments on qualified mortgages and such portion does not vary during the period the interest is outstanding, or any contract to acquire such a debt instrument, (3) foreclosure property, (4) any asset (a) that is an interest rate or foreign currency notional principal contract, letter of credit, insurance, guarantee against payment defaults, or other similar instrument permitted by the Service, and (b) that is reasonably required to guarantee or hedge against the FASIT's risks associated with being the obligor on interests issued by the FASIT, or any contract to acquire such an asset, (5) any regular interest in another FASIT, and (6) any regular interest in a REMIC.ⁿ¹

A debt instrument is permitted property if it is:

- (i) a fixed rate debt instrument, including a debt instrument having more than one payment schedule for which a single yield can be determined under *Regulations Section 1.1272-1(c)* or (d);
- (ii) a variable rate debt instrument within the meaning of *Regulations Section 1.1275-5*, if the debt instrument provides for interest at a qualified floating rate within the meaning of *Regulations Section 1.1275-5(b)*;
- (iii) a REMIC regular interest;
- (iv) a FASIT regular interest (including a FASIT regular interest issued by another FASIT in which the owner or a related person holds an ownership interest);
- (v) an inflation-indexed debt instrument as defined in *Regulations Section 1.1275-7*;
- (vi) any receivable generated through an extension of credit under a revolving credit account, such as a credit card account;
- (vii) a stripped bond or stripped coupon (as defined in *IRC Section 1286(e)(2)* and (3)), if the debt instrument is created under one of the foregoing categories of debt instruments; and
- (viii) a certificate of trust representing a beneficial interest in a debt instrument described above.ⁿ²

A debt instrument is not a permitted debt instrument if it can be converted into or exchanged for an ownership interest, or if payments on the instrument are determined by reference or contingent upon the value of any asset that is not a permitted asset.ⁿ³ A debt instrument also is not a permitted asset if it is in default on the date acquired by the FASIT, unless the owner has a reasonable expectation that all delinquent payments will be paid within 90 days after the instrument is first held by the FASIT.ⁿ⁴

Generally, the permitted assets of a FASIT cannot include any debt instrument issued by the owner or by any related person, or any direct or indirect interest in the debt instrument.ⁿ⁵ The prohibition extends (i) to a debt instrument that is guaranteed by the owner (or a related person) and, based upon all of the facts and circumstances existing at the time the guarantee is given, or at the time the FASIT acquires the debt instrument, the owner or related person is, in substance, the primary obligor on the debt instrument; and (ii) to a debt instrument that is issued by a person other than the owner or a related person if the timing or amount of payments on the instrument are determined by reference to, or contingent on, the timing or amount of payments made on a debt instrument issued by the owner or a related person.ⁿ⁶

A debt instrument is not a permitted asset if the instrument is a partial interest such as a stripped bond or stripped coupon in a debt instrument that is not a permitted debt instrument.ⁿ⁷ Foreign debt is not a permitted asset if the debt instrument is traded on an established securities market and the interest is subject to tax on a gross basis.ⁿ⁸

Foreclosure property is property that would be treated as such if acquired by a real estate investment trust and that is acquired in connection with the default or imminent default of a debt instrument held by the FASIT unless the security interest in the property was created for the principal purpose of permitting the FASIT to invest in the property.ⁿ⁹ In the case of property other than real property or personal property incident to real property, regulations can provide for a reduction in the grace period and extensions thereof applicable in the case of foreclosure property held by a real estate investment trust.ⁿ¹⁰

A hedge or guarantee is a permitted hedge only if it is reasonably required to offset any differences that one of four risk

factors may cause between the amount or timing of receipts on assets that the FASIT holds (or expects to hold) and the amount or timing of payments on regular interests the FASIT has issued (or expects to issue).ⁿ¹¹ The specified risk factors are fluctuations in market rates; fluctuations in currency exchange rates; the credit quality of, or default on, the FASIT's assets or debt instruments underlying the FASIT's assets; and the receipt of payments on the FASIT's assets earlier or later than originally anticipated. The hedge or guarantee cannot reference an asset other than a permitted asset.ⁿ¹² It also cannot reference an index, economic indicator, or financial average that is not both widely disseminated and designed to correlate closely with changes in one of the four specified risk factors. (However, the hedge or guarantee need not be associated with any of the FASIT's assets or regular interests, or any group of its assets or regular interests, if the hedge or guarantee offsets one of the specified risks.)ⁿ¹³ Lastly, a hedge or guarantee is not a permitted hedge if, at the time it is entered into, it in substance creates an investment in the FASIT.ⁿ¹⁴

Generally, a hedge or guarantee issued by the owner is not a permitted asset. An exception is made for a hedge contract if (a) the owner or related person regularly provides, offers, or sells substantially similar contracts in the ordinary course of its trade or business; (b) on the date the contract is acquired by the FASIT (and on any later date that it is substantially modified) its terms are consistent with the terms that would apply in the case of an arm's-length transaction between unrelated parties; and (c) the owner maintains records that show the terms of the contract are consistent with the terms that would apply in the case of an arm's-length transaction, and explain how the owner or related person determined the consideration for the hedge contract.ⁿ¹⁵ A guarantee contract is a permitted asset only if it is a credit enhancement contract, and the value of all guarantee contracts issued by the owner and related persons is less than 3 percent of the value of all the FASIT's assets.ⁿ¹⁶

Two additional rules apply in determining whether assets are permitted assets. Under the first, a lender's position in a contract or agreement in the nature of a line of credit (other than a contract or agreement that is originated by the FASIT) can be a permitted asset.ⁿ¹⁷ The contract or agreement is not subject to the gain recognition rules of *IRC Section 860I(a)* at the time the contract or agreement is transferred to the FASIT; extensions of credit under the contract or agreement are.

The second relates to transfers of permitted hedges or permitted debt instruments to a FASIT.ⁿ¹⁸ An owner or related person cannot transfer a hedge or debt instrument traded on an established securities market for less than fair market value. A hedge or debt instrument that is not traded on an established securities market cannot be transferred for less than 90 percent of its value.

[2] Financial Asset Securitization Investment Trust Interests

The Code provides for three interests in a FASIT—a regular interest, a high-yield interest, and an ownership interest. A regular interest in a FASIT is any interest that is issued by a FASIT on or after the startup date with fixed terms and that is designated as a regular interest if (1) the interest unconditionally entitles the holder to receive a specified principal amount (or other similar amount), (2) interest payments (or other similar amounts), if any, with respect to the interest are determined on a fixed rate, or, except as otherwise provided by the Service, at a variable rate specified in regulations, (3) the interest does not have a stated maturity (including options to renew) greater than 30 years (or such longer period as may be permitted by regulations), (4) the issue price of the interest does not exceed 125 percent of its state principal amount, and (5) the yield to maturity is less than the applicable federal rate in effect under *IRC Section 1274(d)* for the calendar month in which the obligation is issued plus five percentage points.ⁿ¹ An interest will not fail to meet the first requirement merely because the timing (but not the amount) of the principal payments (or other similar amounts) may be contingent to the extent that payments on debt instruments held by the FASIT are made in advance of anticipated payments and on the amount of income from permitted assets.

A high-yield interest is a regular interest that would be treated as such except for the fact that it fails to meet one or more of the clauses in the first, fourth, or fifth requirements, or fails to meet the second requirement but only if interest payments (or other similar amounts), if any, with respect to the interest consist of a specified portion of the interest

payments on permitted assets and the portion does not vary during the period the interest is outstanding.ⁿ²

An ownership interest is any interest issued by a FASIT after the startup date that is designated as an ownership interest and that is not a regular interest.ⁿ³

FOOTNOTES:

(n1)Footnote 1. *IRC § 860L(a)(1)*. Substantially all of the assets held by a FASIT consist of permitted assets if the total adjusted bases of the permitted assets is more than 99 percent of the total adjusted bases of all of the assets held by the FASIT, including those assets deemed to be held under *IRC § 860I(b)(2)*. *Prop Treas Reg § 1.860H-2(a)*. The asset requirement does not apply during the period of a qualified liquidation of a FASIT.

An eligible corporation is defined as any domestic C corporation other than (i) a corporation that is exempt from, or is not subject to, federal income taxation, (ii) a regulated investment company or real estate investment trust, (iii) a REMIC, or (iv) a cooperative. *IRC § 860L(a)(2)*.

(n2)Footnote 2. *Prop Treas Reg § 1.860H-1(a)(2)(i)*.

(n3)Footnote 3. *Prop Treas Reg § 1.860H-1(a)(3)*.

(n4)Footnote 4. *IRC § 860L(a)(3)*. The election must be made by an eligible corporation. *Prop Treas Reg § 1.860H-1(b)(1)*. If the FASIT is an entity, the eligible corporation making the election must hold one or more interests in the entity, and one of those interests must be the interest designated as the FASIT's ownership interest. If it is a segregated pool of assets, the eligible corporation must be the first taxpayer to be treated as the owner of the resulting FASIT.

(n5)Footnote 5. *IRC § 860L(a)(3)*. The election is made by a statement attached to the original federal income tax return of the eligible corporation's taxable year in which the FASIT's startup day occurs; the election cannot be made on an amended return. *Prop Treas Reg § 1.860H-1(b)(3)*. The contents of the statement and the required signatures are specified in *Prop Treas Reg § 1.860H-1(b)(4)* and (5), respectively.

(n6)Footnote 6. *IRC § 860L(a)(4)*.

(n7)Footnote 7. *IRC § 860L(a)(5)*. See § 13A.02 for a discussion of *IRC § 860D(b)(2)(B)*.

(n8)Footnote 1. *IRC §§ 860G(a)(1)(B), 860L(c)(1), 1275(a)(1)*.

(n9)Footnote 2. *Prop Treas Reg § 1.860H-2(b)(1)*. A person is related to another person if the related person bears a relationship specified in *IRC § 267(b)* or *707(b)(1)* (using a 20 percent threshold instead of 50 percent) or the persons are engaged in trades or businesses under common control within the meaning of *IRC § 52(a)* and (b). *IRC § 860L(g)*.

(n10)Footnote 3. *Prop Treas Reg § 1.860H-2(b)(3)(i)*

(n11)Footnote 4. *Prop Treas Reg § 1.860H-2(b)(3)(ii)*.

(n12)Footnote 5. *IRC § 860L(c)(2)*; *Prop Treas Reg § 1.860H-2(b)(3)(iii)*. By statute, the prohibition does not extend to cash or cash equivalents--the US dollar, other currency received as a payment on a permitted asset or required to make payments on regular interests, a permitted debt instrument with a remaining maturity of 270 days or less and rated as investment quality by a national rating organization not related to the issuer, and shares in US dollar denominated money market funds. *Prop Treas Reg § 1.860H-2(c)*. By regulation it does not apply to a fixed rate or variable rate debt instrument that would be a permitted asset if not issued by the owner or a related person, if the instrument has an original stated maturity of 270 days or less, is rated as investment quality by a national rating organization not related to the issuer, and is acquired as a temporary investment of cash awaiting either reinvestment in

permitted assets or distribution to the owner or to holders of regular interests. *Prop Treas Reg § 1.860H-2(b)(2)*.

(n13)Footnote 6. *Prop Treas Reg § 1.860H-2(b)(3)(iv)*, (v). A guarantee includes any promise to pay in the case of the default or imminent default of any debt instrument.

(n14)Footnote 7. *Prop Treas Reg § 1.860H-2(b)(3)(vi)*.

(n15)Footnote 8. *Prop Treas Reg § 1.860H-2(b)(3)(vii)*. The prohibition does not apply if the tax is in the nature of a prepayment on a tax imposed on a net basis.

(n16)Footnote 9. *IRC § 860L(c)(3)(A)*. The election to treat property as foreclosure property required in the case of a real estate investment trust is not required of a FASIT.

(n17)Footnote 10. *IRC § 860L(c)(3)(B)*. The subject of foreclosure property for real estate investment trusts can be found in § 13.02[2][b][ii].

If foreclosure property qualifies as another type of permitted asset, the FASIT can hold the property beyond the grace period. *Treas Reg § 1.860H-2(f)*. However, immediately after the grace period ends, the taxpayer must recognize gain, if any, as if the property had been contributed to the FASIT on that date. In addition, after the close of the grace period, disposition of the property is subject to the prohibited transactions tax imposed under *IRC § 860L(e)* without the benefit of the exception for foreclosure property.

(n18)Footnote 11. *Prop Treas Reg § 1.860H-2(d)(1)*.

(n19)Footnote 12. *Prop Treas Reg § 1.860H-2(d)(2)*.

(n20)Footnote 13. *Prop Treas Reg § 1.860H-2(d)(3)*.

(n21)Footnote 14. *Prop Treas Reg § 1.860H-2(d)(4)*.

(n22)Footnote 15. *Prop Treas Reg § 1.860H-2(e)(1)*.

(n23)Footnote 16. *Prop Treas Reg § 1.860H-2(e)(2)*.

(n24)Footnote 17. *Prop Treas Reg § 1.860H-2(g)*.

(n25)Footnote 18. *Prop Treas Reg § 1.860H-2(h)*.

(n26)Footnote 1. *IRC §§ 163(i)(1)(B), 860G(a)(1)(B)(i), 860L(b)(1)(A)*. The startup date is the date designated in the election to be a FASIT as the startup day of the FASIT. The day is the beginning of the first taxable year of the FASIT. *IRC § 860L(d)(1)*.

The issue price of a FASIT regular interest not issued for property is its purchase price. If issued for property, the issue price is the fair market value of the regular interest on the issue date. *Prop Treas Reg § 1.860H-4(a)*.

(n27)Footnote 2. *IRC § 860L(b)(1)(B)*.

(n28)Footnote 3. *IRC § 860L(b)(2)*. An ownership interest is treated as a security for purposes of the wash sale rule of *IRC § 1091*. *IRC §§ 860F(d), 860L(f)(1)*.



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CHAPTER 13B Financial Asset Securitization Investment Trusts

2-13B Taxation of Securities Transactions § 13B.03

§ 13B.03 Treatment of Interests in a Financial Asset Securitization Investment Trust

[1] Holder of the Ownership Interest

[a] Taxation of the Holder of the Ownership Interest. In determining the taxable income of the owner, (1) all assets, liabilities, and items of income, gain, deduction, loss, and credit of a FASIT are treated as assets, liabilities and items of the owner, (2) the constant yield method (including the rules of *IRC Section 1272(a)(6)*, relating to the determination of the daily portions of original issue discount where the principal of a debt instrument is subject to acceleration) is applied under an accrual method of accounting in determining all interest, acquisition discount, original issue discount and market discount, and all premium deductions or adjustments with respect to each debt instrument of the FASIT, (3) any item of income, gain, or deduction allocable to a prohibited transaction is not taken into account, and (4) when taken into account by the owner, tax-exempt interest accrued by the FASIT is treated as ordinary income.ⁿ¹

For any taxable year the owner cannot offset income or gain from the FASIT ownership interest (including gain or loss from the sale of the ownership interest) with any non-FASIT losses.ⁿ² Any net operating loss carryover of the owner in a FASIT is computed by disregarding any income arising by reason of a disallowed loss.ⁿ³

For purposes of the alternative minimum tax, the taxable income of the owner is determined without regard to the minimum FASIT income.ⁿ⁴ In addition, the alternative minimum taxable income of the owner for any taxable year cannot be less than the FASIT income for that year, and minimum FASIT income is disregarded in computing the alternative minimum tax net operating loss deduction.ⁿ⁵

[b] Transfers of Property to a Financial Asset Securitization Investment Trust by the Holder of the Ownership Interest. If property is sold or contributed to a FASIT by the owner (or by a related person), gain, if any, will be recognized to the owner (or related person) in an amount equal to the excess of the property's value on the date of sale or contribution over its adjusted basis on that date.ⁿ⁶ (The gain recognition rule also applies to transfers by the owner to holder of regular interests in the FASIT.)ⁿ⁷ Property acquired by a FASIT from a person other than the owner (or a related person) is treated as having been acquired by the owner for an amount equal to the FASIT's cost of acquiring the property, and as having been sold by the owner to the FASIT at its value on the acquisition date.ⁿ⁸ If property held by the owner (or by a related person) supports any regular interest in the FASIT gain will be recognized to the owner (or related person) in the same manner as if the property had been sold to the FASIT at its value on the earliest date that the property supports the regular interest.ⁿ⁹ Gain recognition also is required when the FASIT acquires foreclosure property and holds it beyond the grace period.ⁿ¹⁰ Gain required to be recognized under the foregoing rules

must be recognized notwithstanding any other provision of the Code, although regulations can provide that gain otherwise recognized can be deferred until the earliest date on which the property acquired by the FASIT supports any regular interest in the FASIT or any indebtedness of the owner (or of any related person).ⁿ¹¹ The basis of any property on which gain is recognized is increased by the amount of gain so recognized.ⁿ¹²

In determining the amount of gain, the value of any debt instrument that is not traded on an established securities market is the sum of the present values of the reasonably expected payments under the instrument as of the date of gain recognition, discounted at a rate equal to 120 percent of the applicable federal rate, compounded semiannually.ⁿ¹³ The value of any other property is its fair market value.ⁿ¹⁴ For purposes of determining the value of a pool of revolving loan accounts having the same terms, each extension of credit (other than the accrual of interest) is treated as a separate debt instrument and payments are applied to the earliest credit extension.ⁿ¹⁵

In the case of the owner in a pre-effective date FASIT (any FASIT for which the election to be such is in existence on August 31, 1997), gain will not be recognized on property deemed contributed to the FASIT under *IRC Section 860L(d)(2)* (property held by the FASIT on the startup date), nor will gain be recognized under *IRC Section 860I* on property contributed to the FASIT until the property ceases to be properly allocable to a pre-FASIT interest.ⁿ¹⁶ Property will be allocated to a pre-FASIT interest (any interest in a pre-effective date FASIT that was issued before the startup date, other than any interest held by the owner in the FASIT) in such manner as the Service may prescribe, except that all property in a FASIT will be treated as properly allocable to pre-FASIT interests if the fair market value of all such property does not exceed 107 percent of the aggregate principal amount of all outstanding pre-FASIT interests.

[c] Income From Prohibited Transactions. The owner is required to pay a tax equal to 100 percent of the net income derived from a prohibited transaction, defined as (1) the receipt of any income from an asset that is not a permitted asset, (2) the disposition of a permitted asset (other than foreclosure property) except in a permitted disposition, (3) the receipt of any income derived from a loan originated by the FASIT, and (4) the receipt of income representing a fee or compensation for services (other than fees for a waiver, amendment, or consent under permitted assets (other than foreclosure property) held by the FASIT).ⁿ¹⁷ A permitted disposition is any disposition of a permitted asset (1) arising from complete liquidation of a class of regular interests (a qualified liquidation), (2) incident to the foreclosure, default, or imminent default of the asset, (3) incident to the bankruptcy or insolvency of the FASIT, (4) necessary to avoid a default on any indebtedness of the FASIT attributable to a default (or imminent default) on an asset of the FASIT, (5) to facilitate a clean-up call, or (6) to substitute a permitted debt instrument for another such instrument if the FASIT were treated as a REMIC and permitted assets (other than cash or cash equivalents) were treated as qualified mortgages.ⁿ¹⁸ A permitted disposition also includes one made in order to reduce over-collateralization where a principal purpose was not to avoid recognition of gain arising from an increase in its market value after its acquisition by the FASIT. Deductions directly attributable to prohibited transactions are allowed in computing net income from such transactions, except that no item attributable to any prohibited transaction for which there was a loss can be taken into account.ⁿ¹⁹

[2] Holders of Regular Interests

A holder of a regular interest in a FASIT, including a high-yield interest, is taxed in the same manner as a holder of any debt instrument, except that the holder is required to account for income relating to the interest under an accrual method of accounting, irrespective of the method of accounting normally used by the holder.ⁿ¹

If, during the same period, a foreign resident holds a regular interest in a FASIT (either directly or through a vehicle not subject to federal income tax), and the FASIT holds a debt instrument issued by a conduit debtor, any interest paid or accrued on the debt instrument is deemed to be received or accrued by the foreign resident directly from the conduit debtor.ⁿ² The amount treated as received directly from the conduit debtor is limited to the lesser of the income received or accrued by the foreign resident with respect to the FASIT regular interest, or the amount paid or accrued by the

conduit debtor with respect to the debt instrument.ⁿ³ A conduit debtor must be either a United States resident or a foreign resident that can deduct interest expense incurred in carrying on a United States trade or business.ⁿ⁴ The foreign resident must be (i) a 10-percent shareholder of the debtor; (ii) a controlled foreign corporation, but only if the debtor is a related person within the meaning of *IRC Section 864(d)(4)*; or (iii) related to the debtor within the meaning of *IRC Section 267(b)* or *707(b)(1)*.ⁿ⁵

[3] Holders of High-Yield Interests

If a high-yield interest is held by a disqualified holder (a holder other than an eligible corporation or a FASIT), the gross income of the holder does not include any income (other than gain) attributable to the interest, and amounts not so includable must be included in the gross income of the most recent holder of the interest that is not a disqualified holder; the income is includable at the time it would have been had the holder not been a disqualified holder.ⁿ¹ The rule does not apply to a high-yield interest held by a disqualified holder if the holder is a dealer in securities who acquired the interest exclusively for sale to customers in the ordinary course of business (and not for investment).ⁿ² An excise tax is imposed at the highest corporate rate if the dealer ceases to be a dealer in securities or if the holding is for investment purposes.ⁿ³ However, as a general rule, a dealer is not treated as holding the interest for investment before the end of a 31-day grace period.ⁿ⁴

If a pass-through entity (a regulated investment company, real estate investment trust, common trust fund, partnership, trust, estate or cooperative)ⁿ⁵ issues either debt or equity instruments (1) that are secured by regular interests in a FASIT, and bear a yield to maturity greater than both (a) the yield on the regular interests and (b) the applicable federal rate plus five percentage points (determined on the date the pass-through entity acquires the regular interests in the FASIT), and (2) the pass-through entity issued the debt or equity with a principal purpose of avoiding the rule that high-yield interests be held by corporations, an excise tax is imposed on the pass-through entity at a rate equal to the highest corporate rate on the income of the holder of any such instrument attributable to the regular interests.ⁿ⁶

Holders of high-yield interests are not allowed to use net operating losses to offset any income derived from the high-yield debt.ⁿ⁷ Any net operating loss carryover is computed by disregarding any income arising by reason of the disallowed loss.ⁿ⁸

FOOTNOTES:

(n1)Footnote 1. *IRC § 860H(b)*.

(n2)Footnote 2. *IRC § 860J(a)*. *IRC § 860E(a)(1)*, the rule that limits a taxpayer's ability to offset REMIC excess inclusions against net operating losses, applies here as well. See § 13A.05[2] for a discussion of *IRC § 860E(a)(1)*.

All members of an affiliated group filing a consolidated return are treated as one taxpayer in applying this rule and the others in *IRC § 860J*. *IRC § 860J(d)*.

(n3)Footnote 3. *IRC § 860J(b)*.

(n4)Footnote 4. *IRC § 860J(c)(1)*.

(n5)Footnote 5. *IRC § 860J(c)(2), (3)*.

(n6)Footnote 6. *IRC § 860I(a)(1)*. All property held by the FASIT on the startup day is treated as contributed to the entity on that day by the owner. *IRC § 860L(d)(2)*.

If any security that was sold or contributed to a FASIT by the owner was required to be marked-to-market under *IRC § 475* by the holder, *IRC § 475* will continue to apply to the security, except that in applying *IRC § 475* while the security is held by the FASIT, the fair market value of the security for purposes of *IRC § 475* cannot be less than its

value under *IRC § 860I(d)*. *IRC § 860L(f)(2)*.

Under authority granted to the Service to change this result, *Prop Treas Reg § 1.860H-6(d)(1)* provides that mark-to-market accounting does not apply to any permitted asset while it is held or deemed held by a FASIT.

If an owner transfers a permitted asset to a FASIT and the asset would have been marked to market if the taxable year had ended immediately before the transfer, then immediately before the transfer the owner must mark the asset to market and take gain into account as if the taxable year had ended at that point. *Prop Treas Reg § 1.860H-6(d)(2)*. Additional gain may be required if the asset is a debt instrument.

(n7)Footnote 7. *Prop Treas Reg § 1.860I-1(a)*.

(n8)Footnote 8. *IRC § 860I(a)(2)*. Except in the case of property traded on an established securities market, property transferred by a related person to a FASIT or its regular interest holders is treated as having been transferred by the related person to the owner for the property's fair market value, and then transferred by the owner to the FASIT. *Prop Treas Reg § 1.860I-1(g)*.

(n9)Footnote 9. *IRC § 860I(b)*. Property is support property if the owner or a related person (i) pledges the property to pay a FASIT regular interest or identifies the property as providing security for such payments, (ii) sets aside the property for transfer to a FASIT under an agreement or understanding, or (ii) holds an interest in the property that is subordinate to the FASIT's interest therein. *Prop Treas Reg § 1.860I-1(b)*.

(n10)Footnote 10. *Prop Treas Reg § 1.860I-1(a)(1)(iii)*.

(n11)Footnote 11. *IRC §§ 860I(c)(1), 860I(e)(1)*. Any regulations providing deferral of gain recognition must also provide adjustments to other FASIT provisions to the extent appropriate in the context of such deferral. *IRC § 860I(c)(2)*.

(n12)Footnote 12. *IRC § 860I(e)(2)*.

(n13)Footnote 13. *IRC § 860I(d)(1)(A)*. Reasonably expected payments on an instrument must be determined in a commercially reasonable manner and may take into account reasonable assumptions concerning early payments, late payments, nonpayments, and loan servicing costs; no other assumptions may be considered. *Prop Treas Reg § 1.860I-2(c)(1)*. The assumptions must be consistent with a set of categories in the order specified in *Prop Treas Reg § 1.860I-2(c)(2)*.

(n14)Footnote 14. *IRC § 860I(d)(1)(B)*.

(n15)Footnote 15. *IRC § 860I(d)(2)*.

(n16)Footnote 16. A pre-FASIT interest is an interest in a pre-effective date FASIT that was issued before Feb 4, 2000; was outstanding on the date the FASIT election goes into effect; and is considered debt of the owner under general income tax principles. *Prop Treas Reg § 1.860L-3(a)(2)*.

(n17)Footnote 17. *IRC § 860L(e)(1), (2)*. An exception to this rule relates to income from the disposition of an asset that, when first acquired by the FASIT, was a permitted asset because it was an interest rate or foreign currency hedge, but was not such at the time of disposition. The exception extends to dispositions of contract rights to acquire such assets. *IRC § 860L(e)(3)(D)*.

(n18)Footnote 18. *IRC § 860L(e)(3)*; see also *IRC § 860F(a)(2)*.

(n19)Footnote 19. *IRC §§ 860F(a)(3), 860L(e)(4)*.

(n20)Footnote 1. *IRC § 860H(c).*

(n21)Footnote 2. *Prop Treas Reg § 1.860H-5(a).*

(n22)Footnote 3. *Prop Treas Reg § 1.860H-5(c).*

(n23)Footnote 4. *Prop Treas Reg § 1.860H-5(b).*

(n24)Footnote 5. *Prop Treas Reg § 1.860H-5(b).* For this purpose, a 10-percent shareholder is a person who owns 10 percent or more of the total combined voting of all classes of stock of the corporation conduit debtor, or, if the instrument is issued by a partnership, a person who owns 10 percent or more of the capital or profits interest in the partnership. *IRC § 871(h)(3)(B).*

(n25)Footnote 1. *IRC § 860K(a), (c).* Thus, the transferor of the high-yield interest will continue to be taxed on the interest unless the transferee provides the transferor with an affidavit that the transferee is not a disqualified person, or the Service determines that the high-yield interest is no longer held by a disqualified person and a corporate tax has been paid on the income from the high-yield interest while it was held by a disqualified person. *IRC §§ 860E(e)(4), (7), 860K(b).* *Prop Treas Reg § 1.860E-2(a)(7)(ii).*

(n26)Footnote 2. *IRC § 860K(d)(1).*

(n27)Footnote 3. *IRC § 860K(d)(2)(A).* The excise tax is imposed on income of the dealer attributable to the interest for periods after the date of the change in the dealer's status or purpose in holding the interest.

(n28)Footnote 4. *IRC § 860K(d)(2)(B).*

(n29)Footnote 5. *IRC § 860E(e)(6)(B).*

(n30)Footnote 6. *IRC § 860K(e)(1), (2).*

(n31)Footnote 7. *IRC § 860J(b)(1).*

(n32)Footnote 8. *IRC § 860J(b)(2).*



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CHAPTER 13B Financial Asset Securitization Investment Trusts

2-13B Taxation of Securities Transactions § 13B.04

§ 13B.04 Cessation of a Financial Asset Securitization Investment Trust

If a FASIT ceases to be such at any time during the taxable year, it will not be treated as a FASIT after the date of cessation.ⁿ¹ Rules similar to those of *IRC Section 860D(b)(2)(B)* (governing the inadvertent termination of a REMIC) will apply to inadvertent failures to qualify or remain qualified as a FASIT.ⁿ²

The consequences of cessation are as follows:

(1) The FASIT cannot reelect FASIT treatment without the permission of the Internal Revenue Service.ⁿ³ The proper classification of the former FASIT is determined under general income tax principles. Immediately after the cessation, the former FASIT holds the FASIT's assets with a fair market value basis. Any election made (other than the FASIT election), and any method of accounting adopted with respect to those assets continue to be binding. If the former FASIT is a segregated pool of assets, the person holding legal title to the pool is responsible for complying with any tax filing or reporting requirement arising from the pool's operation.

(2) The owner is treated as exchanging the assets of the FASIT for an amount equal to their value.ⁿ⁴ Gain realized on the exchange is treated as gain from a prohibited transaction and the owner is subject to the tax imposed on such transactions without exception. Loss, if any, is disallowed. The determination of gain or loss is made on an asset-by-asset basis.

The owner must recognize cancellation of indebtedness income whenever the adjusted issue prices of the regular interests outstanding before the cessation exceed their fair market value.ⁿ⁵ The owner cannot take any deduction for acquisition premium.

If the owner retains a continuing economic interest in the assets of the former FASIT, the characterization of the interest is made according to general income tax principles.ⁿ⁶ The owner holds the interest with a fair market basis.

(3) Holders of regular interest are treated as exchanging their interests for interests in the former FASIT.ⁿ⁷ Those interests are classified under general income tax principles. Gain must be recognized if the new interest is not classified as debt, or if it is debt that is materially different; no loss can be recognized. The basis of the new interest equals the basis of the old interest increased by any gain that

was recognized.

If the Service finds that the cessation was inadvertent, it can treat the FASIT as continuing or allow a reelection of FASIT status.ⁿ⁸ For this to occur, the Service must find that (1) the cessation was inadvertent, (2) within a reasonable time after discovering the event resulting in the cessation, steps were taken to regain FASIT status, and (3) the former FASIT and each person having an interest in it agree to such adjustments as the Service may require.ⁿ⁹

FOOTNOTES:

(n1)Footnote 1. *IRC § 860L(a)(4)*. The FASIT ceases to be such if it revokes its election with the consent of the Service, or it if fails to qualify as a FASIT and the Service does not find the failure to be inadvertent. *Prop Treas Reg § 1.860H-3(a)*.

(n2)Footnote 2. *IRC § 860L(a)(5)*. See § 13A.02.

(n3)Footnote 3. *Prop Treas Reg § 1.860H-3(c)(1)*.

(n4)Footnote 4. *Prop Treas Reg § 1.860H-3(c)(2)(i)*.

(n5)Footnote 5. *Prop Treas Reg § 1.860H-3(c)(2)(ii)*. The determination is made on a regular interest by regular interest basis.

(n6)Footnote 6. *Prop Treas Reg § 1.860H-3(c)(2)(iii)*.

(n7)Footnote 7. *Prop Treas Reg § 1.860H-3(c)(3)*.

(n8)Footnote 8. *Prop Treas Reg § 1.860H-3(d)(1)*.

(n9)Footnote 9. *Prop Treas Reg § 1.860H-3(d)(2)*.



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CHAPTER 13B Financial Asset Securitization Investment Trusts

2-13B Taxation of Securities Transactions § 13B.05

§ 13B.05 Anti-abuse Rules

IRC Section 860L(h) gives the Service the authority to prescribe regulations to carry out the purpose of the FASIT provisions, "including regulations to prevent the abuse of the purposes of [the FASIT provisions] through transactions which are not primarily related to securitization of debt instruments by a FASIT." According to the Service, implicit in the intent of the FASIT provisions are the following requirements:

- (1) Assets to be securitized through a FASIT are primarily permitted debt instruments.
- (2) The source of principal and interest payments on a FASIT's regular interests is primarily the principal and interest payments on permitted debt instruments held by the FASIT.
- (3) No FASIT provision may be used to achieve a tax result that cannot be achieved without the provision unless the provision clearly contemplates that result.ⁿ¹

If a principal purpose of forming or using a FASIT is inconsistent with the intent of the FASIT provisions, the Service may make appropriate adjustments with respect to the FASIT and any arrangement or transaction involving the FASIT.ⁿ² These adjustments include:

- (1) Disregarding a FASIT election.
- (2) Treating assets of a FASIT as held by a person other than the owner.
- (3) Allocating FASIT income, loss, deduction, or credit to a person other than the owner.
- (4) Disallowing any item of FASIT income, loss, deduction, or credit.
- (5) Treating the ownership interest as held by a person other than the nominal owner.
- (6) Treating a FASIT regular interest as other than a debt instrument.
- (7) Treating a regular interest held by any person as having the same tax characteristics as one or more

assets held by the FASIT.

Whether there has been an abuse is determined on all of the facts and circumstances, including a comparison of the purported business purpose for the transaction and the claimed tax benefits resulting therefrom.ⁿ³

FOOTNOTES:

(n1)Footnote 1. Prop Treas Reg § 860L-2(a).

(n2)Footnote 2. Prop Treas Reg § 860L-2(b).

(n3)Footnote 3. Prop Treas Reg § 860L-2(c).



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CHAPTER 14 The Taxpayer as a Member of a Partnership

2-14 Taxation of Securities Transactions 14.syn

§ 14.syn Synopsis to Chapter 14: The Taxpayer as a Member of a Partnership

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§ 14.02 Tax Consequences to the Partner of Partnership Transactions in Securities

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[3] Sales or Exchanges of Securities--Transactions With Controlled Partnerships

[a] Where the Transaction Results in a Loss.

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§ 14.04 Distributions of Securities by Partnerships

[1] Consequences to the Partner

[a] Treatment of Gains and Losses

[i] Current Distributions.

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CHAPTER 14 The Taxpayer as a Member of a Partnership

2-14 Taxation of Securities Transactions § 14.01

§ 14.01 Introduction

Corporations, estates, and trusts are taxable entities; a partnership is not.ⁿ¹ Instead, liability is imposed on the persons carrying on the business as partners, with each being required to take into account his proportionate share of the partnership's income and deduction items whether or not there is actual distribution of the partner's distributive share during the taxable year.ⁿ² The effect of this conduit theory of taxation on the treatment of securities transactions between partnership and third parties, and between partnership and partners is the central theme of this chapter.

FOOTNOTES:

(n1)Footnote 1. *IRC § 701*. The partnership is still required to file an information return. *IRC § 6031*. For a more detailed discussion, see Rabkin & Johnson, 3 *Federal Income, Gift and Estate Taxation*, Ch 16. The taxpayer faced with the task of filing partnership returns should consult Fiore & Orenstein, *How to Save Time and Taxes Preparing the Federal Partnership Return*.

A multi-member limited liability company (LLC) that does not elect to be taxed as a corporation is treated as a partnership. *Treas Reg § 301.7701-3(b)(1)(i)*.

(n2)Footnote 2. *IRC §§ 701, 702; Treas Reg § 1.702-1(a)*.



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CHAPTER 14 The Taxpayer as a Member of a Partnership

2-14 Taxation of Securities Transactions § 14.02

§ 14.02 Tax Consequences to the Partner of Partnership Transactions in Securities

In computing his taxable income for the year, each partner must take into account his distributive share of the combined net amount of long-term capital gains and losses and his distributive share of the combined net amount of short-term capital gains and losses of the partnership.ⁿ¹ Whether the gain or loss is capital or ordinary, long-term or short-term, is determined at the partnership level.ⁿ² Thus, if gain is derived from a sale of stock held for more than six months by a partnership that is not a dealer in securities, the gain will be treated as long-term capital gain by all partners, even those who are dealers in their separate capacities and those who have held their partnership interests for less than six months.ⁿ³

Example:

Axel, a 50-percent partner of the AB partnership, realizes the following gains and losses in his individual capacity:

Long-term capital gain	\$8,000
Long-term capital loss	4,000
Short-term capital gain	5,000
Short-term capital loss	7,000

The partnership has the following gains and losses from sales of securities held for investment:

Long-term capital loss	\$2,000
Short-term capital gain	3,000
Short-term capital loss	1,000

Therefore, Axel must add \$1,000 of the partnership's \$2,000 long-term capital loss and \$1,000 of the partnership's \$2,000 net short-term capital gain to his gains and losses for the year. This gives him a net long-term capital gain of \$3,000 (\$8,000 - \$5,000) and a net short-term capital loss of \$1,000 (\$7,000 - \$6,000).

A partner must also take into account his proportionate share of other partnership income, including dividends and

interest.ⁿ⁴ Here, too, the character of the income to the partner is determined as though the partner had realized the income directly from the same source from which it was realized by the partnership.ⁿ⁵ Thus, if a partnership receives 20 percent of its income in the form of dividends from domestic corporations, 20 percent of each corporate partner's distributive share will qualify for the dividends received deduction of *IRC Section 243*.ⁿ⁶ In similar fashion, all partners can exclude from gross income so much of their distributive shares as consist of tax-exempt interest, while a nonresident alien partner is not taxed on any portion of his distributive share which represents income received by the partnership from foreign sources.ⁿ⁷

Just as a partner is required to take into account his distributive share of the partnership's income, so must he take into account his allocable share of the firm's deductions, treating them as if incurred by him in the same manner as incurred by the partnership.ⁿ⁸ If an expense is a trade or business expense at the partnership level, it remains a trade or business expense, deductible under *IRC Section 162*, when taken into account by the partners. This may give rise to a deduction which otherwise would be unavailable to the partner. For example, a dealer in securities is permitted a deduction for commissions paid on the sale of securities; a trader or investor is not.ⁿ⁹ Therefore, if the partnership is a securities dealer, each partner can deduct his distributive share of such commissions, whether or not he is a dealer in his own right.^{n9.1}

The requirement that a partner take into account his distributive share of partnership deductions may not always give him an extra deduction. The Regulations provide that "each partner shall aggregate the amount of his separate deductions or exclusions and his distributive share of partnership deductions ... separately stated in determining the amount allowable to him of any deduction ... as to which a limitation is imposed."ⁿ¹⁰ As an illustration:

Example:

Suppose that a partner individually incurs \$15,000 of investment interest expense in a year in which he has \$10,000 of net investment income. Suppose further that the partnership incurs investment interest expense of \$10,000 and has no investment income. If the partner's distributive share of the partnership's investment interest expense is \$5,000, so that his total investment expense for the year is \$20,000, he will be allowed a deduction of only \$10,000; all of the partner's aggregate investment interest expense in excess of \$10,000 is disallowed under *IRC Section 163(d)*.ⁿ¹¹

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.702-1(a)(1), (2)*. Thus, a partner's share of partnership gains can offset losses realized in his individual capacity. *Neuberger v Commr, 311 US 83 (1940)*.

The Service has determined that it is appropriate for a partner of an electing large partnership to take into account separately the partner's distributive share of the partnership's dividends received that are qualified dividend income. *Notice 2004-5, 2004-1 CB 489*.

(n2)Footnote 2. *IRC § 702(b)*. The provision states that

"The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share ... shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership."

See generally Wolfman, "Level for Determining Character of Partnership Income--'Entity' v' Conduit' Principle in Partnership Taxation," *NYU 19th Inst on Fed Tax* 287 (1961).

(n3)Footnote 3. *Cf Barham v US, 301 F Supp 43 (MD Ga 1969)*, *affd per curiam 429 F2d 40 (5th Cir 1970)*; *Grove v Commr, 54 TC 799 (1970)*; *Rev Rul 68-79, 1968-1 CB 310*.

(n4)Footnote 4. *IRC § 702(a)(5), (8), (9); Neuberger v Commr, N 1.*

(n5)Footnote 5. *IRC § 702(b).*

(n6)Footnote 6. *Rev Rul 56-233, 1956-1 CB 51* . The partner uses the date on which the partnership received the dividends as his date of receipt.

(n7)Footnote 7. *Craik v US, 31 F Supp 132 (Ct Cl 1940)* .

(n8)Footnote 8. *IRC §§ 702(a)(8), 702(b).*

(n9)Footnote 9. *Treas Reg § 1.263(a)-2(e); Spreckels v Commr, 315 US 626 (1942)* . See Chs 18 and 19.

(n10)Footnote 9.1. On the other hand, if the partnership is not a dealer, then whether or not its investment expenses are deductible under *IRC § 212* depends on whether the partnership entered the transaction for the purpose of making a profit. For this purpose, only the controlling partner's intent is attributed to the partnership. Thus, where the managing partner's primary motivation in entering a transaction was to avoid taxes, the partnership's operational expenses were not deductible by the partnership's non-controlling partners, even though they paid for and bore the economic burden of the expenses (while the managing partner did not) and, unlike the managing partner, expected to make an economic profit. *Klamath Strat Inv Fund v US, 568 F3d 537, 551 (5th Cir 2009)* .

(n11)Footnote 10. *Treas Reg § 1.702-1(a)(8)(iii).*

(n12)Footnote 11. *IRC § 163(d)* limits the deduction of investment interest expense to net investment income and out-of-pocket expenses in excess of rentals derived from property subject to a net lease. See Ch 19.



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CHAPTER 14 The Taxpayer as a Member of a Partnership

2-14 Taxation of Securities Transactions § 14.03

§ 14.03 Securities Transactions Between Partner and Partnership

[1] Contributions of Securities in Exchange for Partnership Interests.

[a] Recognition of Gain or Loss. Under the general rule of *IRC Section 721(a)*, no gain or loss is recognized either to a partnership or to any of its partners when securities are contributed to the partnership in exchange for a partnership interest.ⁿ¹ Under a special rule contained in *IRC Section 721(b)*, any *gain* realized on such a transfer will be recognized if the partnership would be treated as an investment company were it incorporated.ⁿ² In either case, no distinction is here drawn between a contribution made to a partnership in the process of formation and one made to an already existing concern.ⁿ³

[b] Basis and Holding Period of the Contributed Securities. The partnership's basis for the contributed securities is the same as the adjusted basis of the securities to the partner at the time that he made the contribution increased by the amount of gain recognized to the partner at such time.ⁿ⁴ Because the securities take a substituted basis, at least in part, the partnership's holding period for the property includes the period during which it was held by the contributing partner.ⁿ⁵ However, the nature of any gain or loss realized by the partnership on the sale or exchange of the contributed securities will be determined solely by reference to the character of the property in the hands of the partnership.ⁿ⁶

[c] Basis of the Contributing Partner's Interest. The basis to a partner of a partnership interest acquired by a contribution of securities is the same as the adjusted basis of the securities at the time of contribution, increased by the amount of gain recognized to the partner at that time.ⁿ⁷ If the contributed property is subject to an indebtedness or the partnership assumes a liability of the partner, the basis of the contributing partner's interest must be reduced by the amount of the debt assumed by the other partners;ⁿ⁸ the assumption of the debt is treated as a distribution of money to the contributing partner and an additional contribution by the assuming partners.ⁿ⁹ Gain to the contributing partner will result if the assumed debt exceeds the basis of the property in the hands of the partner,ⁿ¹⁰ but the adjusted basis of his partnership is not increased by the amount of such gain.ⁿ¹¹

A partner's holding period for his partnership interest begins when he first acquires it.ⁿ¹² No change in that holding period will result from subsequent contributions by the partner to the partnership. In other words, the partner cannot have a split holding period for his partnership interest.

[2] Sales or Exchanges of Securities--General Rule.

If, rather than contributing the securities, the partner sells them to his partnership, he engages in a transaction with the partnership other than in his capacity as a partner.ⁿ¹³ In such case, the transaction is considered as occurring between the partnership and one who is not a partner, and, therefore, the general nonrecognition rule of *IRC Section 721(a)* cannot apply.ⁿ¹⁴ This assumes that the transaction between partnership and partner is a true sale, and not a contribution in disguise; the controlling factor is the substance of the transaction, not its form.ⁿ¹⁵

[3] Sales or Exchanges of Securities--Transactions With Controlled Partnerships

[a] Where the Transaction Results in a Loss. *IRC Section 707(b)(1)* bars the deduction of losses from sales or exchanges of property between (1) a partnership and a partner owning more than 50 percent of the capital interest or profits interest in the partnership, or (2) two partnerships in which the same persons own more than 50 percent of the capital or profits interest.^{n15.1} Both direct and indirect ownership are taken into account; the rules for constructive ownership of stock contained in *IRC Section 267(c)* apply in determining the extent of a partner's interest in capital or profits.ⁿ¹⁶ In this regard, the Regulations provide that ownership of a capital interest or profits interest in a partnership may be attributed to a person who is not a member of the partnership, but only for the purpose of reattributing that interest to one who is a partner.ⁿ¹⁷

Example:

John, Tim, and a trust are equal partners in a partnership. John's wife, Pat is the sole beneficiary of the trust. The trust's one-third interest will be attributed to Pat and then to John. Since the trust interest is attributed to Pat solely for the purpose of further attributing ownership of the interest to John any loss sustained by Pat on a sale or exchange of property with the partnership will not be disallowed by *IRC Section 707*. However, under the Regulations to *IRC Section 267*, any sale or exchange between a partnership and a person other than a partner "shall be considered as occurring between the other person and the members of the partnership separately."ⁿ¹⁸ This means that any loss realized by Pat will be disallowed to the extent that the sale to the partnership is deemed made to a related person as defined in *IRC Section 267*.

As is the case when *IRC Section 267* applies to disallow a loss in a transaction between shareholder and controlled corporation, gain realized on a later sale of the property by the transferee need be recognized only to the extent that it exceeds the disallowed loss.ⁿ¹⁹

[b] Where the Transaction Results in a Gain. The disallowance rule of *IRC Section 707(b)(1)* closely approximates the one prescribed by *IRC Section 267(a)* for loss transactions between a shareholder and his controlled corporation. The same cannot be said for transactions which result in a gain. Under *IRC Section 1239*, a shareholder must treat any gain recognized on a sale or exchange of property to a controlled corporation as ordinary income only if the sale or exchange is of property which in the hands of the transferee corporation "is property of a character subject to the allowance for depreciation provided in section 167."ⁿ²⁰ But if the sale or exchange is between a partnership and a partner owning more than 50 percent of the capital interest or profits interest in the partnership or between two partnerships in which the same persons own more than 50 percent of the capital or profits interest,ⁿ²¹ the gain will be converted into ordinary income whenever the property is not a capital asset in the hands of the transferee.ⁿ²² Thus, gain realized on a sale of stock by an investor to a controlled partnership dealing in securities will enter gross income as ordinary income rather than capital gain; the stock in the hands of the partnership would not qualify as a capital asset since it would constitute property held for sale to customers.ⁿ²³

FOOTNOTES:

(n1)Footnote 1. The rule applies with equal force when property other than securities is contributed to the partner ship. Indeed, gain or loss will not be recognized even if the contribution consists of property subject to depreciation recapture or installment obligations. *IRC §§ 1245(b)(3), 1250(d)(3); Treas Reg § 1.721-1(a)*.

Regulations can provide that *IRC § 721(a)* will not apply to gain realized on a transfer to a partnership if the gain,

when recognized, will be includable in the gross income of a person who is not a US person. *IRC § 721(c)*.

If a corporate partner contributes its own stock in exchange for a corporate interest, there is no gain or loss to the corporation upon the contribution. If the partnership later exchanges the stock in a taxable transaction in which gain is realized, the gain will be allocated to the partners in accordance with *IRC § 704*. However, under *IRC § 1032*, the corporate partner will not recognize the gain allocated to it with respect to the exchange of the stock. Moreover, under *IRC § 705*, the corporate partner increases its basis in its partnership interest by an amount equal to its share of the gain. *Rev Rul 99-57, 1999-2 CB 678*.

Regulations have been issued to prevent inappropriate increases or decreases in the adjusted basis of a corporate partner's interest in a partnership resulting from the partnership's disposition of the corporate partner's stock. Where (1) a corporation acquires an interest in a single partnership that owns stock in that corporation (or the partnership subsequently acquires stock in the corporation in an exchanged basis transaction); (2) the partnership does not have an election under *IRC § 754* in effect for the year of acquisition; and (3) the partnership later sells the stock, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent *IRC § 1032*) if, for the year in which the corporation acquired the interest, an election under *IRC § 754* had been in effect. *Treas Reg § 1.705-2(b)(1)*. The purpose of the regulations cannot be avoided through the use of tiered partnerships or other arrangements. *Treas Reg § 1.705-2(c)(1)*.

(n2)Footnote 2. A partnership will be treated as an investment fund if, after the exchange, over 80 percent of the value of its assets, excluding cash and nonconvertible debt obligations, are held for investment and are readily marketable stock or securities or interests in regulated investment companies or real estate investment trusts. *Treas Reg § 1.351-1(c)(1)*. See the discussion of transfers to corporate investment funds in § 3.02[4].

(n3)Footnote 3. *Treas Reg § 1.721-1(a)*.

(n4)Footnote 4. *IRC § 723*. There is no increase in the basis of the property if the property is subject to an encumbrance greater than basis and the partner recognizes gain as a result of *IRC §§ 731 and 752(b)*. *Rev Rul 84-15, 1984-1 CB 158*.

(n5)Footnote 5. *IRC § 1223(2); Treas Reg § 1.723-1*.

(n6)Footnote 6. *Cf Oliver v Commr, TC Memo 1954-34, affd 218 F2d 352 (5th Cir 1955)*.

(n7)Footnote 7. *IRC § 722*.

(n8)Footnote 8. *Treas Reg § 1.722-1*. Generally, there will be no reduction in the basis of the partner's interest after an assumption by the partnership of a liability of the partner if: (1) the trade or business with which the liability is associated is transferred to the partnership assuming the liability as part of the transaction, or (2) substantially all of the assets with which the liability are associated are contributed to the partnership assuming the liability. *Temp Treas Reg § 1.752-6T*.

(n9)Footnote 9. *Treas Reg § 1.722-1*.

(n10)Footnote 10. *Treas Reg § 1.722-1*.

(n11)Footnote 11. *Rev Rul 84-15, 1984-1 CB 158*.

(n12)Footnote 12. *Lehman v Commr, 7 TC 1088 (1946), acq 1950-2 CB 3, affd 165 F2d 383 (2d Cir 1948), cert denied 334 US 819*.

(n13)Footnote 13. *Treas Reg § 1.721-1(a)*; *Treas Reg § 1.707-1(a)*. The purchase of securities by a partner from his partnership is also a transaction in which the partner is treated as if he were not a member of the partnership.

A transfer of partnership property to a partner in satisfaction of a guaranteed payment under *IRC § 707(c)* is a sale or exchange, not a distribution. *Rev Rul 2007-40, 2007-1 CB 1426*.

(n14)Footnote 14. *IRC § 707(a)*; *Treas Reg § 1.721-1(a)*; see, eg, *Davis v Commr, TC Memo 1970-170*.

(n15)Footnote 15. A facts and circumstances test is employed to determine whether a transaction between partner and partnership is to be characterized as a sale or a contribution. *Treas Reg § 1.707-3(b)(2)*. If within a two-year period, a partner transfers property to the partnership and the partnership transfers money or other consideration to the partner, the transfer is presumed to be a sale unless the factors clearly establish that it is not. *Treas Reg § 1.707-3(c)(1)*. Transfers made more than two years apart are presumed not to be sales. *Treas Reg § 1.707-3(d)*.

In *Otey v Commr, 70 TC 312*, *affd per curiam 634 F2d 1046 (6th Cir 1980)*, a transfer of property to a partnership followed by an early withdrawal of funds was held to be a contribution to capital and a distribution to equalized partners' capital accounts, and not a sale.

(n16)Footnote 15.1. The partners' bases in their partnership interests are decreased to reflect the disallowed loss. *Rev Rul 96-10, 1996-4 IRB 26*.

(n17)Footnote 16. *IRC § 707(b)(3)*; see Ch 2. The attribution rule of *IRC § 267(c)(3)*, relating to attribution between partners, is inapplicable.

(n18)Footnote 17. *Treas Reg § 1.707-1(b)(3)*.

(n19)Footnote 18. *Treas Reg § 1.267(b)-1(b)*.

(n20)Footnote 19. *IRC §§ 707(b)(1), 267(d)*. See Ch 2. The partners' bases in their partnership interests are increased to reflect the gain that is not recognized. *Rev Rul 96-10, 1996-1 CB 138*.

(n21)Footnote 20. *IRC § 1239(a)*. *IRC § 1239(a)* also applies to a sale or exchange of depreciable property between a person and a partnership in which the person owns more than 50 percent of the capital or profits interest. *IRC § 1239(b)(1)(A), (c)(1)(B)*.

(n22)Footnote 21. The attribution rules of *IRC Section 267(c)* must be taken into account in determining the ownership of a capital or profits interest in a partnership. *IRC § 707(b)(3)*; see, eg, *Rev Rul 67-105, 1967-1 CB 167*; see also *Burde v Commr, 352 F2d 995 (2d Cir 1965)*, *cert denied 383 US 966*; *Soffron v Commr, 35 TC 787 (1961)*.

(n23)Footnote 22. *IRC § 707(b)(2)*.

(n24)Footnote 23. *IRC § 1221(1)*.



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Taxation of Securities Transactions

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CHAPTER 14 The Taxpayer as a Member of a Partnership

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§ 14.04 Distributions of Securities by Partnerships

[1] Consequences to the Partner

[a] Treatment of Gains and Losses

[i] Current Distributions. As a general rule, a partner recognizes neither gain nor loss when the partnership transfers securities to him as part of a current distribution, that is, a distribution not in liquidation of the distributee's entire partnership interest.ⁿ¹ In the ordinary distribution, gain is recognized only if money is distributed and the amount of money exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution.ⁿ² If the money distributed is less than the partner's adjusted basis, or if no money is distributed, the distribution has only one consequence to the partner--to reduce the adjusted basis of his partnership interest (but not below zero) by the amount of money and the basis to the partner of property other than money received on the distribution.ⁿ³

IRC Section 737 contains an exception to the nonrecognition of gain upon a nonliquidating distribution in instances in which the distributee partner has precontribution gain. The amount of gain to be recognized is equal to the lesser of (1) the excess of (a) the fair market value of the property (other than money) received in the distribution over (b) the adjusted basis of the distributee partner's interest in the partnership immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution, or (2) the net precontribution gain of the partner.^{n3.1} Gain so recognized is in addition to any gain recognized under *IRC Section 731*. The character of the gain is determined by reference to the proportionate character of the net precontribution gain.

The distributee partner's net precontribution gain is the net gain (if any) that would have been recognized by the distributee partner under *IRC Section 704(c)(1)(B)* if all property that (1) had been contributed to the partnership by the distributee partner within five years of the distribution, and (2) is held by the partnership immediately before the distribution, had been distributed to another partner.^{n3.2} (Under *IRC Section 704(c)(1)(B)*, if property contributed by a partner is distributed to other partners within five years of contribution, the contributing partner must recognize gain or loss in an amount equal to the gain or loss that the partner would have had to take into account by reason of the variation between basis and fair market value at the time of contribution had the property had been sold by the partnership on the date of distribution.ⁿ⁴ The provision is inapplicable if other property of like kind (within the meaning of *IRC Section 1031*) is distributed to the contributing partner not later than the earlier of the 180th day after the original distribution or the due date of the contributing partner's tax return for the year in which the original distribution was made.)ⁿ⁵

If any portion of the distributed property consists of property that had been contributed by the distributee partner to the partnership, that property is not taken into account in determining the amount of gain recognized under *IRC Section 737(a)* and the amount of net precontribution gain.^{n5.1} If the distributed property consists of an interest in an entity, the preceding sentence does not apply to the extent that the value of the interest is attributable to property contributed to the entity after the interest had been contributed to the partnership.

If a distribution to a partner consists of marketable securities, then, for purposes of *IRC Sections 731(a)* and *737*, the marketable securities are treated as money to the extent of their fair market value on the date of distribution.^{n5.2} However, the amount of the value of the distributed marketable securities taken into account must be reduced (but not below zero) by the excess (if any) of (a) the distributee partner's distributive share of the net gain that would be recognized if all of the marketable securities of the same class and issuer as the distributed securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value, over (b) the distributee partner's distributive share of the net gain attributable to the marketable securities of the same class and issuer as the distributed securities held by the partnership immediately after the same transaction, at the same fair market value.^{n5.3}

Marketable securities are financial instruments and foreign currencies that are, as of the date of distribution, actively traded (within the meaning of *IRC Section 1092(d)(1)*) and include:

- (1) any interest in a common trust fund, or regulated investment company that is offering for sale or has outstanding any redeemable security (as defined in Section 2(a)(32) of the Investment Company Act of 1940) of which it is the issuer;
- (2) any financial instrument that, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities;
- (3) any financial instrument the value of which is determined substantially by reference to marketable securities;
- (4) except to the extent provided in regulations, any interest in a precious metal that, as of the date of distribution, is actively traded, unless the metal was produced, used, or held in the active conduct of a trade or business by the partnership;
- (5) interests in any entity if substantially all (90 percent or more) of the assets of the entity at the time of distribution consist of marketable securities or money; and
- (6) any interest in an entity to the extent the value of the interest is attributable to marketable securities or money, provided the securities and money amount to 20 percent or more, but less than 90 percent, of the entity's assets.^{n5.4}

The marketable securities-as-money rule does not apply to a distribution of a marketable security to a partner if (i) the security was contributed to the partnership by the distributee partner, except to the extent that the value of the distributed security is attributable to marketable securities or money contributed (directly or indirectly) to the entity to which the distributed security relates, (ii) the property was not a marketable security when acquired by the partnership, or (iii) the partnership is an investment partnership and the distributee partner is an eligible partner thereof.^{n5.5} In addition, the rule does not apply to the distribution of a marketable security that was acquired by the partnership in a nonrecognition transaction where the value of any marketable securities or money exchanged by the partnership in the nonrecognition transaction is less than 20 percent of the value of all of the assets exchanged by the partnership in the nonrecognition transaction, the distributed security is actively traded on the date of distribution, and the security is

distributed within five years of either the date on which the security was acquired by the partnership or, if later, the date on which the security became marketable.^{n5.6} Finally, *IRC Section 731(c)(1)* will not apply to the distribution of a marketable security acquired by the partnership in a nonrecognition transaction in exchange for a security the distribution of which would have been excepted from the scope of *IRC Section 731(c)(1)*.^{n5.7}

An anti-stuffing rule prevents the exceptions contained in *Regulations Section 1.731-2(d)(1)* from applying to the extent that 20 percent or more of the value of the distributed security is attributable to marketable securities or money contributed (directly or indirectly) by the partnership to the entity to which the distributed security relates after the security was acquired by the partnership (other than marketable securities contributed to the partnership by the distributee partner).^{n5.8}

An investment partnership is defined as any partnership that has never been engaged in a trade or business and substantially all of the assets (by value) consist of (1) money, (2) stock in a corporation, (3) notes, bonds, debentures, or other evidences of indebtedness, (4) interest rate, currency, or equity notional contracts, (5) foreign currencies, (6) interests in or derivative financial instruments (including options, forward or futures contracts, short positions, and similar financial instruments) in any of those assets, or in any commodity traded on or subject to the rules of a board of trade or commodity exchange, and (7) any combination of the foregoing.^{n5.9} A partnership is not treated as engaged in a trade or business by reason of (a) any activity undertaken as an investor, trader, or dealer in any asset described in the preceding sentence, including the receipt of commitment fees, break-up fees, guarantee fees, director's fees, or similar fees that are customary in and incidental to any activities of the partnership as an investor, trader, or dealer in such assets, (b) reasonable and customary management services (including the receipt of reasonable and customary fees in exchange for such management services) provided to an investment partnership in which the partnership holds a partnership interest; and (c) reasonable and customary services provided by the partnership in assisting the formation, capitalization, expansion, or offering of interests in a corporation (or other entity) in which the partnership holds or acquires a significant equity interest (including the provision of advice or consulting services, bridge loans, guarantee of obligations, or service on a company's board of directors), provided that the anticipated receipt of compensation for any services does not represent a significant purpose for the partnership's investment in the entity and is incidental to the investment in the entity.^{n5.10} A partnership (upper-tier partnership) is treated as engaged in any trade or business engaged in by, and as holding (instead of a partnership interest) a proportionate share of the assets of, any other partnership (lower-tier partnership) in which the upper-tier partnership holds a partnership interest.^{n5.11} This last stated rule does not apply if the upper-tier partnership does not participate in the management of the lower-tier partnership, and the interest held by the upper-tier partnership is less than 20 percent of the total profits and capital interests in the lower-tier partnership.^{n5.12}

An eligible partner of an investment partnership is one who, before the date of distribution, did not contribute to the partnership any property other than assets that can be held by an investment partnership.^{n5.13} A partner who contributed to a partnership an interest in another partnership is treated as contributing a proportionate share of the assets of the other partnership.^{n5.14}

The basis of the distributee partner's interest in the partnership is determined under *IRC Section 733* as if no gain were recognized by the partner on the distribution by reason of *IRC Section 731(c)*.^{n5.15}

[ii] Liquidating Distributions. A change in the character of the distribution from current distribution to liquidating distribution does not work a corresponding change in the general rule governing gain. Recognition is prescribed only when the distribution consists in whole or in part of money in an amount in excess of the adjusted basis of the partner's interest in the firm immediately before the distribution.ⁿ⁶ Nonrecognition will continue to be the general rule for losses unless the liquidating distribution consists solely of money, unrealized receivables and inventory items, in which case, loss will be recognized to the extent of the excess of the partner's adjusted basis for his interest in the partnership over the sum of (1) any money distributed, and (2) the basis in the hands of the partner of any unrealized receivables and inventory items.ⁿ⁷

The effect of a second provision, *IRC Section 736*, must be considered whenever the distribution is in liquidation of the interest of a retiring partner or deceased partner. Under that section, payments made to the retiring partner or to a deceased partner's successor in interest are divided into two segments, one being treated as a distribution made in exchange for the partner's interest in partnership assets (other than unrealized receivables and good will, except to the extent that the partnership agreement provides for a payment with respect to good will),ⁿ⁸ and the other as a distributive share of partnership income or a guaranteed payment.ⁿ⁹ The amount of the payment attributable to unrealized receivables and good will and the amount considered as a distributive share of partnership income or a guaranteed payment will be treated as ordinary income. The portion of the payment deemed to be made in exchange for the interest in partnership assets will be taxed in accordance with the rules governing partnership distributions.

IRC Section 736 clearly applies when the liquidating distribution consists solely of money. But does it apply when the distribution is made wholly or partially in kind, say, in the form of a distribution of securities? The issue is whether such a distribution can be looked upon as a "payment." The better view is that it can.ⁿ¹⁰ Indeed, a provision in the proposed Regulations, which would have excluded distributions of property from the definition of payment,ⁿ¹¹ did not find its way into the finally adopted version, leading one to the conclusion that certainly the Government views a distribution of property as an *IRC Section 736* payment. Thus, if a retired partner's interest is liquidated by a distribution of stock held by the partnership for investment, and he receives no money or an amount of money less than the adjusted basis of his partnership interest, he will not recognize gain or loss with respect to the portion of the distribution considered to be made in exchange for his interest in partnership property. He will, of course, be in receipt of ordinary income to the extent that the distribution is treated as payment of a distributive share of partnership income or as a guaranteed payment.ⁿ¹²

The previous discussion assumed the existence of a true liquidating distribution. But not every transaction that takes the form of a distribution will be taxed as such. The Regulations except from the scope of *IRC Section 731* the situation in which there is a contribution of property to a partnership followed within a short period of time by a distribution of other property to the contributing partner, or by a distribution of the contributed property to another partner; the transaction is treated as an exchange rather than a distribution;ⁿ¹³ This principle was applied in *Revenue Ruling 57-200*ⁿ¹⁴ to deny nonrecognition of gain. In that instance, two individuals each owned a one-half interest in the *P* partnership and one-half interests in corporations *X* and *Y*. To accomplish a desired severance of their business relationship, each individual transferred his stock in the corporations to the partnership, which was then terminated by a distribution of all of the *X* stock and some of the partnership assets to one partner and all of the *Y* stock and the remaining partnership assets to the other. The Service characterized the transaction by saying:

"The transfer of the capital stock of several corporations to a partnership, where the taxpayers who own such stock are also partners in the partnership, followed immediately by a distribution in complete liquidation of the partnership assets, constitute steps of a single integrated transaction resulting in a taxable exchange of stock interests between the individual partners."ⁿ¹⁵

[iii] Disproportionate Distributions of Inventory Securities. Under *IRC Section 751(b)(1)*, a provision enacted in order to prevent the conversion of potential ordinary income into capital gain,ⁿ¹⁶ a distribution to a partner of (1) substantially appreciated inventory (or of unrealized receivables)--*Section 751* propertyⁿ¹⁷--in exchange for all or part of his interest in other partnership property, or (2) other partnership property in exchange for all or part of his interest in the partnership's substantially appreciated inventory (or its unrealized receivables), must be treated as a sale or exchange between the distributee and the partnership as constituted immediately after the distribution, and not as a distribution governed by *IRC Section 731*.ⁿ¹⁸ However, *IRC Section 751(b)(1)* does not apply to a distribution of property that the distributee partner contributed to the partnership or to any part of the distribution treated, under *IRC Section 736(a)*, as a payment to a retiring partner or to a deceased partner's successor in interest of a distributive share of partnership income or a guaranteed payment.ⁿ¹⁹ Furthermore, *IRC Section 751(b)(1)* will not apply to the extent that a distribution consists of the distributee partner's share of *Section 751* property or his share of other property; in such case, the distribution of

Section 751 property is not in exchange for his interest in other partnership property, nor is the distribution of other partnership property in exchange for his interest in Section 751 property.ⁿ²⁰ To illustrate:

Example:

If a partnership has Section 751 property with a value of \$50,000 in which partner Amanda has a 30-percent interest, and it distributes \$10,000 of the property to Amanda who continues to retain a 30-percent interest in the \$40,000 of Section 751 property remaining in the partnership after the distribution, only \$3,000 of the Section 751 property received by Amanda will be considered to be a distribution of her share of such property; the remaining \$7,000 will be governed by *IRC Section 751(b)*. The \$3,000 figure is determined by taking Amanda's share of the partnership's Section 751 property before the distribution, \$15,000 (30 percent of \$50,000), and subtracting \$12,000, her share of such property after the distribution (30 percent of \$40,000).ⁿ²¹

A partnership's inventory will have substantially increased in value if, at the time of distribution, the total fair market value of all of its inventory items exceeds (1) 120 percent of the aggregate adjusted basis of such property in the hands of the partnership, and (2) 10 percent of the fair market value of all partnership property other than money.ⁿ²² The determination as to whether a partnership's inventory has substantially appreciated in value is made with reference to the aggregate of all partnership inventory items and not just those that are distributed to the partner.ⁿ²³ Thus, Section 751(b)(1) will apply if the partnership's inventory items as a whole are substantially appreciated in value, even though the distributed items are not.ⁿ²⁴ Conversely, Section 751(b)(1) will not apply to a distribution of specific inventory items having a value which is more than 120 percent of their adjusted bases, if the aggregate of the partnership inventory items does not meet the test of substantial appreciation set down by the Code.ⁿ²⁵

For the purposes of *IRC Section 751*, a partnership's inventory is made up of the following items:

- (1) Stock in trade of the partnership, or other property of a kind which would properly be included in the inventory of the partnership if on hand at the close of the taxable year, or property held by the partnership primarily for sale to customers in the ordinary course of its business.ⁿ²⁶
- (2) Any other property which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in *IRC Section 1231*.ⁿ²⁷ Thus, accounts receivable acquired on the sale of stock in trade (e.g., inventory securities) constitute inventory items of the partnership.ⁿ²⁸
- (3) Any other property retained by the partnership after the distribution, which if held by the distributee partner would be property of the type described in the preceding three paragraphs.ⁿ²⁹

Application of *IRC Section 751(b)* can be illustrated by the following examples:

Example 1:

The ABC partnership, a dealer in securities, agrees to liquidate the entire one-third interest of Bob, one of its partners. At the time of distribution, the balance sheet of the partnership is as follows:

As-sets	Adjusted basis	Market Value
Cash		\$ 30,000
	30,000	
Inventory securities	60,000	78,000

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Capital assets (Investment securities)	90,000	102,000
	—	—
	—	—
	—	—
	—	—
	—	—
	—	—
	—	—
Total	\$180,000	\$210,000
<i>Liabilities and capital</i>		
Liabilities	\$60,000	\$60,000
Capital		
Partner A	40,000	50,000
Partner B	40,000	50,000
Partner C	40,000	50,000
	—	—
	—	—
	—	—
	—	—
	—	—
	—	—
	—	—
Total	\$180,000	\$210,000

The distribution to Bob consists of cash of \$20,000 and capital assets (investment securities) having a value of \$30,000. The partnership also agrees to assume Bob's share of partnership liabilities; *IRC Section 752(b)* treats this as the distribution of money.³⁰ Since Bob's partnership interest is being liquidated, the distribution is subject to the provisions of *IRC Section 736*. However, because, in this case, the payment does not exceed the partner's interest in partnership property (one third of \$210,000),

no part of the payment will be considered a distributive share or guaranteed payment under *IRC Section 736(a)*. Therefore, the entire distribution is for an interest in property under *IRC Section 736(b)*, and, to the extent applicable, subject to the rules of *IRC Section 751*.

The partnership's inventory is substantially appreciated in value. Its value of \$78,000 exceeds 120 percent of its adjusted basis (120 percent of \$60,000 is \$72,000) and also exceeds 10 percent of the fair market value of all partnership property other than money (10 percent of \$180,000 is only \$18,000).

Since *IRC Section 751(b)(1)* is applicable, Bob, who received more than his proportionate share of partnership property other than inventory, is considered to have sold his proportionate share of the inventory for \$26,000 (one third of \$78,000), thereby realizing ordinary income of \$6,000 (\$26,000 less \$20,000, one third of the adjusted basis of the inventory in the hands of the partnership).

The remainder of the distribution is not governed by *IRC Section 751(b)(1)*.ⁿ³¹ Before the distribution, Bob's basis for his partnership interest was \$60,000 (\$40,000, plus \$20,000, his share of partnership liabilities).ⁿ³² This basis must be reduced by \$20,000, the basis of the inventory securities which Bob is deemed to have sold to the partnership.ⁿ³³ Thus, Bob has a basis of \$40,000 for the remainder of his partnership interest. Whether or not gain or loss is recognized under *IRC Section 731* depends on the nature of the property received by the distributee partner. Here, Bob received no more than his share of capital assets, but did receive more than his share of partnership money (\$40,000, including the \$20,000 in liabilities assumed by the partnership). Therefore, the proceeds of the sale of the inventory must consist of money and form a part of the money received by Bob. Since the proceeds are treated separately, they must be deducted from the money distribution.ⁿ³⁴ Consequently, the remainder of Bob's interest is liquidated by a distribution of \$44,000, \$30,000 in capital assets and \$14,000 in money (\$40,000 less \$26,000, the "sale price" of the inventory). Under this set of facts, Bob will not recognize any part of the \$4,000 gain (\$44,000 distribution less \$40,000 basis) he realizes on the portion of the distribution falling outside of *IRC Section 751(b)*; the money received by him is less than the basis of his partnership interest.ⁿ³⁵

Example 2:

Assume the same facts as in Example 1, except that the liquidating distribution to Bob consists of inventory securities having a value of \$30,000, capital assets having a value of \$10,000, and cash of \$10,000. Thus, Bob receives exactly his share of cash, more than his share of inventory and less than his share of capital assets. He also is deemed to have received \$20,000 in money by virtue of the assumption by the partnership of Bob's share of partnership liabilities.

IRC Section 751(b)(1)(A) is applicable in this instance, causing the \$4,000 excess distribution of substantially appreciated inventory to be treated as having been received by Bob in exchange for a portion of his interest in capital assets. Bob's basis for that portion is \$3,529 ($90,000/120,000$ ths of \$4,000);ⁿ³⁶ his gain on the exchange is, therefore, \$471.

The balance of the distribution, \$66,000 (\$30,000 in money and liabilities assumed, \$10,000 in capital assets, and \$26,000 in inventory securities) does not come within *IRC Section 751(b)*. Since Bob's basis for the remainder of the partnership interest is \$56,471 (his predistribution basis of \$60,000, including his share of partnership liabilities, less \$3,529, the basis of the property treated as sold by him to the partnership), Bob realizes a gain of \$9,529 which he does not recognize under the general rule of *IRC Section 731(a)(1)*.

Example 3:

Assume the same facts as in Example 1, except that the distribution consists of inventory securities with

a value of \$26,000 and cash of \$24,000. *IRC Section 751(b)(1)* does not apply to any part of the distribution since Bob receives his share of inventory and his share of other property of the partnership. The entire distribution falls within *IRC Section 731*.

[b] Basis of the Distributed Securities

[i] Distributions Other Than in Liquidation of a Partner's Interest. A distributee partner's basis for securities distributed to him in a nonliquidating distribution is their adjusted basis in the hands of the partnership immediately before the distribution.ⁿ³⁷ There is one limitation--the basis of the distributed securities cannot exceed the adjusted basis of the distributee partner's interest in the partnership reduced by any money distributed in the same transaction.ⁿ³⁸ There is also one exception; the carryover basis rule does not apply to the extent that a distribution is treated as a sale or exchange of property under *IRC Section 751(b)*.ⁿ³⁹

If the aggregate basis of the property received by the distributee is limited to the adjusted basis of the partner's interest in the partnership, and the distribution consists of more than one class of securities, or of securities and other property, an allocation of basis is made necessary. The method prescribed by *IRC Section 732(c)* calls for the aggregate basis to be allocated first to any unrealized receivables and inventory items (whether or not substantially appreciated in value) in an amount equal to the adjusted bases of such properties to the partnership.ⁿ⁴⁰ If the remaining basis adjustment is a decrease, it is allocated among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation), and then in proportion to their respective adjustments (taking into account the adjustments already made).ⁿ⁴¹ A remaining basis adjustment that is a decrease arises when the partnership's total adjusted basis in the distributed properties exceeds the amount of the partner's basis in its partnership interest, and the latter amount is the basis to be allocated among the distributed properties.

Example 1:

A partnership distributes securities to a partner in a distribution that is not a liquidation of the partner's interest; the securities are not marketable and are not inventory or unrealized receivables in the hands of the partnership. Security A has a basis to the partnership of \$1,000 and a fair market value of \$8,000. Security B has a basis to the partnership of \$2,000 and a fair market value of \$2,000. The partner's basis in its partnership interest is \$11,000. The basis of the securities in the hands of the distributee partner will be the same as in the hands of the partnership.

Example 2:

Assume the same facts as in Example 1, except that Security A has a basis to the partnership of \$3,000 and a fair market value of \$3,000, Security B has a basis of \$3,000 and a fair market value of \$1,000, and the partner's basis in its partnership interest is \$4,000. This requires that basis first be allocated to the extent of the partnership's basis in the property, or \$3,000 to each distributed property. Because the partner's basis in its interest is only \$4,000, a downward adjustment of \$2,000 (\$6,000 less \$4,000) is required. The entire amount of the \$2,000 downward adjustment is allocated to Security B. Thus, the basis of Security A in the hands of the distributee partner is \$3,000, while the basis of Security B in the partner's hands is \$1,000.

If marketable securities are distributed and gain is recognized under *IRC Section 731(c)*, the basis of those securities is their basis determined under *IRC Section 732*, increased by the amount of such gain.ⁿ⁴² Any such increase is allocated to the distributed marketable securities in proportion to their respective amounts of unrealized appreciation before the increase.ⁿ⁴³

A special rule applies with respect to certain distributions by a partnership to a corporate partner. If (1) a corporate partner receives a distribution of stock in another corporation (the "distributed corporation"), (2) the corporate partner has control of the distributed corporation immediately after the transfer or at any time thereafter, and (3) the partnership's adjusted basis in the stock immediately before the distribution exceeded the corporate partner's adjusted

basis in the stock immediately after the distribution, then an amount equal to the excess is applied to reduce the basis of property held by the distributed corporation at that time (or at the time that the corporate partner acquires control).ⁿ⁴⁴ However, the amount of the reduction cannot exceed the amount by which the sum of the aggregate bases of the property and the amount of money of the distributed corporation exceeds the corporate partner's adjusted basis in the stock of the distributed corporation, nor can any reduction in the basis of any property exceed the adjusted basis of such property (determined without regard to the reduction).ⁿ⁴⁵

Example 3:

C Corp.'s basis for its interest in *P Partnership* is \$800,000. *P*'s basis for 100 percent of the stock in *D Corp.* is \$1 million. *D*'s assets consist of a parcel of real property with a basis of \$900,000 and cash of \$100,000. *P* distributes all of the stock of *D* to *C* in a nonliquidating distribution. *C*'s basis in the *D* stock is \$800,000, the basis of *C*'s partnership interest because it is less than *P*'s basis in the *D* stock.ⁿ⁴⁶ The basis of the parcel of real property must be reduced by \$200,000, the excess of *P*'s adjusted basis in the *D* stock immediately before the distribution over *C*'s basis in the *D* stock immediately after the distribution.

Example 4:

Assume the same facts as in Example 3, except that the cash held by *D* is only \$50,000. The reduction in the basis of the real property will be reduced by \$150,000, the amount by which the sum of the basis of the real property and the amount of money of the distributed corporation exceeds the corporate partner's adjusted basis in the stock of the distributed corporation.

If the amount of any reduction exceeds the aggregate adjusted bases of the property of the distributed corporation, the excess is recognized by the corporate partner as long-term capital gain, with a corresponding increase in the corporate partner's adjusted basis in the stock of the distributed corporation.ⁿ⁴⁷

A corporation is considered to have received a distribution from a partnership of stock it acquires (other than in a distribution from a partnership) if the basis of the stock is determined under the basis rules for current distributions or distributions in liquidation of a partner's interest.ⁿ⁴⁸ For example, if a partnership distributes stock to two corporate partners, neither of which has control of the distributed corporation, and the two corporations merge with the survivor obtaining control of the distributed corporation, the stock of the distributed corporation is treated as received in a partnership distribution; the basis reduction rule will apply.

A special rule applies in the case of tiered corporations. If the property held by a distributed corporation is stock in a corporation that the distributed corporation controls, *IRC Section 732(f)* operates to reduce the basis of the property of the controlled corporation.ⁿ⁴⁹ The provision is reapplied to any property of the controlled corporation that is stock in a corporation that it controls.

[ii] Distributions in Liquidation of the Partner's Interest. The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest in the partnership is an amount equal to the adjusted basis of his partnership interest reduced by any money distributed in the same transaction.ⁿ⁵⁰ This rule will not apply to the extent that the distribution is treated as a sale or exchange of property under *IRC Section 751*.ⁿ⁵¹

Here, too, an allocation of basis is required whenever the distribution consists of different classes of securities or different property. However, in the case of a liquidating distribution, any remaining basis adjustment after the allocation to inventory and unrealized receivables can be either an increase or a decrease. Any remaining basis adjustment, if an increase, is allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation, and then in proportion to their respective fair market values).ⁿ⁵²

Example 5:

Assume the same facts as in Example 1, except that the distribution is in liquidation of the partner's

interest. Basis is first allocated to the properties in the amount of their respective adjusted bases to the partnership (\$1,000 to Security A and \$2,000 to Security B). The remaining basis adjustment is an increase of \$8,000 (the partner's \$11,000 basis less the \$3,000 basis already allocated to the properties). Basis is then allocated to Security A in the amount of \$7,000, its unrealized appreciation; there is no allocation to Security B because it has no unrealized appreciation. The remaining \$1,000 of basis is allocated in proportion to the assets' fair market values--\$800 to Security A (for a total basis of \$8,800) and \$200 to Security B (for a total basis of \$2,200).

Example 6:

Assume the same facts as in Example 5, except that the distribution is a liquidating distribution. The basis allocation will be the same as in Example 5.

[c] The Partner's Holding Period for the Distributed Securities. As a general rule, the partner's holding period for securities received in a partnership distribution includes the period for which they were held by the partnership.ⁿ⁵³ And, if the securities had been contributed to the partnership by the distributee partner, his original holding period is "tacked" as well.ⁿ⁵⁴ However, if the securities are inventory securities, there is a special holding period that begins on the date of distribution and runs for five years. Any gain or loss on the sale or exchange of the securities by the distributee partner within the five-year period will be taxed as ordinary gain or loss and not as capital gain or loss.ⁿ⁵⁵

[2] Gain or Loss to the Partnershipⁿ⁵⁶

By virtue of *IRC Section 731(b)*, no gain or loss is recognized to a partnership on a distribution of property, including money, to a partner. This rule applies to both current and liquidating distributions, but it does not apply to the extent that a disproportionate distribution is treated as a sale or exchange under *IRC Section 751(b)*.

The effect of a disproportionate distribution on partnership gain or loss can be illustrated with the help of the examples discussed in § 14.04[1][a][iii].

Example 1:

The gist of the transaction from the partnership side is a purchase of Arthur's share of the partnership inventory for \$26,000. Since, in this case, the entire consideration for the purchase consisted of money (the partnership distributed \$40,000 in money--\$20,000 in cash and \$20,000 in assumed liabilities), the partnership would realize no capital gain or loss on the portion of the distribution treated as a sale or exchange under *IRC Section 751(b)*. Nor would the partnership realize any ordinary income, for it did not give up any Section 751 property in the distribution. The only consequence to the partnership would be a change in the basis of the inventory. (The new basis of the inventory would be \$66,000. The predistribution basis of the inventory, \$60,000, is first reduced by \$20,000, the basis of Arthur's share of the inventory, since the partnership is treated as having distributed his share of the inventory to him, and then increased by \$26,000, the partnership's cost of repurchasing the inventory.)

Example 2:

Under *IRC Section 751(b)*, the distribution of inventory securities is considered a distribution to the extent of \$26,000 (the partner's share of inventory securities) and a sale to the extent of \$4,000. This produces ordinary income for the partnership in the amount of \$923; the \$4,000 of inventory had a basis of \$3,077 ($60,000/78,000 \times \$4,000$). The partnership recognizes no gain or loss on the portion of the distribution which is not treated as a sale or exchange. The partnership would have to adjust the basis of the capital assets which it is deemed to have purchased from Arthur with the appreciated inventory. Again, this entails a reduction in basis in an amount equal to the basis of the capital assets which Arthur is deemed to have sold to the partnership, followed by an increase in basis in the amount of the purchase price (\$90,000 - \$3,529 + \$4,000, or \$90,471).

Example 3:

Here the partner received his share of the appreciated inventory securities and his share of other property of the partner. This bars the application of *IRC Section 751(b)*, the distribution is governed wholly by *IRC Section 731*, and no gain or loss is recognized to the partnership.

FOOTNOTES:

(n1)Footnote 1. *IRC § 731(a)*. This is a logical extension of the rule that a partnership's income is taxable to its partners when earned.

The Service has determined that, in order to carry out the purposes of the repeal of the *General Utilities* doctrine, a partnership distribution to a corporate partner of the stock of the corporation (or the stock of any member of the affiliated group of which the partner is a member) should be treated as a redemption of the partner's stock with property consisting of its partnership interest. The Service will issue regulations that *IRC § 311(b)*, and not *IRC § 731*, will govern such transactions, and that gain (but not loss) with respect to the partnership interest will be recognized. *Notice 89-37, 1989-1 CB 679*.

(n2)Footnote 2. *IRC § 731(a)(1)*. The gain is treated as gain from the sale or exchange of the partnership interest of the distributee partner. *IRC § 731 (a)*; *Rev Rul 56-5, 1956-1 CB 630*.

For purposes of the passive activity loss rules of *IRC § 469*, if a partner receives a distribution of money in excess of its adjusted basis in its partnership interest and recognizes gain under *IRC § 731(a)*, the gain is treated as gain from the sale or exchange of a partnership interest under *Treas Reg § 1.469-2T(e)(3)*. *Rev Rul 95-5, 1995-1 CB 100*.

(n3)Footnote 3. *IRC § 733*. The partner's basis for property distributed in kind is determined under *IRC § 732*, discussed in § 14.04[1][b][i].

(n4)Footnote 3.1. *IRC § 737(a)*. The adjusted basis of the partner's interest in the partnership is increased by the amount of gain recognized; the increase is treated as occurring immediately before the distribution. *IRC § 737(c)(1)*. This increase is not taken into account in determining the amount of gain recognized on a distribution of marketable securities governed by *IRC § 731(c)*. *Treas Reg § 1.731-2(g)(2)(iii)*.

Appropriate adjustments are made to the adjusted basis of the partnership in the contributed property to reflect the amount of gain recognized. *IRC § 737(c)(2)*.

(n5)Footnote 3.2. *IRC § 737(b)*.

(n6)Footnote 4. The character of the gain or loss is determined by reference to the character that would have resulted if the property had been sold by the partnership to the distributee.

(n7)Footnote 5. *IRC § 704(c)(2)*. The like kind property is treated as contributed property to the extent of the value thereof.

(n8)Footnote 5.1. *IRC § 737(d)*.

(n9)Footnote 5.2. *IRC § 731(c)(1)*. Marketable securities contributed to a partnership are treated as property other than money in determining the contributing partner's net precontribution gain under *IRC § 737(b)*.

(n10)Footnote 5.3. *IRC § 731(c)(3)(B)*. A partner's distributive share of net gain is determined (i) by taking into account any basis adjustments under *IRC § 743(b)* with respect to that partner; (ii) without taking into account any special allocations adopted with a principal purpose of avoiding the effect of *IRC § 731(c)*; and (iii) without taking into account any gain or loss attributable to a distributed security to which *IRC § 731(c)* does not apply. *Treas Reg § 1.731-2(b)(3)*.

(n11)Footnote 5.4. *IRC § 731(c)(2)(A), (B); Treas Reg § 1.731-2(c)(2), (3)(i), (ii)*. A discussion of *IRC § 1092(d)(1)* can be found in Ch 9.

The value of the assets of an entity is determined without regard to any debt that may encumber or otherwise be allocable to those assets, other than debt that is incurred to acquire an asset with a principal purpose of avoiding or reducing the effect of *IRC § 731(c)*. *Treas Reg § 1.731-2(c)(4)*.

A financial instrument includes stocks and other equity interests, evidences of indebtedness, options, forward or future contracts, notional principal contracts, and derivatives. *IRC § 731(c)(2)(C)*.

(n12)Footnote 5.5. *IRC § 731(c)(3)*. The exception for a security that was not marketable when contributed applies only if the entity to which the security relates had no outstanding marketable securities on that date, the security is actively traded on the date of distribution, and the security was held by the partnership for at least six months before the security became marketable and the security was distributed within five years of the date on which it became marketable. *Treas Reg § 1.731-2(d)(1)*.

(n13)Footnote 5.6. *Treas Reg § 1.731-2(d)(1)*.

(n14)Footnote 5.7. *Treas Reg § 1.731-2(d)(3)*.

(n15)Footnote 5.8. *Treas Reg § 1.731-2(d)(2)*. Money contributed by the partnership does not include any money deemed contributed by the partnership as a result of *IRC § 752*.

(n16)Footnote 5.9. *IRC § 731(c)(3)(C)(i)*.

(n17)Footnote 5.10. *IRC § 731(c)(1)(C)(ii); Treas Reg § 1.731-2(e)(3)*.

(n18)Footnote 5.11. *IRC § 731(c)(3)(C)(iv)(I)*.

(n19)Footnote 5.12. *Treas Reg § 1.731-2(e)(4)*.

(n20)Footnote 5.13. *IRC § 731(c)(3)(C)(iii)(I)*. An eligible partner cannot be the transferor or transferee in a nonrecognition transaction involving the transfer of any portion of an interest in a partnership with respect to which the transferor was not an eligible partner. *IRC § 731(c)(3)(C)(iii)(II)*.

(n21)Footnote 5.14. *IRC § 731(c)(3)(C)(iv)(II)*.

(n22)Footnote 5.15. *IRC § 731(c)(5)*.

(n23)Footnote 6. *Treas Reg § 1.731-1(a)*.

(n24)Footnote 7. *IRC § 731(a)(2)*; but see *Cora-Texas Mfg Co v US*, 222 F Supp 527 (ED La 1963), *affd per curiam* 341 F2d 578 (5th Cir 1965) where a distribution to a corporate partner of its own stock gave rise to a recognized loss; the stock had a predetermined and fixed value and could not be reissued.

The terms "unrealized receivables" and "inventory items" are defined in *IRC § 751(c)* and *IRC § 751(d)(2)* respectively.

(n25)Footnote 8. *IRC § 736(b)(2)* prescribes this result by stating that a payment in exchange for an interest in partnership property cannot include any amount paid for unrealized receivables and good will.

(n26)Footnote 9. A distributive share is determined with regard to the income of the partnership, a guaranteed payment is not. *IRC § 736(a)*.

(n27)Footnote 10. Egger, "Sales of Partnership Interests and Death or Retirement of Partner," *NYU 15th Inst on Fed Tax* 115, 121 (1957).

(n28)Footnote 11. Prop Treas Reg § 1.736-1(a)(2), *20 Fed Reg* 5871 (1955) .

(n29)Footnote 12. Any portion of the distribution attributable to unrealized receivables and good will should not be treated as a payment for an interest in partnership property except to the extent that the partnership agreement calls for a payment for good will. *IRC* § 736(b)(2).

(n30)Footnote 13. *Treas Reg* § 1.731-1(c)(3).

(n31)Footnote 14. *1957-1 CB* 205 .

(n32)Footnote 15. *Rev Rul* 57-200, *1957-1 CB* 205, 206 .

(n33)Footnote 16. S Rep No 1622, 83rd Cong, 2d Sess, 401 (1954).

(n34)Footnote 17. *Treas Reg* § 1.751-1(e).

(n35)Footnote 18. Under *IRC* § 751(a), so much of the amount realized on the sale or exchange of a partnership interest as is attributable to inventory items or unrealized receivables must be considered as an amount realized from the sale or exchange of noncapital assets, causing so much of the gain or loss as is attributable to the Section 751 property to be taxed as ordinary gain or loss.

The Taxpayer Relief Act amended *IRC* § 751(a) to eliminate the requirement that inventory items have substantially appreciated in value. The amendment is effective for sales, exchanges, and distributions after Aug 5, 1997.

(n36)Footnote 19. *IRC* § 751(b)(2).

(n37)Footnote 20. *Treas Reg* § 1.751-1(b)(1)(ii); *Rev Rul* 57-68, *1957-1 CB* 207 .

(n38)Footnote 21. *Treas Reg* § 1.751-1(b)(1)(ii).

(n39)Footnote 22. *IRC* § 751(b)(3)(A). Inventory property is excluded from the determination of whether inventory has appreciated substantially in value if a principal purpose for acquiring the property was to avoid the provisions of *IRC* § 751(b). *IRC* § 751(b)(3)(B).

(n40)Footnote 23. *Treas Reg* § 1.751-1(d)(1).

(n41)Footnote 24. *Treas Reg* § 1.751-1(d)(1).

(n42)Footnote 25. *Treas Reg* § 1.751-1(d)(1).

(n43)Footnote 26. *IRC* §§ 751(d)(1), 1221(a)(1).

(n44)Footnote 27. *IRC* § 751(d)(2).

(n45)Footnote 28. *Treas Reg* § 1.751-1(d)(2)(ii). Stock in a DISC and stock in controlled foreign corporations constitute unrealized receivables *IRC* § 751(c).

(n46)Footnote 29. *IRC* § 751(d)(3). Property actually distributed to the partner does not come within the scope of *IRC* § 751(d)(3). *Treas Reg* § 1.751-1(d)(2)(iii).

(n47)Footnote 30. The deemed distribution is treated as an advance or drawing of money and is taken into account

at the end of the partnership taxable year. *Rev Rul 94-4, 1994-1 CB 195* .

(n48)Footnote 31. Instead, *IRC § 731* will apply.

(n49)Footnote 32. *IRC § 752(a)*.

(n50)Footnote 33. *Treas Reg § 1.751-1(g)*, Ex (2)(d)(2).

(n51)Footnote 34. *Treas Reg § 1.751-1(g)*, Ex (2)(d)(2).

(n52)Footnote 35. *IRC § 731(a)(1)*.

(n53)Footnote 36. *Treas Reg § 1.751-1(b)(2)(iii)*.

(n54)Footnote 37. *IRC § 732(a)(1)*. A special election regarding basis is available to a distributee partner who acquired his interest from other partners not more than two years before the distribution. *IRC § 732(d)*, discussed in Rabkin & Johnson, 3 *Federal Income, Gift and Estate Taxation*, § 16.12 (Matthew Bender).

(n55)Footnote 38. *IRC § 732(a)(2)*.

(n56)Footnote 39. *IRC § 732(e)*.

(n57)Footnote 40. *IRC § 732(c)(1)(A)(i)*.

(n58)Footnote 41. *IRC § 732(c)(1)(A)(ii), (3)*.

(n59)Footnote 42. *IRC § 731(c)(4)(A)*.

(n60)Footnote 43. *IRC § 731(c)(4)(B)*.

(n61)Footnote 44. *IRC § 732(f)(1)*, effective with respect to distributions made after July 14, 1999. However, in the case of a corporation that is a partner in a partnership as of July 14, 1999, *IRC § 732(f)(1)* will apply to any distribution made (or treated as made) after June 30, 2001, except that, if a distribution is made after Dec 17, 1999 and before July 1, 2001, *IRC § 732(f)(1)* will apply only if the corporate partner so elects.

IRC § 732(f)(1) does not apply to any distribution of stock in the distributed corporation if the corporate partner does not have control immediately after the exchange immediately after the distribution, and the corporate partner establishes to the satisfaction of the Service that the distribution was not part of a plan or arrangement to acquire control of the distributed corporation. *IRC § 732(f)(2)*.

Control for purposes of *IRC § 732(f)(1)* means the ownership by the corporate partner of stock that possesses at least 80 percent of the total voting power of the stock of the distributed corporation, and has a value equal to at least 80 percent of the total value of the stock of the distributed corporation. *IRC §§ 732(f)(5), 1504(a)(2)*.

(n62)Footnote 45. *IRC § 732(f)(3)*.

(n63)Footnote 46. *IRC § 732(a)(2)*.

(n64)Footnote 47. *IRC § 732(f)(4)*.

(n65)Footnote 48. *IRC § 732(f)(6)*.

(n66)Footnote 49. *IRC § 732(f)(7)*.

(n67)Footnote 50. *IRC* § 732(b). The *IRC* § 732(d) election may also be available in the case of a liquidating distribution.

The basis adjustment rules of *IRC* § 732(f) apply to a liquidating distribution to a corporate partner of stock in a controlled corporation. See the discussion above.

(n68)Footnote 51. *IRC* § 732(e).

(n69)Footnote 52. *IRC* § 732(c)(1)(B), (2).

(n70)Footnote 53. *IRC* § 735(b).

(n71)Footnote 54. *Treas Reg* § 1.735-1(b).

(n72)Footnote 55. *IRC* § 735(a)(2).

(n73)Footnote 56. A full discussion of the partnership's basis for the property retained by it after the distribution is beyond the scope of this book. Generally, "the basis of partnership property shall not be adjusted as the result of a distribution of property to a partner. ..." *IRC* § 734(a). All that happens is that the partnership reduces its basis for a particular class of property by the basis of any property of the same class distributed to the partner. However, there may be a different result if the partnership has elected the optional adjustment to basis provided by *IRC* § 754. See Janin, "Current and Liquidating Distributions and Partnership Elections Under Section 754," *NYU 15th Inst on Fed Tax* 95 (1957).



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CHAPTER 15 The Taxpayer as an S Corporation Shareholder

2-15 Taxation of Securities Transactions 15.syn

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CHAPTER 15 The Taxpayer as an S Corporation Shareholder

2-15 Taxation of Securities Transactions § 15.01

§ 15.01 Introduction

In 1954, Congress passed legislation permitting noncorporate businesses to elect to be taxed as corporations. At the same time, a Senate provision, which would have permitted a corporation to forego payment of any tax and required the shareholders to report the corporate income as their own, was not enacted into law. Such legislation did pass in 1958, making it possible for a business to select the form of business organization desired without the necessity of taking into account major differences in tax consequence.ⁿ¹

As first enacted, the basic scheme of Subchapter S was the elimination of tax at the corporate level and the inclusion of a proportionate share of the corporation's undistributed taxable income in the gross income of each shareholder owning stock on the last day of the corporation's taxable year. Losses sustained by the corporation similarly passed through to, and could be deducted by, its shareholders, based on each shareholder's pro rata share of ownership in the corporation during the taxable year. Specific items of income or deduction other than long-term capital gains did not pass through.

A belief "that partnership-like rules which pass items of income and loss through to the corporation's shareholders with distributions being generally a return of the shareholder's investment is a simpler and more rational taxing scheme"ⁿ² led to the enactment of the Subchapter S Revision Act of 1982. With some exception, the rules governing S corporations and their shareholders parallel those prescribed for partnerships and partners.

The discussion in this chapter will focus on the effect of a Subchapter S election on the corporation and its shareholders. It will not touch upon the requirements for electing Subchapter S treatment or upon the conditions that must be met if a corporation desires to remain an S corporation.ⁿ³

FOOTNOTES:

(n1)Footnote 1. S Rep No 1983, 85th Cong, 2d Sess 87 (1958). Congress also believed that the elimination of the "double tax" would be a substantial aid to small business.

(n2)Footnote 2. HR Rep No 826, 97th Cong, 2d Sess 6 (1982).

(n3)Footnote 3. See R. Robinson & A. Weiss, *Tax Planning for S Corporations*, Chs 8 and 11 (Matthew Bender); 3 Rabkin & Johnson, *Federal Income, Gift and Estate Taxation*, Ch 18 (Matthew Bender).



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Taxation of Securities Transactions

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CHAPTER 15 The Taxpayer as an S Corporation Shareholder

2-15 Taxation of Securities Transactions § 15.02

§ 15.02 Effect of the Election on the Corporation

[1] Taxes Imposed on the Corporation.

The essential feature of a Subchapter S election is, with limited exceptions, the elimination of all income taxes on the corporation's income.ⁿ¹

The first of the exceptions arises whenever, for any taxable year, an S corporation that was once a C corporation has a net recognized built-in gain.ⁿ² The tax imposed on such gain is determined by applying the highest tax rate specified in *IRC Section 11* to the net recognized built-in gains for the taxable year.ⁿ³ The corporation will be allowed to continue to utilize any unexpired net operating loss, capital loss, or business credit carryforward in computing the amount of tax on net recognized built-in gains.ⁿ⁴

The corporation's net recognized built-in gain is the amount that would be its taxable income (except as provided for net operating loss carryforwards) if only recognized built-in gains and losses were taken into account.ⁿ⁵ If the corporation became an S corporation after March 30, 1988, the amount of net recognized built-in gain for any year cannot exceed its taxable income determined without regard to any of the deductions allowed by *IRC Sections 241 through 250* (other than the deduction for amortization of organizational expenses permitted by *IRC Section 248*) or the net operating loss deduction; any net recognized built-in gain not subject to tax because of this limitation is carried forward and treated as recognized built-in gain or loss in the succeeding year.

The corporation's built-in gain or loss is the amount of gain or loss that arose prior to its conversion to an S corporation; it becomes recognized if the corporation disposes of an asset with built-in gain or loss within ten yearsⁿ⁶ after the S election took effect.ⁿ⁷ Gains and losses on sales or distributions by the corporation are presumed to be built-in gains and losses, unless the corporation can establish that the asset was not held at the beginning of the ten-year period or that all or part of the gain or loss arose after the conversion. However, any asset acquired after the conversion date in a tax-free exchange for an asset held on that date is subject to the rules of *IRC Section 1374*.ⁿ⁸ The total taken into account during the ten-year period cannot exceed the aggregate net unrealized built-in gain of the corporation at the time of the conversion; the amount taxable in any year is limited to the excess of the corporation's net unrealized built-in gain over its net recognized built-in gains for prior years in the ten-year recognition period.ⁿ⁹

The regulations further limit the amount of an S corporation's net recognized built-in gain for any taxable year to the

least of:

- (1) its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover (pre-limitation amount);
- (2) its taxable income determined by using all rules applying to C corporations as modified by *IRC Section 1375(b)(1)(B)* (taxable income limitation); and
- (3) the amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior taxable years (net unrealized built-in gain limitation).ⁿ¹⁰

If an S corporation's pre-limitation amount for any taxable year exceeds its net recognized built-in gain for that year, the S corporation's net recognized built-in gain consists of a ratable portion of each item of income, gain, loss and deduction included in the pre-limitation amount.ⁿ¹¹ If an S corporation's net recognized built-in gain for any taxable year is equal to its taxable income limitation, the amount by which its pre-limitation amount exceeds its taxable income limitation is a recognized built-in carryover included in its pre-limitation amount for the succeeding taxable year. The recognized built-in gain carryover consists of that portion of each item of income, gain, loss, and deduction not included in the S corporation's net recognized built-in gain for the year in which the carryover arises.ⁿ¹²

Example:

A Corp. is a calendar year C corporation that elects to become an S corporation on January 1, 1996. A has a net unrealized built-in gain of \$200,000 and no net operating loss or capital loss carryforwards. In 1996, A has:

- (1) a pre-limitation amount of \$80,000 (consisting of ordinary income of \$60,000 and capital gain of \$20,000);
- (2) a taxable income limitation of \$38,400; and
- (3) a net unrealized built-in gain limitation of \$200,000.

A's net recognized built-in gain for 1996 is \$38,400, the least of the three limitations. Under the allocation rule, A's net recognized built-in gain for 1996 consists of a ratable portion of each item of income and gain in the pre-limitation amount, namely, recognized built-in ordinary income of \$28,800 ($\$38,400 \text{ taxable income} / \$80,000 \text{ pre-limitation amount} \times \$60,000 \text{ built-in ordinary income}$) and recognized built-in capital gain of \$9,600 ($\$38,400 \text{ taxable income} / \$80,000 \text{ pre-limitation amount} \times \$20,000 \text{ built-in capital gain}$). A has a recognized built-in gain carryover to 1997 of \$41,600 ($\$80,000 \text{ pre-limitation amount less } \$38,400 \text{ net recognized built-in gain for 1996}$), consisting of \$31,200 of recognized built-in ordinary income and \$10,400 of recognized built-in capital gain. The ten-year period is a calendar period measured from the first day the corporation is an S corporation or the day an S corporation acquires assets in a transaction in which its basis in the assets is determined in whole or in part by reference to the basis of the assets in the hands of a C corporation. *Treas Reg § 1.1374-1(d)*.

For purposes of the built-in gains tax, any item of income that is properly taken into account for any taxable year during the ten-year recognition period but is attributable to periods before the first taxable year that the corporation was an S corporation is treated as a recognized built-in gain for the taxable year in which it is properly taken into account.ⁿ¹³ Thus, the term "disposition" includes not only sales or exchanges but other income recognition events that effectively dispose of or relinquish the taxpayer's right to claim or receive income, e.g., the collection of accounts receivable by a cash basis taxpayer.ⁿ¹⁴ Amounts that are allowable as a deduction during the recognition period but are attributable to

periods before the conversion to S corporation status are treated as recognized built-in losses in the year of deduction.ⁿ¹⁵ The amount of net unrealized built-in gain is adjusted for amounts treated as recognized built-in gains or losses pursuant to the foregoing rules.

If a corporation sells an asset before or during the recognition period and reports the income from the sale under the installment method during or after the recognition period, the income is subject to tax under *IRC Section 1374*.ⁿ¹⁶ For purposes of this rule, the taxable income limitation is equal to the amount by which the S corporation's net recognized built-in gain would have been increased from the year of sale to the earlier of (1) the year the income is reported under the installment method or (2) the last year of the recognition period, assuming all income from the sale had been reported in the year of sale, and all provisions of *IRC Section 1374* applied. If the corporation sells the asset before the recognition period, the income from the sale that is not reported before the recognition period is treated as having been reported in the first year of the recognition period.ⁿ¹⁷

The tax generally does not apply to corporations that have always been S corporations.ⁿ¹⁸ However, the built-in gain tax will apply to such a corporation if it acquires an asset and its basis in the asset is determined in whole or in part by reference to the basis of the asset in the hands of a C corporation.ⁿ¹⁹ In such case, each acquisition of assets from a C corporation is subject to a separate determination of the amount of net built-in gain.

If *IRC Section 1374(d)(8)* applies to an S corporation's acquisition of assets, some or all of the stock of the corporation from which the assets were acquired was taken into account in the computation of net unrealized built-in gain for a pool of assets of the S corporation, and some or all of such stock is redeemed or canceled in the transaction, then, the net unrealized built-in gain is adjusted to eliminate any effect that any built-in gain or built-in loss in the redeemed or canceled stock (other than stock for which a loss is claimed under *IRC Section 165*) had on the initial computation of net unrealized built-in gain for that pool of assets.ⁿ²⁰ This adjustment to net unrealized built-in gain is made only to reflect built-in gain or built-in loss in the redeemed or canceled stock that has not resulted in recognized built-in gain or recognized built-in loss during the recognition period.ⁿ²¹

The built-in gain rule clearly affects a corporation that employs the first-in, first-out (FIFO) inventory method and sells appreciated inventory within the ten-year period. A last-in, first-out (LIFO) method corporation can escape the effect of the tax if it does not invade LIFO layers during the period. *IRC Section 1363(d)* forces any LIFO-method C corporation electing to be an S corporation to include "the LIFO recapture amount" (the excess of the value of its inventory under the FIFO method over the value under the LIFO method) in income in its last taxable year as a C corporation.ⁿ²² The increased tax is payable in four annual installments, the first due on the due date (determined without regard to extensions) for the return for the corporation's last C corporation taxable year. The remaining installments must be paid before the due dates (without regard to extensions) for the succeeding three taxable years. No interest is payable if the payments are timely.

A C corporation that does not include a LIFO recapture amount in gross income for the last taxable year before its S election becomes effective may be liable for a 20-percent accuracy-related penalty under *IRC Section 6662*.ⁿ²³ A corporation that fails to make a LIFO recapture installment payment by its required due date may be liable for a failure to pay penalty under *IRC Section 6651*. In addition, the corporation may be liable for interest under *IRC Section 6601*. The failure to pay, or late payment of, a LIFO recapture installment payment does not cause the remaining unpaid installments to become due immediately.

The second tax applies only if, at the end of the taxable year, an S corporation has earnings and profits remaining from years in which it was a C corporation (a regularly taxed corporation subject to the provisions of Subchapter C) and has passive investment incomeⁿ²⁴ amounting to more than 25 percent of its gross receipts for the year. (The corporation's Subchapter S election will terminate if the corporation's passive investment income exceeds 25 percent of gross receipts for three consecutive taxable years and the corporation has accumulated earnings and profits at the close of each of those taxable years.)ⁿ²⁵ The impost here is 35 percent (the highest corporate rate) of the corporation's excess net

passive income (its net passive income multiplied by a fraction the numerator of which is the amount by which the passive investment income for the taxable year exceeds 25 percent of the gross receipts for that year and the denominator of which is the passive investment income for the year).ⁿ²⁶ However, the amount of excess net passive income cannot exceed the corporation's taxable income for the year, determined without regard to the special deductions allowed to corporations under *IRC Sections 241 through 250* (except for the deduction for amortization of organizational expenses sanctioned by *IRC Section 248*) and the net operating loss deduction. To illustrate:

Example:

For a given taxable year, an S corporation has \$140,000 of gross receipts, \$60,000 of passive income, and \$15,000 in expenses directly connected with such income. Its excess net passive income is \$18,750, determined by multiplying net passive income of \$45,000 by the fraction, 25,000/60,000. (The numerator of the fraction is the amount by which passive investment income exceeds 25 percent of gross receipts; the denominator is passive income.) The tax on excess net passive investment income is \$6,563 (35 percent of \$18,750).

The Service can waive the tax if the S corporation can establish to the satisfaction of the government that it determined in good faith that it had no accumulated earnings and profits at the close of the taxable year, and, during a reasonable time after it was determined that it did have earnings and profits at the close of the year, the earnings and profits were distributed.ⁿ²⁷

The corporation can avoid the tax on excess passive income and the three-year termination rule by electing, with the consent of its shareholders, to distribute all of its accumulated earnings and profits as a dividend to its shareholders.ⁿ²⁸

Finally, an S corporation that claimed an investment credit for property acquired when it was a C corporation will be visited with the increase in tax mandated by *IRC Section 47* if it makes an early disposition of that property.ⁿ²⁹

Under *IRC Section 6655(g)(4)*, an S corporation that becomes obligated for any of the above taxes must make installment payments of its estimated tax liability.ⁿ³⁰

[2] Computation of the Corporation's Taxable Income.

Pursuant to *IRC Section 1363(b)*, an S corporation's taxable income is computed "in the same manner as ... an individual," except that:

- (1) items of income, loss, deduction, or credit the separate treatment of which could affect the tax liability of any shareholder must be separately stated;
- (2) the deductions for personal exemptions, foreign taxes, charitable contributions, and depletion, the net operating loss deduction, and the deductions provided in *IRC Sections 211 through 220* are not available;
- (3) the amortization of organizational expenditures under *IRC Section 248* is allowed as a deduction; and
- (4) the restrictions on corporate use of certain tax benefits prescribed by *IRC Section 291* will continue to apply to an S corporation if it or any predecessor corporation was a C corporation for any of the three immediately preceding years.

S Corporations with one or more "qualified subchapter S subsidiaries" ("QSubs") are required to consolidate with those subsidiaries when filing a return. Under the "deemed liquidation" rule, a QSub is not treated as a separate corporation, and all of its assets, liabilities and items of income, deduction and credit are treated as assets, liabilities and items of the parent S corporation.ⁿ¹ A QSub is any domestic subsidiary that (1) is 100 percent owned by the S Corporation, (2) the

S Corporation elects to treat as a QSub, and (3) would not be ineligible to make an election to be taxed as an S Corporation.ⁿ²

The Regulations make a limited exception to the deemed liquidation rule, pursuant to authority expressly granted by Congress, for S Corporations and QSubs that are banks: "Any special rules applicable to banks under the Internal Revenue Code" will "continue to apply separately to the bank parent or bank subsidiary as if the deemed liquidation of any QSub ... had not occurred."ⁿ³ In *Vainisi v Commr*,ⁿ⁴ the Internal Revenue Service argued that this exception justified denying a deduction for 20 percent of the amount deducted by a QSub bank for interest on indebtedness incurred to purchase or carry qualified tax exempt bonds pursuant to *IRC Section 291(a)(3)*, an anti-corporate tax preference provision normally applicable only to C corporations. *IRC Section 1363(b)(4)*, referred to above, provides that an S corporation can also be subject to Section 291, but only if it (or a predecessor) was a C corporation in any of the three preceding taxable years. The Court of Appeals for the Seventh Circuit rejected the Service's attempt to use its regulation to apply Section 291 to an S Corporation (or QSub) that had elected S Corporation status more than three years previously, finding no evidence that Congress intended to allow the Service to administratively overrule *IRC Section 1363(b)(4)* when it authorized administrative exceptions to the deemed liquidation rule, and concluding moreover that the language of *Treasury Regulation Section 1.1361-4(a)(3)* did not purport to overrule that statutory provision.

Elections affecting the computation of items derived from an S corporation are generally made at the corporate level.ⁿ⁵ However, each shareholder must separately make the elections called for by *IRC Section 617* (deduction and recapture of certain mining exploration expenditures) and *IRC Section 901* (the foreign tax credit).ⁿ⁶

The rules prescribed by Subchapter C will usually apply to S corporations unless the result would be inconsistent with the treatment of the S corporation as a pass-through entity.ⁿ⁷ A further exception decrees that an S corporation in its capacity as a shareholder of another corporation is to be treated as an individual.ⁿ⁸ For example, an S corporation would handle dividends received from other corporations under the provisions of *IRC Section 301* governing noncorporate distributees and would be precluded from claiming a deduction for dividends received under *IRC Section 243*.

[3] The Corporation's Taxable Year.

An S corporation is generally required to adopt a taxable year that ends on December 31 unless it can establish a business purpose for a different taxable year.ⁿ¹ A deferral of income to shareholders is not a business purpose.

However, *IRC Section 444* permits an S corporation to elect a different taxable year if the adopted year results in a deferral period of not longer than three months.ⁿ² The deferral period is the number of months between the close of the taxable year and the close of the taxable year otherwise required.ⁿ³ For example, if a taxable year ending October 31 is elected and a taxable year ending December 31 is otherwise required, the deferral period of the taxable year ending October 31 is two months.

The election is made at the entity level and carries with it the "required payment" imposed by *IRC Section 7519* for each year that the election is in effect.ⁿ⁴ The required payment for an applicable election year (any year of the corporation for which the election is in effect) is equal to the excess of (a) the product of the applicable percentage of the adjusted highest Section 1 tax rate multiplied by the corporation's net base-year income over (b) the net required payment balance (the excess, if any, of the required payments for all preceding applicable election years over the aggregate amount allowable as a refund to the entity for all preceding applicable election years).ⁿ⁵ The adjusted highest Section 1 rate is the highest tax rate imposed by *IRC Section 1* at the end of the year preceding the election year, plus one percentage point.ⁿ⁶ If the required payment for any applicable election year is negative, the corporation is entitled to a refund.ⁿ⁷

The corporation's net base year income is equal to the sum of the deferral ratio multiplied by the corporation's net income for the base year,ⁿ⁸ plus the excess of (i) the deferral ratio multiplied by the aggregate amount of applicable payments made during the base year, over (ii) the aggregate amount of applicable payments made during the deferral period of the base year.ⁿ⁹ The deferral ratio is the ratio that the number of months in the deferral period of the base year bears to the number of months in the corporation's taxable year. The corporation's net income cannot be less than zero and is determined by taking into account all items (other than credits and tax-exempt income) passed through to shareholders pursuant to *IRC Section 1366(a)*.ⁿ¹⁰ If the corporation was a C corporation for the base year, its taxable income for that year is deemed to be its net income for the year. Applicable payments are amounts paid by an S corporation that are includible in the gross income of its shareholders, other than gains from the sale or exchange of property between the shareholder and the corporation and dividends paid by the S corporation.ⁿ¹¹

An entity does not need to make a required payment if the total of required payments for the current and all preceding applicable election years does not exceed \$500.ⁿ¹² An amount not required to be paid is not considered to be part of the required payment for the preceding applicable election year for the purpose of determining the amount of the required payment for the current election year. For example, assume that a corporation's required payment for each of its first and second applicable election years is \$400. The corporation will not make a required payment for the first year, but will have to make a required payment of \$800 for the second year.

Any required payment is treated as a tax for purposes of determining interest. However, interest is not payable to a corporation that has a negative required payment.ⁿ¹³

A penalty of 10 percent of the underpayment is imposed for failure to make a timely payment of any amount required by *IRC Section 7519*. In addition, the required payment is treated as a tax for purposes of the negligence and fraud penalties of *IRC Sections 6662* and *6663*.

The effect of the *IRC Section 444* election and *IRC Section 7519* payment can be illustrated by the following example:

Example:

An S corporation has a fiscal year that ends on September 30. It has net income of \$100,000 for the year ended September 30, 2002, and \$200,000 for the following year. The corporation does not make any applicable payments to its shareholders.

The required payment for the fiscal year ending in 2002 is \$9,650. The corporation's net income of \$100,000 is multiplied by a deferral ratio of 3/12 (three months in the deferral period, 12 months in the taxable year) and then by 38.6 percent (the adjusted highest Section 1 rate for 2002).

The required payment for 2003 is \$9,650. The corporation's net income of \$200,000 is multiplied by the deferral ratio of 3/12 and then by 38.6 percent (\$19,300), yielding \$9,650. The \$2,250 required payment for 2002 is then subtracted to produce the required payment for 2003.

FOOTNOTES:

(n1)Footnote 1. *IRC § 1363(a)*. The exemption from tax extends to the environmental tax imposed on corporations by *IRC § 59A*. *Rev Rul 89-82, 1989-1 CB 23*.

(n2)Footnote 2. *IRC § 1374(a)*. In *Ltr Rul 200004032*, the Service held that an S corporation's charitable contribution of real estate did not result in gain or loss recognition under *IRC § 1374*.

(n3)Footnote 3. *IRC § 1374(b)(1), (4), (c)(2)*. The only credit that can be taken is the credit for certain uses of gasoline, special fuels, and lubricating oil allowed by *IRC § 34*. *IRC § 1374(b)(3)(A)*.

(n4)Footnote 4. *IRC § 1374(b)(2), (3)(B).*

(n5)Footnote 5. *IRC § 1374(d)(2).*

(n6)Footnote 6. *IRC § 1374(d)(7)(B)* temporarily shortens the recognition period from ten to seven years for purposes of calculating an S corporation's net recognized built-in gain in any taxable year beginning in 2009 or 2010. Thus, for example, if a corporation converted to S corporation status in 2002, and held an asset with a built in gain in that year, a disposition of that asset in 2010 will not be subject to the *IRC § 1374* tax. Unless the rule of *IRC § 1374(d)(7)(B)* is extended, however, if the corporation waits until its next taxable year, beginning in 2011, to sell the asset, the built-in gain will again be taxable since the recognition period reverts to ten years after 2010.

(n7)Footnote 7. *IRC § 1374(d)(3), (4), (7).*

A loss attributable to the basis of redeemed stock that is taken into account pursuant to the rules of *Prop Treas Reg § 1.302-5* is allowed as a deduction against net recognized built-in gain of the S corporation for the taxable year, if the loss arose in a year in which the corporation was a C corporation. *Prop Treas Reg § 1.1374-5(a)*. The rule will be applicable to redemptions occurring after the regulation becomes final.

The Service has ruled that income derived from timber, coal, and iron ore during the recognition period constitutes normal operating income and is not recognized built-in gain within the meaning of *IRC § 1374(d)(3)*. *Rev Rul 2001-50, 2001-2 CB 343*. In so ruling, the Service stated that there is no indication that Congress intended the capital gain rate benefits provided by *IRC § 631* to change that result.

(n8)Footnote 8. *IRC § 1374(d)(6).*

(n9)Footnote 9. *IRC § 1374(c)(2), (d)(1).*

(n10)Footnote 10. *Treas Reg § 1.1374-2(a)*. In determining its taxable income for pre-limitation amount and taxable income limitation purposes, a corporation must use the accounting method it uses for tax purposes as an S corporation. *Treas Reg § 1.1374-2(d)*.

(n11)Footnote 11. *Treas Reg § 1.1374-2(b).*

(n12)Footnote 12. *Treas Reg § 1.1374-2(c).*

(n13)Footnote 13. *Treas Reg § 1.1374-4(b)(1)*. *Treas Reg § 1.1374-4(d)(1)* treats an *IRC § 481(a)* adjustment (an adjustment required because of a change in accounting method) taken into account in the recognition period as recognized built-in gain or loss to the extent the adjustment relates to items attributable to periods before the beginning of the recognition period. The Tax Court reached the same conclusion in *Argo Sales Co v Commr*, 105 TC 86 (1995), involving a year prior to the effective date of the regulation.

(n14)Footnote 14. *IRC § 1374(d)(5); Frank J. Leou, M.D., P.A. v Commr*, TC Memo 1994-393.

(n15)Footnote 15. *Treas Reg § 1.1374-4(b)(2).*

(n16)Footnote 16. *Treas Reg § 1.1374-4(h)(1).*

(n17)Footnote 17. *Treas Reg § 1.1374-4(h)(2)*. If the limitation applies, the excess of the amount reported under the installment method over the amount subject to tax under the limitation is treated as if it were reported in the succeeding taxable year or years within the recognition period. The amount reported in a later year is reduced to the extent that the amount not subject to tax under the limitation was not subject to tax because the S corporation had an excess of recognized built-in loss over recognized built-in gain in the taxable year of the sale and succeeding years in

the recognition period. *Treas Reg § 1.1374-4(h)(3)*.

(n18)Footnote 18. *IRC § 1374(c)(1)*.

(n19)Footnote 19. *IRC § 1374(d)(8)*. *IRC § 1374(d)(8)* applies to any transaction described in that section that occurs after Dec 27, 1994, regardless of the date of the corporation's election to be an S corporation. *Temp Treas Reg § 1.1374-8T(a)(2)*.

(n20)Footnote 20. *Treas Reg § 1.1374-3(b)(1)*. A pool of assets is defined as (i) the assets held by the corporation on the first day it became an S corporation, if the corporation was previously a C corporation; or (ii) the assets of the S corporation acquired from a C corporation in an *IRC § 1374(d)(8)* transaction. *Treas Reg § 1.1374-3(b)(4)*.

(n21)Footnote 21. *Treas Reg § 1.1374-3(b)(2)*.

(n22)Footnote 22. The rules relating to (a) the prohibition on adjustments of earnings and profits of an S corporation (*IRC § 1371(c)(1)*) and (b) the requirement to reduce the basis of stock of the S corporation by reason of nondeductible expenses (*IRC § 1367(a)(2)(D)*) do not apply to the LIFO recapture tax. *IRC § 1363(d)(5)*.

Except as provided in regulations, the corporation is not treated as a member of an affiliated group with respect to the amount of the LIFO recapture amount.

Rev Proc 94-61, 1994-2 CB 775, sets forth procedures for reporting the LIFO recapture amount.

As part of a restructuring, a C corporation that was a holding company elected S corporation status. Newly formed S corporation subsidiaries of the corporation contributed assets and cash to limited partnerships in exchange for general partnership interests, and liabilities to the limited partnerships in exchange for limited partnership interests. The subsidiaries were then liquidated, leaving the corporation with the limited partnership interests. In *Coggin Automotive Corp v Commr*, 115 TC 349 (2000), the Tax Court applied the aggregate approach of partnerships to hold that corporation owned a pro rata share of the partnerships' inventories. This triggered application of *IRC § 1363(d)*. The Eleventh Circuit reversed on the ground that the holding company never owned any LIFO inventory that required recapture when it became an S corporation. The appellate opinion is reported at 292 F3d 1326 (11th Cir 2002).

(n23)Footnote 23. *Notice 2003-4, 2003-1 CB 294*.

(n24)Footnote 24. The term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest and annuities. *IRC § 1362(d)(3)(C)(i)*. It does not include interest on obligations acquired from sales of inventory, interest earned by a lending or finance company that meets the requirements of *IRC § 542(c)(6)*, or amounts received on the complete liquidation of a corporation in which the S corporation owned more than 50 percent of each class of stock. *IRC §§ 1362(d)(3)(C)(ii), 1375(b)(3)*. If an S corporation holds stock in a C corporation and that stock (a) possesses at least 80 percent of the total voting power of the stock of the C corporation, and (b) has a value equal to at least 80 percent of the total value of the stock of the C corporation, passive investment income does not include dividends from the C corporation attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business. *IRC §§ 1362(d)(3)(C)(iv), 1504(a)(2)*.

In the case of a bank (as defined in *IRC § 581*), a bank holding company (within the meaning of § 2(a) of the Bank Holding Company Act of 1956), or a financial holding company within the meaning of § 2(p) of that Act), passive investment income does not include (i) interest income earned by the bank or company, or (ii) dividends on assets required to be held by the bank or company, including stock in the Federal Reserve Bank, the Federal Home Loan Bank, or the Federal Agricultural Mortgage Bank or certificates issued by a Federal Intermediate Credit Bank. *IRC § 1362(d)(3)(C)(v)*.

The term "rents" means amounts received for the use of, or right to use, property. The term does not include rents derived in the active trade or business of renting property. Rents are so derived only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally significant services are not provided in connection with net leases. Factors for determining whether significant services are performed or substantial costs are incurred include the number of employees providing services and the types and amounts of costs incurred. *Treas Reg § 1.1362-2(c)(5)(ii)(B)(2)*; *Ltr Rul 9411015* ; *Ltr Rul 9409010* ; *Ltr Rul 9129015* .

(n25)Footnote 25. *IRC § 1362(d)(3)*. If a corporation was an electing small business corporation under Subchapter S for any taxable year beginning before Jan 1, 1983, and the corporation is an S corporation for its first taxable year beginning after Dec 31, 1996, the amount of the corporation's accumulated earnings and profits (as of the beginning of that first taxable year) will be reduced by an amount equal to the portion (if any) of the accumulated earnings and profits that were accumulated in any taxable year beginning before Jan 1, 1983, for which the corporation was an electing small business corporation. Small Business Job Protection Act of 1996, § 1311.

(n26)Footnote 26. *IRC § 1375(a), (b)*. The *IRC § 34* credit is the only credit allowed against the tax. *IRC § 1375(c)*. The amount of passive net income is determined by not taking into account any recognized built-in gain or loss of the S corporation for any taxable year in the recognition period. *IRC § 1375(b)(4)*.

(n27)Footnote 27. *IRC § 1375(d)*. The request for waiver is made to the district director. *Treas Reg § 1.1375A-1(d)(2)*.

(n28)Footnote 28. *IRC § 1368(e)(3)*; *IR 83-91, 1983-32 IRB 31*.

(n29)Footnote 29. *IRC § 1371(d)(2)*.

(n30)Footnote 30. No installment payments of estimated tax are due if the amount of the tax is less than \$500. *IRS Ann 90-44, 1990-13 IRB 25* .

(n31)Footnote 1. *IRC § 1361(b)(3)*; *Treas Reg § 1.1361-4(a)(2)*.

(n32)Footnote 2. *IRC § 1361(b)(3)(B)*.

(n33)Footnote 3. *Treas Reg § 1.1361-4(a)(3)*. Authority for the regulation is in *IRC § 1361(b)(3)(A)*, which prefaces the deemed liquidation rule with the statement "Except as provided in regulations prescribed by the Secretary ... " Apart from treating a QSub bank as a separate entity for purposes of applying "special rules applicable to banks under the Internal Revenue Code," *Treas Reg § 1.1361-4(a)(3)* provides that in all other respects taxable income should be calculated under the deemed liquidation rule.

(n34)Footnote 4. *599 F3d 567 (7th Cir 2010)* , *rev'g 132 TC 1 (2009)* .

(n35)Footnote 5. *IRC § 1363(c)(1)*.

(n36)Footnote 6. *IRC § 1363(c)(2)*.

(n37)Footnote 7. *IRC § 1371(a)(1)*. No carryforward or carryback of a loss arising in a year in which a corporation is a C corporation can be carried to a year in which it is an S corporation, but the S corporation years are counted in determining the maximum number of years to which an item can be carried. *IRC § 1371(b)(1), (3)*. No carryback or carryforward arises at the corporate level for a taxable year for which the corporation is an S corporation. *IRC § 1371(b)(2)*.

A loss attributable to unutilized basis of redeemed shares is treated as a carryforward arising in a taxable year for which the corporation was a C corporation. Therefore, it cannot be carried to a taxable year for which the corporation is

an S corporation. *Prop Treas Reg §§ 1.302-5(a), 1.1371-1(a)*.

The Tax Court held that a suspended passive activity loss incurred by a closely held C corporation that later elects to be an S corporation cannot be deducted by the S corporation in the year in which the corporation disposes of its entire interest in the activity generating the loss. *St Charles Inv Co v Commr*, 110 TC 46 (1998). The Tenth Circuit reversed. In its opinion, the "except as otherwise stated in this section" language of *IRC § 469(b)* prevents the application of unenumerated exceptions to the statute. Because the restrictions on carryforwards contained in *IRC § 1371* are not mentioned in *IRC § 469*, they have no effect on the operation of *IRC § 469(b)*. Thus, the deductibility of suspended passive activity losses is subject only to the provisions of *IRC § 469*. The appellate opinion is reported at 232 F3d 773 (10th Cir 2000).

(n38)Footnote 8. *IRC § 1371(a)(2)*.

(n39)Footnote 1. *IRC § 1378(a), (b)*.

(n40)Footnote 2. *IRC § 444(b)(2)*. The election is made on Form 8716 and must be filed with the appropriate IRS Service Center by the earlier of (i) the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective, or (ii) the due date (without regard to extensions) of the income tax return resulting from the election. *Temp Treas Reg § 1.444-3T(b)(1)*.

The election is not required if the corporation can show a business purpose for a different taxable year. A corporation that has filed a business-purpose request can also file a back-up election to take effect if the Service denies its business-purpose request. The words "BACK-UP ELECTION" should appear at the top of Form 8716. *Temp Treas Reg § 1.444-3T(b)(4)*.

See generally, Godshalk, "A Section 444 Election: Who, What, When and Why," 38 *Tax Notes* 1537 (1988).

(n41)Footnote 3. *IRC § 444(b)(4)*.

(n42)Footnote 4. *IRC § 444(c)(1), (d)(1)*. The election remains in effect until the corporation changes its taxable year or otherwise terminates the election. A change to a calendar year can be made without the Service's consent. *IRC § 444(d)(2)*.

No election can be made with respect to an S corporation that is part of a tiered structure, other than a tiered structure consisting only of partnerships or S corporations (or both), all of which have the same taxable year. *IRC § 444(d)(3)*. An S corporation is considered a member of a tiered entity if a deferral entity owns any portion of the corporation. *Temp Treas Reg § 1.444-2T(b)(1)*. A trust is normally a deferral entity. *Temp Treas Reg § 1.444-2T(b)(2)*. However, a trust that is treated as an electing small business trust under *IRC § 1361(e)* is not a deferral entity. *Treas Reg § 1.444-4(a)*. The same holds true with respect to a trust that is described in *IRC § 401(a)* or *IRC § 501(c)(3)*, and is exempt from taxation under *IRC § 501(a)*. *Treas Reg § 1.444-4(b)*.

See generally Bailey, "Tax Years of Partnerships, S Corporations, and Personal Service Corporations: The Mechanics of Sections 444, 7519 and 280H," 13 *Rev of Taxn of Individuals* 229 (1989).

(n43)Footnote 5. *IRC § 7519(b)*.

(n44)Footnote 6. *IRC § 7519(b)*.

(n45)Footnote 7. *IRC § 7519(c)*. The refund is payable on the later of April 15th of the year in which the required payment becomes negative or 90 days after a claim for refund is filed.

The corporation is also entitled to a refund of the net required payment balance if the election under *IRC § 444* is terminated or the entity is liquidated. The refund in this case is payable on the later of April 15th of the year following the calendar year of termination or liquidation, or 90 days after a refund claim is filed.

(n46)Footnote 8. The base year with respect to any applicable election year is the preceding taxable year of the S corporation. *IRC § 7519(e)*.

(n47)Footnote 9. *IRC § 7519(d)(1)*.

(n48)Footnote 10. *IRC § 7519(d)(2)*. Any limitation on the amount of any pass-through item that may be taken into account in computing the shareholder's taxable income is disregarded.

(n49)Footnote 11. *IRC § 7519(d)(3)*.

(n50)Footnote 12. *IRC § 7519(a)(2)*.

(n51)Footnote 13. *IRC § 7519(f)(3)*. A payment is timely if made on or before April 15 of the calendar year following the calendar year in which the applicable election year begins (or such later year as may be prescribed by the Service). *IRC § 7519(f)(2)*.



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Taxation of Securities Transactions

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CHAPTER 15 The Taxpayer as an S Corporation Shareholder

2-15 Taxation of Securities Transactions § 15.03

§ 15.03 Effect of the Election on the Shareholders of an S Corporation

[1] Pass-Through of Items to Shareholders.

Each shareholder of the S corporation takes into account the shareholder's pro rata share of each item of the corporation's income, loss, deduction, or credit for the shareholder's taxable year in which the taxable year of the S corporation ends.ⁿ¹ Generally, a shareholder's pro rata share of any item for any taxable year is determined on a per-share, per-day basis.ⁿ² However, if any shareholder terminates the shareholder's interest in the corporation and all affected shareholders and the corporation agree, the pro rata shares are applied to the affected shareholders as if the taxable year consisted of two taxable years, the first of which ends on the date of termination.ⁿ³ Items taken into account by members of a shareholder's family may be adjusted as necessary to reflect reasonable compensation for services rendered or capital furnished to the corporation.ⁿ⁴

The items fall into two categories--separately stated items that can affect the liability of any shareholder and nonseparately computed income or loss.ⁿ⁵ The consequences of the pass-through of separately treated items can be illustrated by the following examples:ⁿ⁶

(1) Capital gains and losses pass through to the shareholder as such and are not offset by ordinary losses at the corporate level;

(2) *IRC Section 1231* gains and losses (gains and losses on certain property used in a trade or business) are passed through separately and aggregated with the shareholder's other *IRC Section 1231* gains and losses. Under prior law, an S corporation's *IRC Section 1231* gains were added to the corporation's capital gains and passed through as such;

(3) The charitable contributions of an S corporation are not subject to the 10 percent of taxable income deduction limit imposed on corporations by *IRC Section 170(b)(2)*. Instead, the contributions pass through and are added to the shareholder's personal contributions, and become subject to the individual percentage limitations on deductibility;

(4) Tax-exempt interest earned by an S corporation passes through to the shareholders retaining that character and increases the shareholders' bases in their S corporation stock. A subsequent distribution of

the tax-exempt interest is nontaxable and merely reduces basis;

(5) Items excludable from income under *IRC Section 108(a)* (income from discharge of indebtedness), unlike tax-exempt interest income, do not pass through to shareholders of an S corporation as "items of income (including tax-exempt income)" under *IRC Section 1366(a)(1)* and do not increase shareholder basis under *IRC Section 1367(a)(1)*.ⁿ⁷ Effective for discharges of indebtedness occurring after October 11, 2001, if an S corporation excludes discharge of indebtedness income under *IRC Section 108(a)*, the S corporation's "deemed operating loss" (i.e., the S corporation's "suspended" losses that exceed its shareholders' bases in the corporation's stock and debt and would normally be carried over to the next taxable year) must be reduced at the corporate level under *IRC Section 108(b)(2)*.ⁿ⁸

(6) Contributions to the capital of an S corporation do not pass through as "items of income (including tax-exempt income)" to shareholders, and do not increase shareholder basis.ⁿ⁹ The Supreme Court held in the early years of the income tax that, contributions to capital do not constitute income to a corporation within the meaning of *IRC Section 61*.ⁿ¹⁰ Since contributions to capital are not income, not even tax-exempt income, they do not constitute items of income for purposes of *IRC Section 1366(a)(1)* and *IRC Section 1367(a)(1)*. Stated another way, *IRC Section 118* excludes (not exempts) contributions to capital from income while, *IRC Sections 103* (tax-exempt interest) and *108* (cancellation of indebtedness income) establish exemptions for items that, in the absence of those sections, would constitute items of gross income.ⁿ¹¹

(7) Foreign taxes paid by an S corporation pass through as such to the shareholders, who, individually, must elect to claim them as deductions or credits on their own returns.ⁿ¹² However, because an S corporation is ineligible for the foreign tax credit for taxes paid by a foreign corporation in which the S corporation is a shareholder, there is no pass-through for those taxes;ⁿ¹³

(8) Items involved in the determination of credits (eg, the basis of property for purposes of computing the amount of qualified investment eligible for the investment tax credit) must be computed separately and passed through to the corporation's shareholders;

(9) Domestic losses and foreign losses pass through separately. Moreover, if an S corporation has foreign losses and domestic income, or vice versa, each passes through separately without aggregation at the corporate level;

(10) Depletion on an S corporation's interest in minerals is passed through to the shareholders as a separate item. This mirrors the treatment that has long obtained with respect to partnership interests;

(11) Although, generally, limitations on the amount of deduction, exclusion, or credit available to shareholders of an S corporation is determined solely at the shareholder level, a number of items are subject to limitations at both the corporate and shareholder levels, namely, the expensing of certain depreciable property (*IRC Section 179*) and the amortization of reforestation expenditures (*IRC Section 194*).

A conduit theory determines the character of items realized by the corporation and included in the shareholder's pro rata share of such items.ⁿ¹⁴ In general, this leads to characterization at the entity level.ⁿ¹⁵ Thus, for example, an expenditure which is a trade or business expense for the corporation remains so for the shareholder, even though it would not be deductible if incurred by the shareholder directly. In like fashion, items of tax preference for the corporation become items of tax preference for the shareholder.

The regulations contain two special exceptions to the general rule that character of items is determined at the corporate

level. If an S corporation is formed or availed of by any shareholder for a principal purpose of selling or exchanging contributed property that in the hands of the shareholder would not have produced capital gain if sold or exchanged by the shareholder, any gain recognized by the corporation on a sale or exchange of the property is treated as ordinary income.ⁿ¹⁶ If the corporation is formed or availed of for a principal purpose of selling or exchanging property that in the hands of the contributing shareholder would have produced a capital loss if sold or exchanged by the shareholder, any loss recognized by the corporation on a sale or exchange of the property is treated as a capital loss to the extent that, immediately before the contribution, the adjusted basis of the property in the hands of the shareholder exceeded the fair market value of the property.ⁿ¹⁷

[2] Calculating Basis in S Corporation Stock and Debt.

A shareholder's pro rata share of an S corporation's net operating loss passes through to the shareholder's individual return subject to the limitation that it may not exceed the sum of the shareholder's adjusted basis in the corporation's stock plus the shareholder's adjusted basis in any indebtedness owed to the shareholder by the corporation.ⁿ¹ Losses disallowed to the shareholder by reason of the basis limitation are deemed incurred by the corporation in its next taxable year, and continue to be carried forward indefinitely until the basis of the shareholder's stock or debt increases sufficiently to absorb the suspended loss.ⁿ² Termination of the corporation's S election results in a permanent disallowance of the suspended losses, unless the shareholder takes advantage of a post-termination grace period to increase the basis of his stock by a sufficient amount to deduct the suspended losses.ⁿ³

The rules generally applicable in calculating the basis of property for purposes of determining gain or loss are also applicable in determining the basis of stock or debt in an S corporation.ⁿ⁴ In addition, adjustments to basis must be made as of the close of each taxable year of the S corporation to reflect each shareholder's pro rata share of the S corporation's items of income, loss, and deduction, as well as any nontaxable distributions made with respect to such stock.ⁿ⁵ Basis is first increased by the shareholder's pro rata share of all income items of the corporation, whether or not taxable,ⁿ⁶ and then decreased (but not below zero) in the following order: (1) by nontaxable distributions received by the shareholder with respect to the stock, (2) by noncapital and nondeductible expense items,ⁿ⁷ and (3) by the corporation's other loss or deduction items.ⁿ⁸

Once basis in S corporation stock is reduced to zero, corporate losses can only flow through to the shareholder's individual return if and to the extent the shareholder has a basis "in any indebtedness of the S corporation to the shareholder."ⁿ⁹ If so, the S corporation's losses will pass through to the individual return of the shareholder and decrease the basis of corporate indebtedness held by that shareholder until that basis also reaches zero.ⁿ¹⁰ Once the basis of corporate debt is reduced under *IRC Section 1367(b)(2)(A)* (whether or not it is reduced to zero), any "net increase" in a subsequent taxable year (*i.e.*, in general, "net increase" means the amount by which the shareholder's pro rata share of income items described in *IRC Section 1367(a)(1)* exceeds his pro rata of deduction and other items described in *IRC Section 1367(a)(2)*) must be used to increase the shareholder's basis in the indebtedness, until the original basis of the indebtedness is restored.ⁿ¹¹

The restoration rule may be illustrated as follows. Suppose that A, the sole shareholder in an S corporation using the calendar year as its taxable year, advances \$1,000 to the corporation on January 1, 2010 in return for the corporation's promissory note. If the corporation has a \$600 net loss in 2010, and the basis of A's stock in the S corporation has been reduced to zero in previous years, the \$1,000 loan allows the \$600 loss to pass through to A's individual return, which in turn reduces the basis of the S corporation's note in A's hands from \$1,000 to \$400. If in 2011 the corporation has a net increase of \$200, and the note remains unpaid at the end of the year, an adjustment increasing the basis of the note by \$200, from \$400 to \$600, is made at the close of the taxable year under *IRC Section 1367(b)(2)(B)*. No adjustment is made to the basis of A's stock.

Under the regulations, if the basis of shareholder indebtedness is reduced and the indebtedness is later wholly or partially retired or otherwise disposed of before the end of a taxable year in which a "net increase" occurs, any

restoration of basis that would ordinarily be required as of the close of the corporation's taxable year is instead made effective immediately prior to the disposition of, or receipt of the first repayment on, the debt during the taxable year.ⁿ¹² Further, if the basis of indebtedness has been reduced and has not been fully restored when it is first paid or disposed of, "the disposition or repayment is a recognition event effective immediately before the indebtedness is disposed of or repaid (in whole or in part)."ⁿ¹³ Under existing case law, "the general rule...for payments on a debt where the face amount of the debt is in excess of its basis, is that the payments thereon each include income in proportion to a fraction, the numerator of which is the difference between the face amount and the basis of the debt and the denominator of which is the face amount of the debt."ⁿ¹⁴ So, in the example above, had the S corporation made a \$500 partial payment on its indebtedness to A before the end of 2011, the \$200 increase in basis adjustment normally made at the end of the taxable year would instead be made retroactive to the date on which A received the payment. Under the regulations and case law, A would realize income of \$200 on the \$500 partial payment of the \$1,000 promissory note in 2011 (\$400 total potential gain)ⁿ¹⁵ /\$1,000 face value x \$500 payment = \$200), and A will have a \$300 basis in the corporation's remaining \$500 indebtedness to him. If the S corporation has a \$300 net increase in the following year, 2012, \$200 of that amount must be used to fully restore A's basis in the remaining corporate indebtedness to \$500, after which \$100 may be used to increase the basis of A's stock from zero to \$100.

If an S corporation shareholder holds several notes from the corporation, the following rules apply:

- (1) If the corporation has a loss for the taxable year and the shareholder's basis in his stock is zero, the loss reduces the basis of each indebtedness in the same proportion as the basis of each indebtedness bears to the aggregate bases of all corporate indebtedness to the shareholder.ⁿ¹⁶
- (2) If in a year subsequent to the loss year the corporation has net income, the income is used to restore the basis of each note in the proportion that the amount of prior unrestored basis reductions made to that note bears to the prior unrestored basis reductions made to all of the shareholder's outstanding notes. However, if any of the shareholder's notes which have had a reduction in basis is repaid in whole or in part during the year, any available increase in basis must be applied first to increase the basis of the repaid note(s) to the extent necessary to offset any gain that would otherwise be realized on the repayment. Any remaining amount increases proportionately the basis of the other notes held by the shareholder at the close of the year which have had basis reductions.ⁿ¹⁷
- (3) Nothing in the regulations requires that repayments be applied ratably to each outstanding indebtedness or in any particular order. For example, it is possible to repay a corporate note that has not had a reduction in basis before repaying one that has.

Different rules may apply when an S corporation shareholder loans money to the corporation on open account. All advances made on open account are treated as a single indebtedness and all advances and repayments of advances made during the year are netted at the end of the year to determine the net advance or net repayment on the open account for that year.ⁿ¹⁸ For example, suppose A loans his wholly owned S corporation \$5,000 in 2009 on open account, that the basis of the debt is reduced to zero as a result of the corporation's losses in 2009, and that in 2010 (1) the S corporation repays the \$5,000 debt in full on February 1, 2010, (2) A makes an open account advance of \$6,000 on December 1, 2010, and (3) the S corporation has a loss of \$1,000 in 2010. Had the original \$5,000 advance been made as a separate written indebtedness, the \$5,000 repayment on February 1, 2010 would be a recognition event on which A would realize a \$5,000 gain. However, under the open account regulations the February 1 repayment has no tax significance but rather is put into suspense until the close of the year, at which time it is netted against the later \$6,000 open account advance, resulting in a net additional open account advance for the year of \$1,000. The \$1,000 increase in basis of open account indebtedness is available to offset the corporation's \$1,000 loss for the year, reducing the basis of the open account indebtedness to zero at the close of the year.

The tax avoidance potential of the open account netting rule was brought home to the Internal Revenue Service by the

Tax Court's decision in *Brooks v Comm'r*.ⁿ¹⁹ In response, the Treasury has amended the regulations to limit the amount of indebtedness that may be treated as "open account" to no more than \$25,000 at the close of any taxable year.ⁿ²⁰ If at the close of any taxable year an S corporation's open account indebtedness exceeds \$25,000, in all subsequent years the entire aggregate amount of such indebtedness will thereafter be treated for purposes of the regulations as indebtedness evidenced by a separate written instrument.ⁿ²¹

Unlike the Subchapter K basis rules applicable to partnerships and other passthrough entities, subchapter S does not permit an S corporation shareholder to add a pro rata share of the S corporation's third party indebtedness to his outside basis.ⁿ²² To qualify as "indebtedness of the S corporation to the shareholder" for purposes of the basis limitation in *IRC Section 1366(d)(1)(B)*, the indebtedness must have been incurred as the result of the shareholder's "actual economic outlay" to or on behalf of the S corporation that made the shareholder "poorer in a material sense."ⁿ²³ The "economic outlay" requirement stems from the Tax Court's reading of the legislative history of Subchapter S, which speaks of allowing basis only to the extent of the shareholder's "investment" in the corporation.ⁿ²⁴ The Tax Court concluded that the word 'investment' indicated an intent to limit basis to that shareholder's "actual economic outlay" in the S corporation, a test that is now universally applied by all the courts of appeal that have considered it, as well as the Tax Court.ⁿ²⁵ No economic outlay is made if a loan is made by a third party lender and the shareholder merely guarantees it,ⁿ²⁶ or pledges his own assets as collateral for the loan,ⁿ²⁷ or purchases a subordinated participation interest in the loan.ⁿ²⁸ In short--

"[N]o form of indirect borrowing, be it a guaranty, surety, accommodation, co-making or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the existing obligation. Before that crucial act, "liability" may exist, but not debt to the shareholders."ⁿ²⁹

On the other hand, an S corporation shareholder may claim basis in a loan originating from a third party by structuring the transaction so that the loan is made first to the shareholder and then re-loaned by the shareholder to the S corporation (i.e., a "back to back" loan).ⁿ³⁰ Indeed, an existing shareholder-guaranteed loan from a third party in which the shareholder has no basis may be restructured into a basis-creating shareholder loan by substituting the shareholder as the borrower in place of the S corporation.ⁿ³¹

In *Rev Rul 75-144* the Internal Revenue Service allowed a shareholder to substitute for his S corporation as borrower on a loan when the original lender was a third party bank, but the Service has challenged similar restructurings when the lender is related to the shareholder and the S corporation. In one such case, *Underwood v Comm'r*,ⁿ³² the Court distinguished *Rev Rul 75-144* on the ground that a bank or other independent lender stands ready to enforce the shareholder's substituted obligation, ensuring that an economic outlay will eventually be made by the shareholder. When a related party holds the shareholder's obligation, it remains unclear whether the shareholder will ever cause the related corporation to enforce the note, leaving open the possibility that the shareholder might never make the economic outlay that is a prerequisite to acquiring basis. *Underwood* did not hold that the economic outlay test could never be satisfied when a related party is the lender, however, and in *Bhatia v Comm'r*,ⁿ³³ the Tax Court, after noting that there is "a heavy burden on shareholders who seek to rearrange the indebtedness of related closely held S corporations," added that "the existence of such a relationship is not necessarily fatal if other elements are present which clearly establish the bona fides of the transactions and their economic impact."ⁿ³⁴

A shareholder's basis is adjusted downward when an S corporation makes a deductible charitable contribution. The purpose of this adjustment is to avoid giving the shareholder a double deduction.

Prior to the Pension Protection Act of 2006 ("PPA"), that downward basis adjustment was equal to the fair market value of the contributed property. PPA provided that this reduction would only be in an amount equal to the basis of the contributed property rather than the fair market value, for 2006 and 2007. The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (part of Pub L No 110-343, October 3, 2008) extended this shareholder-favorable rule so that it

now applies through 2009.ⁿ³⁵

If any person acquires stock in an S corporation by reason of the death of a decedent or by bequest, devise, or inheritance, *IRC Section 691* (income in respect of a decedent) must be applied with respect to any item of income of the S corporation in the same manner as if the decedent had held directly his pro rata share of such item.ⁿ³⁶ The basis determined under *IRC Section 1014* of any stock in an S corporation must be reduced by the portion of the value of stock that is attributable to items constituting income in respect of a decedent.ⁿ³⁷

[3] Treatment of Distributions.

Distributions of cash or property by an S corporation without accumulated earnings and profits are tax free to the extent of the shareholder's basis and serve to reduce the shareholder's basis in his stock.ⁿ¹ If the amount of the distribution exceeds the basis of the stock, the excess is treated as gain from the sale or exchange of the stock, normally capital gain.ⁿ²

A distribution by an S corporation with accumulated earnings and profits will be treated as made by an S corporation with no earnings and profits up to the amount of its "accumulated adjustment account" (post-1982 gross income less deductible expenses, not previously distributed), unless the corporation and all shareholders to whom distributions are made during the taxable year consent to forego application of the accumulated adjustment account rule.ⁿ³ Any excess (or all of the distribution if the election mentioned in the preceding sentence is made) will be treated as a dividend to the extent of the corporation's accumulated earnings and profits, with the remainder of the distribution used, first, to reduce basis to zero, and then to produce gain.ⁿ⁴ If the distributions during the taxable year exceed the amount in the accumulated adjustments account at the close of the taxable year, the account is allocated among the distributions in proportion to their respective sizes.ⁿ⁵

In determining the treatment of distributions, the applicable provisions are applied by taking into account (to the extent proper) the adjustments to the basis of the shareholder's stock described in *IRC Section 1367*, and the adjustments to the accumulated adjustments account required by *IRC Section 1368(e)(1)*.ⁿ⁶ In the case of any distribution made during any taxable year, the adjusted basis of the stock is determined with regard to the adjustments provided in *IRC Section 1367(a)(1)* for the taxable year.ⁿ⁷

Post-1982 earnings of an S corporation are not earnings and profits for distribution purposes. In other words, a corporation will not have earnings and profits attributable to any year beginning after 1982 if a Subchapter S election is in effect for that year. However, the corporation can have earnings and profits attributable to:

- (1) taxable years after 1982 for which an election was not in effect;
- (2) taxable years beginning prior to 1983 for which an election was in effect; and
- (3) a corporate acquisition which results in a carryover of earnings and profits under Section 381.

Any distribution of *money* during the "post-termination transition period" is applied against and reduces the adjusted basis of the stock to the extent that the amount of the distribution does not exceed the accumulated adjustments account.ⁿ⁸ This permits such distributions to remain tax free. However, the corporation can elect not to have the stated rule apply, provided all shareholders to whom distributions are made during the "post-termination transition period" consent to the election.ⁿ⁹

An S corporation that elected Subchapter S status before the 1982 Act and did not distribute all of its previously taxed income will continue to be governed by the old rules governing the distribution of such income.ⁿ¹⁰ Thus, post-1982 distributions of pre-1983 previously taxed income will be tax free to the extent cash distributions exceed current

earnings.

FOOTNOTES:

(n1)Footnote 1. *IRC § 1366(a)(1)*. The meaning of "shareholder" for purposes of Subchapter S is a matter of federal law, that is, whether beneficial or record ownership is required. The question of whether a particular shareholder is of the kind required is a matter of state law. *Pahl v Commr, 150 F3d 1124 (9th Cir 1998)*.

The corporation's method of accounting determines the year in which the income or deduction is taken into account by the shareholder. See, eg, *Hoffman v Commr, TC Memo 1989-154*, where cash basis shareholders were required to report as income the face amount of promissory notes received by an accrual method S corporation on the sale of inventory.

The Supreme Court held in *Bufferd v Commissioner, 113 S Ct 927 (1993)* that the Service could adjust a shareholder's return based on an adjustment to an S corporation's return even though the statute of limitations had run on the corporation's return. The decision involved a year that preceded enactment of *IRC §§ 6241-6245*, which set forth S corporation audit procedures and call for determination of the corporation's tax items in a unified proceeding at the corporate level. However, the procedures do not apply to S corporations with five or fewer shareholders (*Temp Treas Reg § 301.6241-1T(c)(2)(ii)*). Before *Bufferd* the lower courts disagreed as to the proper result when the statute of limitations had run with respect to the corporation. Compare *Kelley v Commissioner, 877 F2d 756 (9th Cir 1989)*, with *Felhaber v Commissioner, 94 TC 863 (1990)*, *Brody v Commissioner, TC Memo 1991-78*, and *Aries v Commr, TC Memo 1991-41*.

As part of a unified proceeding, the Service sent Final Notices of S Corporation Administrative Adjustment in which the income of the corporation was reallocated from shareholders of record to nonshareholders. In *Hang v Commr, 95 TC 74 (1990)*, the Tax Court held that the determination of shareholder status was not within the scope of judicial review in an S corporation proceeding.

A shareholder of two S corporations filed for personal bankruptcy before the end of the corporations' taxable years. At issue in *Williams v Commr, 123 TC 144 (2004)*, was whether the shareholder or his individual bankruptcy estate was entitled to claim losses generated by the corporations in the year of bankruptcy. The Tax Court held that the provisions of *IRC § 1398* must be considered before applying the rules of *IRC § 1377* to S corporation shareholders in bankruptcy. Because the taxpayer did not receive or accrue any items of income or loss before he filed for bankruptcy, all of the losses flowed through to the bankruptcy estate. Under *IRC § 1398(e)(2)*, the taxpayer could have elected to bifurcate the year into prepetition and postpetition years, but did not.

(n2)Footnote 2. *IRC § 1377(a)(1)*. A shareholder who disposes of stock in an S corporation is treated as the shareholder for the day of disposition. A shareholder who dies is treated as the shareholder for the day of the shareholder's death. *Treas Reg § 1.1377-1(a)(2)(ii)*.

(n3)Footnote 3. *IRC § 1377(a)(2)(A)*. The term "affected shareholder" means the shareholder whose interest is terminated and all shareholders to whom the terminated shareholder transferred shares during the taxable year. If the terminated shareholder transferred shares to the corporation, the term includes all persons who were shareholders during the year. *IRC § 1377(a)(2)(B)*.

An S corporation makes a terminating election by attaching a statement to its timely filed original or amended return (Form 1120S) for the taxable year in which the shareholder's entire interest is terminated. The election statement must include: (1) a declaration by the S corporation that it is electing under *IRC § 1377(a)(2)* and *Treas Reg § 1.1377-1(b)(5)* to treat the taxable year as if it consisted of two separate taxable years; (2) information setting forth when and how the shareholder's entire interest was terminated; (3) the signature on behalf of the S corporation of an authorized officer of the corporation under penalties of perjury; and (4) a statement by the corporation that the corporation and each affected shareholder consents to the S corporation making the terminating election. *Treas Reg § 1.1377-1(b)(5)(i)*.

(n4)Footnote 4. *IRC § 1366(e)*.

(n5)Footnote 5. *IRC § 1366(a)(1)*. Nonseparately computed income or loss is defined as gross income less deductions, less all separately computed items. *IRC § 1366(a)(2)*.

A corporate general partner claimed an interest deduction when it was a C corporation. It later recovered the deduction when it was an S corporation. Held, the tax benefit rule required inclusion in income by the S corporation shareholders. *Ltr Rul 9202002*. Discharge of indebtedness income that is not included in income because of an S corporation's insolvency is not a separately stated item of tax-exempt income that passes through to the corporation's shareholders or increases the basis of their stock in the corporation. *TAM 9541006*.

(n6)Footnote 6. The amount of pass-through for built-in gain is reduced by the amount of any tax payable under *IRC § 1374*. A similar reduction results with respect to passive investment income if the corporation is subject to the tax imposed by *IRC § 1375*. *IRC § 1366(f)(2), (3)*.

(n7)Footnote 7. See *IRC § 108(d)(7)(A)*, added by § 402 of the Job Creation and Worker Assistance Act of 2002. The 2002 legislation reversed the Supreme Court's decision in *Gitlitz v Comm'r*, 531 US 206 (2001), which had allowed the exclusion under *IRC § 108(a)* of income from the discharge of an S corporation's indebtedness at less than face value to pass through to its shareholders and increase their basis, effectively allowing them to deduct losses financed by the indebtedness even though neither they nor their S corporation would ever have to pay it.

(n8)Footnote 8. See *IRC § 108(d)(7)(B)*; *IRC § 1367(d)*; Prop Treas Reg § 108-7(d), REG-102822-08, 73 FR 45656 (2008).

(n9)Footnote 9. *Nathel v Commr*, 131 TC 262 (2008), *aff'd* 2010 US App LEXIS 11244 (2d Cir 2010).

(n10)Footnote 10. See *Edwards v The Cuba RR Co*, 268 US 628 (1925). See also *Treas Reg § 1.118-1*.

(n11)Footnote 11. *Nathel v Commr*, 131 TC 262 (2008), *aff'd* 2010 US App LEXIS 11244 (2d Cir 2010).

(n12)Footnote 12. Rules concerning the source of income and the amount of creditable taxes apply at the shareholder level.

(n13)Footnote 13. A corporation electing out of Subchapter S will be subject to the special foreign loss recapture rules of *IRC § 904(f)* if it passed through foreign losses to its shareholders while an S corporation.

(n14)Footnote 14. *IRC § 1366(b)* Because of this, an S corporation that has a nonbusiness bad debt deduction must state the deduction separately as a short-term capital loss under *IRC § 166(d)* *Rev Rul 93-36, 1993-1 CB 187*

(n15)Footnote 15. However, the Service has ruled that shareholders of an S corporation that sold stock at a loss could not claim the loss as an ordinary loss under *IRC § 1244* *Ltr Rul 9130003*.

(n16)Footnote 16. *Treas Reg § 1.1366-1(b)(2)* The rule applies as well to a group of shareholders who contribute the property to the corporation.

(n17)Footnote 17. *Treas Reg § 1.1366-1(b)(3)*.

(n18)Footnote 1. *IRC § 1366(d)(1)*.

(n19)Footnote 2. *IRC § 1366(d)(2)(A)*. Normally, this loss carryover is personal to the shareholder and may not be transferred to any other person, including a purchaser of the shares to which the losses are attributable. See *IRC § 1366(d)(2)(A)*; *Treas Reg § 1.1366-2(a)(5)(i)*. However, when an S corporation shareholder transfers shares to his spouse (or former spouse if the transfer is incident to a divorce) in a transaction to which the nonrecognition provisions

of IRC § 1041 apply (see § 1.02[4][c]), and losses allocable to such shares remain suspended because the transferor does not have sufficient basis to claim a deduction, the unused losses allocable to the transferred shares as of the close of the taxable year of the transfer are deemed to have been incurred by the S Corporation in the year following the transfer and effectively become suspended losses allocable to the shares in the hands of the transferee spouse. *IRC* § 1366(d)(2)(B); *Treas Reg* § 1.1366-2(a)(5)(ii) and (iii).

(n20)Footnote 3. The statute refers to the grace period as the "post-termination transition period" or PTTP. *IRC* § 1366(d)(3). The PTTP generally begins on the day after the last day of the last taxable year of the corporation as an S Corporation and ends one year later (but may end as late as the due date of the S Corporation's return for its last taxable year, including extensions, if that is later). *IRC* § 1377(b)(1)(A). If the IRS subsequently makes audit adjustments to the S Corporation's return(s) that increase basis in the shareholders' stock, additional 120-day PTTPs are available following the audit but only to allow shareholders to utilize the increases in basis resulting from the audit to make tax-free distributions from the corporation. See *IRC* §§ 1377(b)(1)(B) & (C) and 1377(b)(3)(A); H Rep 108-696, 108th Cong, 2d Sess (2004).

(n21)Footnote 4. See *IRC* § 1011(a); *Treas Reg* § 1.1367-1(a)(2); *Estate of Bean v Comm'r*, 268 F 3d 553, 559 (8th Cir 2004). For example, basis may be determined by the cost of acquiring the stock by purchase (*IRC* § 1012), or by fair market value at the date of the decedent's death for stock acquired by bequest or inheritance (*IRC* § 1014), or with reference to the stock's basis in the hands of the transferor in the case of a gift (*IRC* § 1015) or transfer from a spouse or former spouse (*IRC* § 1041(b)), or determined with reference to the basis of property given up in exchange in the case of stock received in a tax-free reorganization (*IRC* § 358(a)). See generally § 1.05.

(n22)Footnote 5. *IRC* § 1367(a). When an S corporation shareholder disposes of stock in the corporation, a pro rata portion of the adjustments normally made at the end of the S corporation's taxable year must be made to the shareholder's basis in such stock as of the date of disposition. *Treas Reg* § 1.1367-1(d)(1).

(n23)Footnote 6. See *IRC* §§ 1367(a)(1) and 1366(a)(1). The excess of the shareholder's pro rata share of the corporation's deductions for depletion over the basis of the properties subject to depletion also increases basis. *IRC* § 1367(a)(1)(C).

(n24)Footnote 7. The deduction must be permanently disallowed and not merely deferred. *Treas Reg* § 1.1367-1(c)(2). Examples of items that reduce basis include illegal bribes and kickbacks nondeductible under *IRC* § 162(f), expenses and interest relating to tax-exempt income nondeductible under *IRC* § 265, losses incurred in transactions with related parties disallowed by *IRC* § 267, and the portion of meals and entertainment expenses disallowed by *IRC* § 274.

(n25)Footnote 8. See *Treas Reg* § 1.1367(f). The ordering rules apply to taxable years beginning on or after August 18, 1998. A shareholder may make an election, binding in the current and future taxable years unless the IRS consents to its revocation, to decrease basis on account of loss and deduction items before decreasing basis on account of noncapital, nondeductible items, providing the shareholder agrees that, if there is insufficient basis in the shareholder's stock and debt to offset against the shareholder's pro rata share of nondeductible items in the current year, the amount not used to effect a basis decrease will be carried forward (and retain its character as a nondeductible item) to the subsequent taxable year. *Treas Reg* § 1.1367(g).

(n26)Footnote 9. *IRC* § 1367(b)(2)(A).

(n27)Footnote 10. *Id.*

(n28)Footnote 11. *IRC* § 1367(b)(2)(B).

(n29)Footnote 12. *Treas Reg* § 1.1367-2(d)(1).

(n30)Footnote 13. *Id.*

(n31)Footnote 14. See *Smith v Comm'r*, 48 TC 872, 879 (1967) , *affd* 424 F2d 219 (9th Cir 1970) ; *Cornelius v Comm'r*, 494 F2d 465 (5th Cir 1974) .

(n32)Footnote 15. Total potential gain is the \$1,000 face value of the note minus A's \$600 basis (increased from \$400 to \$600 by the retroactive restoration of the \$200 "net increase" for the year).

(n33)Footnote 16. *Treas Reg* § 1.1367-2(b)(3).

(n34)Footnote 17. *Treas Reg* § 1.1367-2(c)(2).

(n35)Footnote 18. *Treas Reg* § 1.1367-2(d)(2).

(n36)Footnote 19. *TC Memo 2005-204* . In *Brooks*, the netting of year-end open account advances against beginning of the year repayments allowed the taxpayer not only to avoid gain recognition on the repayments but to enjoy passthrough deductions of S corporation losses in the millions of dollars.

(n37)Footnote 20. *Treas Reg* § 1.1367-2(a)(2)(ii).

(n38)Footnote 21. *Treas Reg* §§ 1.1367-2(a)(2)(ii) and 1.1367-2(d)(2)(ii).

(n39)Footnote 22. Compare *IRC* § 752(a) (increase in partner's share of partnership liabilities treated as a contribution of money to the partnership). The exclusion of corporate debt to third parties from shareholder basis limits the S corporation's ability to pass through losses to its individual shareholders and is thus a disadvantage relative to other passthrough entities.

(n40)Footnote 23. *Perry v Commissioner*, 54 TC 1293, 1296 (1970) .

(n41)Footnote 24. See S Rep 1983, 85th Cong, 2d Sess. 219-220 (1958).

(n42)Footnote 25. See *Russell v Comm'r*, *Tax Ct Memo 2008-246* (n 5). See, eg, *Maloof v Comm'r*, 456 F3d 645 (6th Cir 2006) ; *Grosjean v Comm'r*, 248 F3d 572 (7th Cir 2001) ; *Bergman v US*, 174 F3d 928 (8th Cir 1999) ; *Sleiman v Comm'r*, 187 F3d 1352 (11th Cir 1999) , *Spencer v Comm'r*, 110 TC 62 (1998) , *affd without published opinion* 194 F3d 1324 (11th Cir 1999) ; *Reser v Comm'r*, 112 F3d 1258 (5th Cir 1997) ; *Uri v Comm'r*, 949 F2d 371 (10th Cir 1991) ; *Estate of Leavitt v Comm'r*, 875 F2d 420 (4th Cir 1989) .

(n43)Footnote 26. See, eg, *Sleiman v Comm'r*, 187 F3d 1352 (11th Cir 1999) .

(n44)Footnote 27. See, eg, *Estate of Bean v Comm'r*, 268 F3d 553 (8th Cir 1999) , But see *Selfe v US*, 778 F2d 769 (11th Cir 1985) , in which the Eleventh Circuit suggested that a pledge of assets might be considered an economic outlay since the pledged asset is then "not available as collateral for other investments." No other court has treated a pledge as an economic outlay, but the Eleventh Circuit recently reaffirmed its view in *Rose v Comm'r*, 2008 US App LEXIS 9287 (11th Cir 2008) .

(n45)Footnote 28. *Grosjean v Comm'r*, 248 F3d 572 (7th Cir 2001) .

(n46)Footnote 29. *Raynor v Commissioner*, 50 TC 762, 770-771 (1968) . For a time S corporation shareholders had reason to hope that the Eleventh Circuit's opinion in *Selfe v US*, 778 F2d 769 (11th Cir 1985) , in at least some circumstances, would allow them to treat a loan guarantee as a contribution to capital, increasing the basis of their stock (but not the debt itself) by the amount of the loan. The *Selfe* opinion acknowledged the possibility that, in substance, the lender was really loaning money to the shareholder/guarantor, who in turn contributed the money to the corporation as a contribution to capital. See *Plantation Patterns, Inc. v Comm'r*, 462 F2d 712 (5th Cir 1972) . However, other courts of

appeal (and the Tax Court) distinguished and disagreed with *Selfe*, refusing to look behind the form in which the parties had cast the transaction (loan by lender to corporation, guarantee by shareholder to lender), finding in every case that the lender intended to do exactly what it did: make a loan to the corporation rather than the shareholder. The Eleventh Circuit ultimately joined the other circuits by effectively limiting *Selfe* to its "unusual set of facts," *Sleiman v Comm'r*, 187 F3d 1352 (11th Cir 1999), (including the unique fact that the loan in *Selfe* had been initially made to the shareholder, and only later converted by the bank into a loan to the corporation).

(n47)Footnote 30. See *Bolding v Comm'r*, 117 F3d 270 (5th Cir 1997); *Raynor v Comm'r*, 50 TC 762 (1968); *Gleason v Comm'r*, TC Memo 2006-191; *Miller v Comm'r*, TC Memo 2006-125; *Ruckriegel v Comm'r*, TC Memo 2006-78; *Yates v Comm'r*, TC Memo 2001-280; *Culnen v Comm'r*, TC Memo 2000-139, rev'd on other grounds 28 Fed Appx 116 (3d Cir 2002). But see *Oren v Comm'r*, 357 F3d 854 (8th Cir 2004), where the S corporation shareholder had one of his wholly owned corporations loan money to him, which he reloaned another of his wholly owned S corporations, which re-loaned the money back to the original related lender. Affirming the Tax Court, *Oren v Comm'r*, TC Memo 2002-172, the court of appeals agreed that these transactions "had no economic substance and, thus, were not real economic outlays;" the court added that any basis that might have been created by these transactions would be disallowed by the "at risk" rules, IRC § 465(b)(2), since the shareholder "was protected from personal loss by the circular nature of the loan transactions."

(n48)Footnote 31. See *Miller v Commissioner*, TC Memo 2006-125; *Gilday v Comm'r*, TC Memo 1982-242; *Rev Rul 75-144*, 1975-1 CB 277. Care must be taken that the S corporation's debt is actually cancelled, however, for if the S corporation remains liable to the third party lender the transaction will be treated as no different than a shareholder guarantee notwithstanding the addition of the shareholder as a borrower. *Hitchins v Comm'r*, 103 TC 711 (1994).

(n49)Footnote 32. 535 F2d 309 (5th Cir 1976).

(n50)Footnote 33. TC Memo 1996-429.

(n51)Footnote 34. *Bhatia v Comm'r*, TC Memo 1996-429. See also *Rose v Comm'r*, 2008 US App LEXIS 9287 (11th Cir 2008); *Hitchins v Commissioner*, 103 TC 711, 717 (1994); *Bergman v United States*, 174 F3d 928 (8th Cir 1999). Taxpayers have been successful carrying their "heavy burden" in the Tax Court in two debt restructuring cases involving related party lenders, *Culnen v Comm'r*, TC Memo 2000-139 and *Yates v Comm'r*, TC Memo 2001-280, and partially successful in a third. *Ruckriegel v Comm'r*, TC Memo 2006-78. See Lipman, "S Corporation Loss Limitations: The Tax Court Provides Potential Hope for Related Party Debt Restructurings," 22 Va Law Rev 67 (2002).

(n52)Footnote 35. IRC § 1367(a)(2).

(n53)Footnote 36. IRC § 1367(b)(4)(A).

(n54)Footnote 37. IRC § 1367(b)(4)(B).

(n55)Footnote 1. IRC §§ 1368(b)(1), 1367(a)(2)(A).

(n56)Footnote 2. IRC § 1368(b)(2). For purposes of the passive activity loss rules of IRC § 469, if an S corporation shareholder receives a distribution of money in excess of its adjusted basis in its stock in the corporation and recognizes gain under IRC § 1368(b)(2), the gain is treated as gain from the sale or exchange of the S corporation stock under *Treas Reg* § 1.469-2T(e)(3). *Rev Rul 95-5*, 1995-1 CB 100.

(n57)Footnote 3. IRC § 1368(c)(1), (3), (e)(1), (3). No adjustment is made for federal taxes attributable to the period that the corporation was a C corporation. A distribution taxed to a shareholder under IRC § 1368(b)(2) reduces the accumulated adjustment account of an S corporation with accumulated earnings and profits. *Treas Reg* § 1.1368-2(a)(3)(iii).

In applying *IRC § 1368(e)(1)* to distributions made during the taxable year, the amount in the accumulated adjustments account is determined without regard to any net negative adjustment for the taxable year. The net negative adjustment for any taxable year is the excess (if any) of the reductions in the account for the taxable year (other than for distributions), over the increases in the account for the year. *IRC § 1368(e)(1)(C)*.

The election to reverse the order of distribution to allow a distribution of earnings and profits before accumulated S corporation earnings is made by attaching a statement to a timely filed original or amended return for the taxable year. *Treas Reg § 1.1368-1(f)(5)*. The statement must state that the corporation is making an election under *Treas Reg § 1.1368-1(f)*, identify the election, and be signed under penalties of perjury by an officer of the corporation and each shareholder who receives a distribution. There may be circumstances in which substantial compliance will suffice, namely where there is a clear expression of the electing party's intention to elect and an unequivocal agreement to accept the benefits and burdens of the election. The court in *Thurman v Commr*, *TC Memo 1998-233*, refused to allow the taxpayer to use substantial compliance because the taxpayer never filed an election with any return.

The size of the accumulated adjustment account is determined at the end of the year, not at the time of distribution. *Ltr Rul 8842024*.

If any stock is redeemed in a transaction entitled to capital gain under either *IRC § 302(a)* or *303(a)*, the accumulated adjustments account is reduced by an amount equal to the percentage of the total shares of the corporation that are redeemed in the transaction. *IRC § 1368(e)(2)*. If stock is redeemed in a transaction that is treated as a distribution under *IRC § 301*, the entire redemption amount is treated as a distribution that reduces the corporation's accumulated adjustment account. *Rev Rul 95-14, 1995-61 CB 169*.

(n58)Footnote 4. *IRC § 1368(c)(2)*.

(n59)Footnote 5. *IRC § 1368(c)(3)*.

(n60)Footnote 6. *IRC § 1368(d)*.

(n61)Footnote 7. *IRC § 1368(d)*.

(n62)Footnote 8. *IRC § 1371(e)(1)*.

(n63)Footnote 9. *IRC § 1371(e)(2)*.

(n64)Footnote 10. *IRC § 1379(c)*.



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CHAPTER 16 The Taxpayer as the Beneficiary of an Estate or Trust

2-16 Taxation of Securities Transactions 16.syn

§ 16.syn Synopsis to Chapter 16: The Taxpayer as the Beneficiary of an Estate or Trust

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CHAPTER 16 The Taxpayer as the Beneficiary of an Estate or Trust

2-16 Taxation of Securities Transactions § 16.01

§ 16.01 Introduction

We saw in earlier chapters (Chapters 14 and 15) that a partner must take into account separately his proportionate share of the partnership's income and deduction items, and that an S corporation shareholder must do the same with respect to the income and deduction items of the corporation. The same does not hold true for the beneficiary of an estate or trust who does not have additional income to report merely because the estate or trust earns income during the taxable year. Instead, the income is reportable only if the beneficiary receives a distribution or is entitled to receive income currently, and, then, only if the estate or trust has distributable net income for the current year.

The purpose of this inquiry will be the effect on beneficiary and entity of the distribution of securities by an estate or trust. In addition, we will examine the tax consequences of the distribution of securities of the employer corporation by an employees' trust. Finally, the tax consequences of the operation of, and participation in, common trust funds will be discussed.



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CHAPTER 16 The Taxpayer as the Beneficiary of an Estate or Trust

2-16 Taxation of Securities Transactions § 16.02

§ 16.02 The Conduit Approach of Subchapter J

[1] In General.

By virtue of *IRC Section 641(a)*, "the tax imposed by section 1(e) shall apply to the taxable income of estates or of any kind of property held in trust" Thus, unlike partnerships, estates and trusts are treated as taxable entities separate and apart from their beneficiaries. As taxable entities, they compute taxable income in roughly the same manner as individual taxpayers,ⁿ¹ the major difference being the deduction available to estates and trusts for amounts distributed to beneficiaries.ⁿ² The latter deduction lies at the heart of the conduit approach to taxation taken by Subchapter J. It reflects the notion that trust income should be subject to tax only once--either at the trust level or at the beneficiary level.ⁿ³ In this way, income passed through to a beneficiary is taxed to the beneficiary; income retained by the estate or trust is taxed to it.

[2] The Concept of Distributable Net Income.ⁿ¹

Under the 1939 Code, a distribution was deductible by the estate or trust and taxable to the beneficiaries only if it could be traced to the income of the estate or trust for the current year. The 1986 Code eliminates the need to identify the source of the distribution. Instead, it employs a measuring device--the concept of distributable net income--to impose an outside limit on the amount deductible by the estate or trust and taxable to the beneficiary. The concept serves a qualitative function as well; the distribution is deemed to consist of "the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust" ⁿ² In other words, if there is tax-exempt interest in the distributable net income of the estate or trust, a portion of the distribution enters the beneficiary's hands as tax-exempt interest which he can exclude from gross income.

The distributable net income of an estate or trust for any given year is its taxable income with the following modifications:

(1) No deduction is allowed under either *IRC Section 651* or *661* on account of distributions made to beneficiaries.ⁿ³

(2) The personal exemption provided by *IRC Section 642(b)* (\$600 in the case of an estate, \$300 in the case of a trust required to distribute income currently, and \$100 in the case of all other trusts) cannot be

taken as a deduction.ⁿ⁴

(3) Capital gains are excluded to the extent that they are allocated to corpus and not (a) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (b) paid, permanently set aside, or to be used for charitable purposes.ⁿ⁵ Thus, in the ordinary course of events, capital gains will be subject to tax in the estate or trust. However, gain from the sale or exchange of qualified small business stock is not taken into account to the extent excludable from gross income under *IRC Section 1202*.ⁿ⁶

(4) Capital losses are excluded except to the extent such losses are taken into account in determining the amount of capital gains paid, credited, or required to be distributed to any beneficiary during the taxable year.ⁿ⁷

(5) A trust that distributes current income only is required to exclude extraordinary dividends and taxable stock dividends which the trustee, acting in good faith, does not pay or credit to any income beneficiary because of his determination that such dividends are allocable to corpus under the terms of the trust and the applicable local law.ⁿ⁸

(6) Distributable net income includes the amount of tax-exempt interest (interest excluded from gross income under *IRC Section 103*) received by the estate or trust in excess of the expenses of the estate or trust which are allocable to such interest and would have been deductible under *IRC Section 212* were it not for the disallowance rule of *IRC Section 265*.ⁿ⁹

(7) If the estate claims a charitable deduction under *IRC Section 642(c)*, the amount of tax-exempt interest includable in distributable net income will be further reduced to the extent that the income which is paid, permanently set aside, or to be used for charitable purposes is deemed to consist of tax-exempt interest. In addition, proper adjustment must be made for any exclusion allowable to the estate or trust under *IRC Section 1202*.

(8) If the trust is a foreign trust:

(a) distributable net income includes the amount of the trust's gross income from sources outside the United States, reduced by disbursements allocable to such income but not deductible because of the provisions of *IRC Section 265(a)(1)*;ⁿ¹⁰

(b) the amount of gross income from sources within the United States must be determined without regard to *IRC Section 894*, which excludes from gross income items exempted from taxation by treaty;ⁿ¹¹ and

(c) distributable net income includes the excess of capital gains over capital losses.ⁿ¹² (Distributable net income is not decreased if capital losses exceed capital gains for the year.)ⁿ¹³

Example:

Assume that a trust required to distribute all of its income currently has the following items of income and deduction for the taxable year:

Dividends from domestic corporations	\$15,000
Extraordinary dividends allocated to corpus by the trustee acting in good faith	10,000
Taxable interest	5,000

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Tax-exempt interest	5,000
Long-term capital gains allocable to corpus	5,000
Commissions and other expenses charged to corpus	2,500

The income which the trust must distribute to the income beneficiary is \$25,000, consisting of \$15,000 in domestic dividends, \$5,000 in taxable interest and \$5,000 in tax-exempt interest.ⁿ¹⁴ However, distributable net income is only \$22,500, computed as follows:

Dividends from domestic corporations	\$15,000
Taxable interest	5,000
Tax-exempt interest	\$5,000
Less: Expenses allocable thereto	500 ⁿ¹⁵
	4,500
	\$24,500
Less: Commissions and expenses (\$2,500 less \$500 allocable to tax-exempt interest) ⁿ¹⁶	2,000
Distributable net income	\$22,500

If the \$2,000 of expenses allocable to taxable income is apportioned ratably to the dividends and taxable interest, distributable net income will consist of \$13,500 of dividends, \$4,500 of taxable interest, and \$4,500 of tax-exempt interest.

In determining the distributable net income of \$22,500, no deductions were allowed for distributions made to the income beneficiary or for the personal exemption of the trust; the capital gains allocable to corpus were excluded; the extraordinary dividends were likewise excluded since they were allocated to corpus in good faith; and the tax-exempt interest was included after being reduced by the amount of expenses allocable to such interest.

FOOTNOTES:

(n1)Footnote 1. *IRC § 641(b)*. See generally 4 Rabkin & Johnson, *Federal Income, Gift and Estate Taxation*, Ch 54; Michaelson, *Income Taxation of Estates and Trusts* (rev ed 1970); Kamin, Surrey & Warren, "The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries," *54 Colum L Rev* 1237 (1954).

(n2)Footnote 2. *IRC §§ 651(a), 661(a)*.

(n3)Footnote 3. Gelband, "Taxation of Trust Income," *NYU 24th Inst on Fed Tax* 233, 234 (1966).

(n4)Footnote 1. Comprehensive discussions of distributable net income can be found in *How to Save Time and Taxes Preparing Fiduciary Income Tax Returns*, Ch 9 (Matthew Bender) and 2 *Modern Estate Planning* Ch 6 (Matthew Bender); Ferguson, Freeland & Ascher, *Federal Income Taxation of Estates, Trusts and Beneficiaries* 4:1-4:44 2d ed (1993).

(n5)Footnote 2. *IRC § 662(b)*. The rule applies unless the governing instrument specifically allocates different classes of income to different beneficiaries.

IRC § 662(b) applies to estates and to trusts which are not required to distribute income currently or which distribute income and corpus ("complex" trusts). *IRC § 652(b)* prescribes the same rule for "simple" trusts, trusts required to distribute all of their income currently and which do not distribute anything other than current income.

(n6)Footnote 3. *IRC § 643(a)(1)*.

(n7)Footnote 4. *IRC § 643(a)(2)*.

(n8)Footnote 5. *IRC § 643(a)(3)*. Capital gains are not considered as paid, credited, or required to be distributed to a beneficiary unless they are allocated to income under the terms of the governing instrument or local law; allocated to corpus and actually distributed to beneficiaries during the taxable year under the terms of the governing instrument upon the happening of a specific event; or utilized in determining the amount that is distributed or required to be distributed. *Treas Reg § 1.643(a)-3(a)*. In line with this, capital gains realized by a trust on distribution of securities to a beneficiary in satisfaction of an annuity (trust income being insufficient to fund the required payment) were held to be excludable from distributable net income because none of the specified conditions for inclusion were met. *Rev Rul 68-392, 1968-2 CB 284*.

Capital gains allocated to income by the trustee under authority granted in the trust instrument to allocate receipts between income and principal are includable in distributable net income. *Ltr Rul 8728001*.

In *Rev Rul 92-84, 1992-2 CB 216*, the Service held that gain derived from the sale of S corporation stock by a qualified Subchapter S trust (QSST) was taxable to the beneficiary of the trust, even though the gain was allocable to corpus under local law. The trust was treated as the owner of the stock. *Rev Rul 92-84* has been rendered obsolete by the promulgation of *Treas Reg § 1.1361-1*, providing that the income beneficiary of a QSST should not be treated as the owner of the consideration received by the QSST upon its disposition of S corporation stock. Therefore, any gain recognized on the sale of the S corporation stock is the gross income of the trust. In addition, the trust can use the installment method to report any gain realized on the sale if the sale otherwise qualifies as an installment sale.

(n9)Footnote 6. See § 2.06[2][a][ii] for a discussion of *IRC § 1202*.

(n10)Footnote 7. *IRC § 643(a)(3)*.

(n11)Footnote 8. *IRC § 643(a)(4)*.

(n12)Footnote 9. *IRC § 643(a)(5)*. A discussion of this provision of *IRC § 265* can be found in Ch 19.

Under the Regulations, a portion of the deductions not directly attributable to a specific class of income must be allocated to nontaxable income. *Treas Reg §§ 1.652(b)-3(b), 1.661(b)-2.*

(n13)Footnote 10. *IRC § 643(a)(6)(A).*

(n14)Footnote 11. *IRC § 643(a)(6)(B).*

(n15)Footnote 12. *IRC § 643(a)(6)(C).*

(n16)Footnote 13. *IRC § 643(a)(6)(C).*

(n17)Footnote 14. *IRC § 643(b).*

(n18)Footnote 15. The allocation is based on the proportion of the tax-exempt interest, \$5,000, to the entire amount of income to be distributed currently, \$25,000.

A corporate distribution that is not out of earnings and profits, and reduces the basis of the stock with respect to which it is made, cannot be included in the formula for allocating expenses of the trust to tax-exempt income. The distribution is not included in the computation of distributable net income even if the trustee distributes it to the income beneficiary of the trust. *Rev Rul 80-165, 1985-1 CB 134.*

(n19)Footnote 16. The excess of the deductions that are not attributable to any specific class of income over the amount allocable to tax-exempt income may be allocated to any item of income included in computing distributable net income. *Treas Reg § 1.652(b)-3(b).*



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CHAPTER 16 The Taxpayer as the Beneficiary of an Estate or Trust

2-16 Taxation of Securities Transactions § 16.03

§ 16.03 Specific Bequests of Securities

[1] Effect on the Beneficiary

The gross income of a beneficiary does not include the value of any securities acquired in a transfer which qualifies as a bequest of specific property under *IRC Section 663(a)(1)*.ⁿ¹ In order to so qualify, (1) the identity of the specific property must be ascertainable under the terms of the testator's will at the time of his death,ⁿ² (2) the terms of the will must provide for payment of the bequest all at once or in not more than three installments,ⁿ³ and (3) the terms of the will must not require that the bequest be payable only out of the income of the estate, whether from the income for the year of payment or from the income accumulated from a prior year.ⁿ⁴ If the transfer does not meet the requirements of *IRC Section 663(a)(1)*, it will be treated as an estate distribution subject to the general distribution rules of Subchapter J.ⁿ⁵

The basis to the beneficiary of specifically bequeathed securities is their fair market value on the date of the decedent's death or applicable alternate valuation date.ⁿ⁶ The beneficiary's holding period for the securities commences with the date of death even though he does not come into possession of the property until some later date.ⁿ⁷

[2] Effect on the Estate

The transfer of property from estate to beneficiary is not a taxable event giving rise to the realization of gain or loss, unless the distribution is in satisfaction of a right to receive a specific dollar amount or to receive specific property other than that distributed.ⁿ⁸ However, if the transfer qualifies as a specific bequest under *IRC Section 663(a)(1)*, the estate is barred from claiming the amount of the distribution as a deduction under *IRC Section 661* (relating to deductions for distributions made to beneficiaries).ⁿ⁹

FOOTNOTES:

(n1)Footnote 1. *IRC § 102(a)*. A gift of specific property made under the terms of the trust instrument will also be excluded from gross income.

Interest required by state law to be paid to a beneficiary when distribution of a specific legacy is delayed is not part of the gift and must be included in the beneficiary's income. *Rev Rul 73-311, 1973-2 CB 44*.

(n2)Footnote 2. *Treas Reg § 1.663(a)1(b)(1)*. This prevents a residuary legacy or a gift of the remainder of a trust

from being treated as a specific bequest. Treas Reg § 1.663(a)1(b)(2)(iii).

A bequest of "assets, in cash or in kind or partly in each" with a fair market value at the date of distribution equal to a specified dollar amount, is a bequest of a specific sum of money under *IRC § 663(a)*. *Rev Rul 86-105, 1986-2 CB 82* .

A bequest that required the decedent's executor to distribute in kind a specified dollar amount of a certain stock, but no more than all of such stock owned by the decedent, did not qualify as a specific bequest; only the kind of property, not the amount thereof, was ascertainable under decedent's will at the time of his death. *Rev Rul 72-295, 1972-1 CB 197* .

(n3)Footnote 3. *IRC § 663(a)(1)*; Treas Reg §§ 1.663(a)1(a), 1.663(a)1(b)(2)(iv), 1.663(a)1(c).

(n4)Footnote 4. *IRC § 663(a)(1)*; *Treas Reg § 1.663(a)-1(b)(2)(i)*.

(n5)Footnote 5. Treas Reg § 1.662(a)3(a); see § 16.05[1].

(n6)Footnote 6. *IRC § 1014(b)(1)*.

(n7)Footnote 7. *Treas Reg § 1.1014-4(a)(2)*; *McFeely v Commr, 296 US 102 (1935)* ; see § 2.05[2][a].

(n8)Footnote 8. *Treas Reg § 1.661(a)-2(f)(1)*; *Rev Rul 55-117, 1955-1* , CB 233; see also *Rev Rul 68-666, 1968-2 CB 283* , where the Service ruled that gain realized on securities sold by the executor of an estate in compliance with the request of the beneficiaries of a specific bequest of the securities was not includable in the gross income of the estate.

(n9)Footnote 9. The estate can claim a deduction for interest paid on account of late payment of specific bequests. *Rev Rul 73-322, 1973-2 CB 44* .



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CHAPTER 16 The Taxpayer as the Beneficiary of an Estate or Trust

2-16 Taxation of Securities Transactions § 16.04

§ 16.04 Distributions of Securities in Satisfaction of Pecuniary Legacies

[1] Effect on the Beneficiary

The payment of a legacy stated in terms of a fixed sum of money can be classified as a bequest, excludable from gross income under *IRC Section 102*, if the requirements of *IRC Section 663(a)(1)* are met. The conditions for qualification are the same as those prescribed for bequests of specific property, with one exception--in a bequest of a specific sum of money, the thing that must be ascertainable under the terms of the testator's will as of the date of his death is the amount of money to be paid to the beneficiary.ⁿ¹ A change in payment medium from cash to securities does not produce a corresponding change in tax consequence; the beneficiary still has nothing to include in gross income. The transaction is looked upon as the equivalent of a cash distribution to the beneficiary, followed by his use of the funds to purchase the securities from the estate.ⁿ²

If the securities were owned by a decedent, or if they were purchased by the estate, the basis of the securities in the hands of the beneficiary will be their cost, i.e., the amount or portion of the pecuniary legacy satisfied by the distribution in kind.ⁿ³ This result should obtain irrespective of the value of the securities at the time of distribution; the beneficiary's cost is the value of the thing given up, not the value of the thing received.ⁿ⁴ Thus, if a beneficiary agrees to accept stock worth \$95,000 in payment of a legacy of \$100,000, his basis for the stock should be \$100,000. The beneficiary's holding period for the acquired securities begins on the day following the date of acquisition and does not relate back to the decedent's death.

[2] Effect on the Estate

A taxable event occurs whenever an estate distributes property in kind to a beneficiary in satisfaction of a fixed pecuniary legacy.ⁿ⁵ If the property was owned by a decedent, or if it was purchased by the estate, the measure of gain or loss is the difference between the amount satisfied and the basis to the estate of the distributed property. In such case, the value of the property plays no part in determining the extent of the gain or loss realized by the estate; its amount realized is the value of what it receives and not the value of what it gives up.

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.663(a)-1(b)(1)*. This rule holds true for payments of fixed sums from trusts, eg, a required payment of \$10,000 to a beneficiary at age 25. *Treas Reg § 1.663(a)-1(c)(2)*, Ex (1)(iii).

A pecuniary legacy need not be stated in terms of a fixed sum of money. A prime example of this is the bequest to a spouse of an amount equal to one-half of the adjusted gross estate. See Rev Proc 64-19, 1964-1 CB 682 .

(n2)Footnote 2. Cf Rev Rul 67-74, 1967-1 CB 194 .

(n3)Footnote 3. *Commr v Matheson*, 82 F2d 380 (5th Cir 1936) ; see also *Wilson v Tomlinson*, 306 F2d 103 (5th Cir 1962) (taxpayer received stock in satisfaction of a claim against estate); *Howard v Commr*, 23 TC 962 (1955) , acq 1955-2 CB 6 (beneficiary surrendered right to receive accumulated income in return for stock).

(n4)Footnote 4. Freeland, "Estate Distributions in Kind," 23 *Tax L Rev* 59, 86 (1967). An early Board of Tax Appeals case, *Ewing v Commr*, 40 BTA 912 (1939) , acq 1941-1 CB 4 , had suggested that the proper measure of basis was the fair market value of the securities at the time acquired by the beneficiary.

(n5)Footnote 5. *Kenan v Commr*, 114 F2d 217 (2d Cir 1940) ; *Suisman v Eaton*, 15 F Supp 113 (D Conn 1935) , *affd per curiam* 83 F2d 1019 (2d Cir) , *cert denied* 299 US 573 (1936) ; Rev Rul 66-207, 1966-2 CB 243 ; Rev Rul 60-87, 1960-1 CB 286 , clarifying Rev Rul 56-270, 1956-1 CB 325 .

The use of appreciated property to satisfy a debt of the decedent also gives rise to a taxable event. Rev Rul 74-178, 1974-1 CB 196 .



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CHAPTER 16 The Taxpayer as the Beneficiary of an Estate or Trust

2-16 Taxation of Securities Transactions § 16.05

§ 16.05 n1 Distributions of Securities in Satisfaction of Residuary Legacies or of Payments Due to Trust Beneficiaries

[1] Effect on the Beneficiary's Incomen2

A bequest of the residuary of an estate is not considered a bequest of a sum of money or of specific property within the meaning of *IRC Section 663(a)(1)*.ⁿ³ Therefore, any transfer of cash or property by an estate, in satisfaction of all or part of a residuary legacy, must be treated as an estate distribution subject to the rules of Subchapter J, and not as a bequest excludable from gross income under *IRC Section 102*.

Under *IRC Section 662(a)*, the beneficiary of an estate must include in gross income any amounts (other than amounts treated as bequests under *IRC Section 663(a)(1)*)ⁿ⁴ paid, credited, or required to be distributed to him during the taxable year of the estate. However, the amount so includable may not exceed the beneficiary's proportionate share of the distributable net income of the estate. What we have, then, is a scheme of taxation that treats any distribution by an estate as a distribution of current income to the extent of the estate's distributable net income for the year. This is not unlike the rules respecting dividends, to wit, that every distribution made by a corporation is deemed to be out of earnings and profits to the extent thereof.ⁿ⁵ And, as in the case of dividends, the label placed upon the distribution by local law or proper accounting practice will have no bearing on the tax consequences of the distribution; a payment charged to corpus on the records of the estate will still be treated as income, provided it does not exceed the amount of distributable net income for the taxable year.ⁿ⁶

The determination of a beneficiary's share of distributable net income is made according to an established order of priority and not merely by reference to the amount received by the beneficiary. This order of priority, or "tier" system, allocates distributable net income first to those beneficiaries who are entitled to receive income currently under the terms of the will and applicable local law.ⁿ⁷ Any distributable net income then remaining is allocated to the "second tier," that is, to all other beneficiaries who received distributions of income or principal from the estate during the taxable year.ⁿ⁸ The distributable net income so allocated is apportioned ratably among the beneficiaries in the respective tiers.ⁿ⁹ Thus, before one is required to treat all distributions as coming out of current income, the distributable net income of the estate must exceed the sum of the distributions it made and was required to make during the taxable year.

The operation of *IRC Section 662* can be illustrated by the following examples:

Example 1:

During the taxable year, an estate, which is not required to distribute any of its current income, has the following items of income and deduction:

Dividends from domestic corporations	
.....	\$20,000
Taxable interest.....	5,000
Tax-exempt interest.....	5,000
Long-term capital gains allocable to corpus	
.....	5,000
Commissions and other expenses chargeable to corpus	
.....	3,000

The estate's distributable net income for the year is \$27,000, computed as follows:

Dividends from domestic corporations		\$20,000
Taxable interest		5,000
Tax-exempt interest		\$5,000
Less Expenses allocable thereto	500	4,500
: (5,000/30,000ths of \$3000)		
		\$29,500
Less Commissions and expenses		2,500
: (\$3,000 less \$500 allocable to tax-exempt interest)		
Distributable net income		\$27,000

During the year, A, B, and C, the residuary legatees, each received \$10,000 in securities from the estate. Since there are no further beneficiaries, each of the distributees is deemed to be the recipient of \$9,000 current income and \$1,000 of corpus. Moreover, since the character of the income in the hands of the beneficiary is the same as in the hands of the estate, each beneficiary will be treated as having received \$1,500 (1/3 of \$4,500) of tax-exempt interest and \$7,500 of taxable income.¹¹

Example 2:

Assume the same facts as in Example 1, except that the will also requires the payment of \$18,000 of income to A each year. Now, the first \$18,000 of distributable net income must be allocated to A, the sole "first-tier" distributee, and only the balance of \$9,000 apportioned equally to A, B, and C. Thus, because of the first-tier distribution to A, each of the other residuary legatees receives only \$3,000 of distributable net income, of which \$500 (3,000/27,000ths of \$4,500) is tax-exempt interest. The \$21,000 of distributable net income allocated to A is broken down into \$3,500 of tax-exempt interest and \$17,500 of taxable income.

The foregoing example assumed that the value of the securities and their basis in the hands of the trust were the same.

For distributions made after December 31, 1983, the amount of the distributions for purposes of *IRC Section 662* is the lesser of: (1) the basis of the property in the hands of the trust immediately before the distribution, adjusted for any gain or loss recognized to the trust on the distribution; or (2) the fair market value of the property.ⁿ¹² However, if the trust elects to recognize gain to the extent it would have had the property been sold to the beneficiary at its fair market value, the amount of the distribution will be such fair market value.ⁿ¹³

[2] The Beneficiary's Basis and Holding Period

[a] When Distributable Net Income Equals or Exceeds the Value of the Distributed Securities. Prior to 1984, the basis of property distributed in kind in a distribution governed by the provisions of Subchapter J was its fair market value at the time it was paid, credited, or required to be distributed, to the extent such value was included in the gross income of the beneficiary.ⁿ¹⁴ Thus, it can be seen that whenever distributable net income was at least as great as the amount of the distributed property and consisted entirely of items of taxable income, the full value of the distribution was includable in gross income and provided the measure of the beneficiary's basis for the property. For example, if an estate, having distributable net income of \$25,000, distributed securities worth \$20,000 to a residuary legatee, and the distribution was the only one made or required to be made by the estate during the taxable year, the securities would have had a basis of \$20,000 in the hands of the beneficiary; \$20,000 was also the amount which the beneficiary included in gross income (assuming that distributable net income consisted solely of taxable income items). Since the basis was equal to fair market value, the beneficiary's holding period for the securities commenced on the day following acquisition.

The basis for distributions made after December 31, 1983, is the adjusted basis of the property in the hands of the estate immediately before the distribution, adjusted for any gain or loss recognized by the estate on the distribution.ⁿ¹⁵ Therefore, if the trust made the distribution described in the previous paragraph after 1983, the basis of the securities in the hands of the beneficiary would be \$20,000 only if that were the basis in the hands of the estate. However, the fair market value of the property will continue to serve as the basis of the property in the hands of the beneficiary if the estate elects to recognize gain or loss on the distribution.ⁿ¹⁶

The holding period for distributions made after 1983 will depend on whether or not the estate elects to recognize gain or loss on the distribution. If it does not, the tacking provisions of *IRC Section 1223(2)* will apply, and the period for which the estate held the property will be added to the beneficiary's holding period. If the election is made, the beneficiary will assume a new holding period beginning the day after the distribution.

[b] When Distributable Net Income Is Less Than the Value of the Distributed Securities. Suppose that, before 1984, an estate, having distributable net income of \$15,000, transferred securities with a basis of \$20,000 and a value of \$25,000 to its sole residuary legatee. Clearly, the basis of the securities in the hands of the beneficiary could not be \$25,000, since a basis equal to fair market value was permitted only to the extent that the value of the property was included in the beneficiary's gross income;ⁿ¹⁷ and here it was included only to the extent of \$15,000, the distributable net income of the estate. Just as clear was the fact that the beneficiary's basis could not be the estate's basis, for, then, no effect would be given to the inclusion of a part of the value of the property in gross income. The regulations solved the problem by providing that to the extent that the value of property distributed in kind was not included in the gross income of the beneficiary, its basis in the hands of the beneficiary was governed by the rules in *IRC Sections 1014* (governing the basis of property acquired from a decedent) and *1015* (governing the basis of property acquired by gift).ⁿ¹⁸ Thus, the basis in the hands of the beneficiary could never be less than the estate's basis for the securities (a situation that would obtain whenever distributable net income was zero) or more than the fair market value of the securities. Where the estate had distributable net income, but in an amount less than the value of the distributed securities, the beneficiary's basis was the estate's basis adjusted by multiplying the unrealized appreciation or depreciation in value of the securities by a fraction, of which the amount includable in gross income was the numerator, and the fair market value of the distributed securities was the denominator.ⁿ¹⁹ Applying this rule, we find that, in our case, the basis of the securities in the hands of the beneficiary would be \$23,000, computed as follows:

Basis of the securities to the estate			\$20,000
Adjustment	\$15,000		
		x	\$5,000
			3,000
	25,000		
			\$23,000
			Beneficiary's basis

It has been suggested that a less obscure route to the same result is one that proceeds on the assumption that 15/25ths of the property has been purchased and 10/25ths acquired as a transfer of property with a substituted basis.ⁿ²⁰ Using this approach, the beneficiary's basis of \$23,000 would consist of a cost basis of \$15,000 (15/25ths of \$25,000) and a substituted basis of \$8,000 (10/25ths of \$20,000, the estate's basis for the securities).

The combination of a cost basis and a substituted basis for the same item of property produced a split holding period.ⁿ²¹ The beneficiary was permitted to include the estate's holding period in his own to the extent that his basis for the securities was determined by reference to the estate's basis.ⁿ²² To the extent that the securities had a cost basis, they had a holding period that began on the day following distribution. Thus, if the securities were sold within one year of their receipt by the beneficiary, 15/23rds of the gain or loss would be short-term, while 8/23rds would be long-term.

The rules applicable to distributions made after 1983 produce the same result here as when distributable net income is equal to or greater than the value of the distributed securities. Absent an election, the beneficiary's basis will be the same as the estate's and the holding period will be tacked.

[c] When Distributable Net Income Includes Tax-Exempt Income. Our discussion of basis for pre-1984 distributions proceeded on the assumption that the items comprising the estate's distributable net income were all subject to federal income taxation. Suppose, however, that the opposite situation obtains--the estate's distributable net income consisted entirely of tax-exempt income. If the estate were to distribute securities with a basis of \$40,000 and a value of \$50,000 to its sole residuary legatee, the effect on him would be the same as when distributable net income was zero; he would have had nothing to include in gross income,ⁿ²³ and his basis for the stock would be the estate's basis, \$40,000.ⁿ²⁴

Now suppose that distributable net income was composed of \$30,000 of taxable income and \$20,000 of tax-exempt income. Looked at logically, since the amount includable in the beneficiary's gross income was only \$30,000, he was in exactly the same position as the beneficiary who received a distribution of securities worth \$50,000 from an estate having distributable net income of \$30,000, consisting entirely of taxable income items. In other words, the basis of the securities could not be \$30,000, for that was less than the basis he would have if distributable net income were zero. Nor could it be \$50,000, for that would fail to take into account the fact that a portion of the value of the distribution was excluded from the gross income of the beneficiary. The obvious conclusion was a split basis, that is, a cost basis for a part of the property and a basis determined under *IRC Section 1014*ⁿ²⁵ for the remainder. Under the facts given, the beneficiary would have had a cost basis of \$30,000 (three fifths of the value of the property and the amount includable in gross income), and a substituted basis of \$16,000 (two fifths of \$40,000, the estate's basis for the securities), or a total of \$46,000. The same figure could be obtained by starting with the estate's basis, \$40,000, and then adding thereto an amount that reflected the difference between the basis and the fair market value of that portion of the property deemed to have been included in the gross income of the beneficiary. The amount of the adjustment was again determined by use of the following formula:

$$\frac{\text{amount included in gross income}}{\text{fair market value of the property}} \times \text{unrealized appreciation} \quad n26$$

Substituting, we get:

$$\$30,000 \times \$10,000 = \$6,000$$

$$\begin{array}{r} \text{-----} \\ \text{-----} \\ \text{-----} \\ - \\ \$50,000 \end{array}$$

The divisible basis carried with it a split holding period, one part of which commenced with the acquisition of the securities by the beneficiary and one part of which included the period during which the securities were held by the estate.ⁿ²⁷

If the distribution is made after 1983, the existence of tax-exempt income in distributable net income does not affect the determination of basis or holding period. Basis still carries over and holding period is tacked unless the fiduciary elects to recognize gain or loss on the distribution.

[d] When the Distribution Consists of Mixed Property

[i] Entire Distribution in Kind.ⁿ²⁸ Assume that, prior to 1984, an estate having distributable net income of \$30,000, no part of which consisted of tax-exempt items, distributed the following items of property to its sole residuary beneficiary:

	Estate's Basis	Fair Market Value
A Corp stock	\$25,000	\$25,000
B Corp stock	15,000	25,000
Bond	15,000	10,000
	-----	-----
	-----	-----

	-	
	\$55,000	\$60,000

The situation is one we have seen before--an amount includable in the beneficiary's gross income less than the value of the distributed property--so that once again there would be a need to adjust the estate's basis to arrive at the basis of the property in the hands of the beneficiary. The adjusting fraction remained the same. The numerator was the value of the property included in gross income; the denominator was the total value of the distributed property.ⁿ²⁹ In the above case, this worked out to \$30,000/\$60,000 or one half. Applying this to the unrealized appreciation or depreciation of each item of property, the following result was reached:

	Unrealized		Basis to
Basis to	Appreciation	Adjust-	Benif-
Estate	(or Depreci-	ment	ciary

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	ation)			
A Corp Stock	\$25,000	\$--0--	\$--0--	\$25,000
B Corp Stock	15,000	10,000	+5,000	20,000
Bond	15,000	(5,000)	-2,500	12,500
Total	\$55,000	\$ 5,000	\$ 2,500	\$57,500

It will be noted that the basis of the A Corp stock to the beneficiary was the same as its basis to the estate. However, this did not mean that the beneficiary's holding period for the stock was determined solely under *IRC Section 1223(2)*, for, although his basis was equal to the estate's basis, he was deemed to have acquired a portion of each share of stock by purchase. The cost basis attributable to each item of property received was:

A Corp stock	25,000	x	\$30,000 = \$12,500
	<u>60,000</u>		
B Corp stock	25,000	x	\$30,000 = \$12,500
	<u>60,000</u>		
Bond	10,000	x	\$30,000 = \$ 5,000
	<u>60,000</u>		

Thus, since each item of property had a cost basis and a substitute basis,ⁿ³⁰ the beneficiary had a dual holding period for each item.

If the distribution takes place after 1983, the basis to the beneficiary would be the same as in the hands of the estate, namely, A Corp stock, \$25,000, B Corp stock, \$15,000, and the bond, \$15,000, unless the estate elected to recognize gain, in which case the B Corp stock would have a basis of \$25,000, and the bond a basis of \$10,000.ⁿ³¹

We have been considering distributions made to a single residuary beneficiary. The results are no different when there are multiple residuary legatees and the distribution is pro rata. Nor will there be any change in result if the estate makes a non-pro rata distribution pursuant to an authorization contained in the will or in the applicable local law. However, there will be an additional tax consequence if the distribution is not pro rata and both the instrument and local law are silent as to the authority of the executor to make a non-pro rata distribution in kind. In such case, the distribution will be viewed as the equivalent of a pro rata distribution followed by an exchange of property between the residuary legatees.ⁿ³²

Example:

Suppose that, before 1984, an estate, which had no distributable net income, distributed stock with a basis of \$10,000 and a value of \$15,000 to A, one of the residuary legatees, and bonds with a basis of \$16,000 and a value of \$15,000 to B, the other residuary beneficiary. Suppose further that the executor

had no authority to make non-pro rata distributions in kind, but did so upon the request and agreement of the residuary legatees. Since there was no distributable net income, neither beneficiary had anything to include in gross income, with the result that each was deemed to receive stock with a basis of \$5,000 and bonds with a basis of \$8,000. However, inasmuch as *A* received only stock, he, in substance, exchanged his pro rata share of the bonds for *B*'s pro rata share of the stock. Because of this, *A* realized a loss of \$500 (basis of bonds, \$8,000, less value of stock received, \$7,500). *B*, in turn had a gain of \$2,500; he exchanged stock having a basis of \$5,000 for bonds worth \$7,500.ⁿ³³

[ii] Distribution Partly in Kind and Partly in Cash. No problem with respect to basis was encountered before 1984 when an estate distributed cash and securities and the estate had distributable net income equal to or greater than the total amount of the distribution. Since the entire value of the securities was includable in the beneficiary's gross income (assuming, of course, that distributable net income was composed only of taxable income items), his basis for the securities was their fair market value. (There was also no difficulty if the transfer of securities qualified as a bequest of specific property. *IRC Section 102* excludes the value of the bequest from gross income; *IRC Section 1014* determined the beneficiary's basis for the property.)ⁿ³⁴

But what was the basis of the securities if the amount of the distribution (the value of the property and the cash) exceeded distributable net income? This depended on what portion of the value of the securities was considered taxable, for, as we have seen, the basis of the property in the hands of the beneficiary was its fair market value "to the extent such value is included in the gross income of the beneficiary."ⁿ³⁵ The Code was silent in this regard, but the regulations provided that if the amount of cash and property distributed to the beneficiary exceeded the amount includable in his gross income for the year, the value of the property other than cash was normally considered as includable in his gross income only to the extent that the amount includable exceeded the cash distributed to the beneficiary.ⁿ³⁶ Thus, if the estate had distributable net income of \$30,000 (or if it had, say, distributable net income of \$40,000, composed of taxable items of \$30,000 and tax-exempt interest of \$10,000), and it distributed \$20,000 in cash and securities with a basis of \$15,000 and a fair market value of \$20,000, the beneficiary had to include the entire amount of the cash, but only \$10,000 of the value of the property in his gross income.ⁿ³⁷ This gave him a cost basis of \$10,000 for one-half of the property and a substituted basis for the remaining half, or a total basis of \$17,500 (\$10,000 + 1/2 of \$15,000, the estate's basis for the securities).

Did the regulations prescribe an inflexible rule? If so, then what was the reason for the use of the word "normally"? But, since the regulations did not say in what circumstances some other rule should be applied, it may be that the rule had to be applied absolutely, even though the language in which it is cast was permissive.

The basis of property received in a mixed distribution after 1983 is unaffected by the presence of cash. The general rule that the basis of the property carried over from estate to beneficiary applies in this instance as well.

[3] Effect on the Estate.

It has already been seen that an estate is precluded from taking a distributions deduction when it transfers securities to a beneficiary and the transfer qualifies as a bequest of specific property under *IRC Section 663(a)(1)*.ⁿ³⁸ It has also been seen that the estate does not realize gain or loss by reason of the distribution, unless it is made in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed, is a distribution where the fiduciary elects to recognize gain or loss, or, solely with respect to gain, is in satisfaction of a requirement to distribute income currently.ⁿ³⁹ The discussion in this subsection will focus on the consequences to the estate of a distribution that is subject to the general rules of Subchapter J.

[4] Additional Considerations in the Year of Termination if the Estate Has a Capital Loss Carryover.

Suppose that, for a given year, an estate has long-term capital gains of \$5,000 and short-term capital losses of \$10,000.

Its loss deduction is limited to \$8,000, the amount of the gains plus \$3,000.ⁿ¹ In addition, the estate is entitled to carry over the disallowed portion of the losses, \$2,000, to subsequent years. But if this is the final year of the estate's existence, there will be no subsequent year. However, this does not mean that the loss carryover evaporates with the termination of the estate, for *IRC Section 642(h)* provides:

"If on the termination of an estate or trust, the estate or trust has--

(1) ... a capital loss carryover under section 1212, ...

...

then such carryover ... shall be allowed as a deduction, in accordance with regulations prescribed by the Secretary, to the beneficiaries succeeding to the property of the estate or trust."ⁿ²

If the beneficiary is an individual (or some other noncorporate taxpayer) the capital loss carryover has the same character in his hands as in the hands of the estate.ⁿ³ If the beneficiary is a corporation, the loss carryover is a short-term loss irrespective of whether it would have been a long-term or short-term capital loss in the hands of the estate.ⁿ⁴

The first taxable year to which the loss can be carried over is the taxable year of the beneficiary in which or with which the estate terminates.ⁿ⁵ The noncorporate beneficiary can carry over the loss indefinitely;ⁿ⁶ the corporate beneficiary can carry the loss over for four additional years.ⁿ⁷ Thus, if the estate terminates on December 31, 2000, and one of its beneficiaries is a corporation that reports on a calendar year basis, the corporation can use its share of the capital loss carryover of the estate in 2000, 2001, 2002, 2003, and 2004.

To illustrate:

Example:

On December 31, 2000, an estate distributes all of its assets equally to its two residuary legatees, A, an individual, and X Corporation, and then terminates its existence. On the date of termination, the estate has a long-term loss carryover of \$4,000, and a short-term loss carryover of \$4,000. A, a calendar year taxpayer, has \$10,000 of ordinary income, \$2,000 of long-term capital gain, and \$1,000 of long-term loss for the taxable year 2000. X Corporation, also a calendar year taxpayer, realizes \$2,000 in short-term gains during 2000.

The pass-through of one half of the estate's unused capital loss carryover gives A \$3,000 (\$1,000 + \$2,000) of long-term capital losses to apply against his long-term capital gain of \$2,000, leaving him with a net long-term capital loss of \$1,000. In addition, A will pick up \$2,000 of the estate's short-term capital loss and be allowed to deduct an additional \$3,000 against ordinary income.

X Corporation will use \$2,000 of its \$4,000 share of the unused capital losses of the estate to offset 2000 capital gains. The balance is carried over as a short-term loss to 2001, and, if necessary, to 2002, 2003, and 2004, but not beyond.

FOOTNOTES:

(n1)Footnote 1. The discussion in this section will be cast in terms of distributions from an estate. However, the provisions of Subchapter J apply with equal force to distributions by a trust to its beneficiaries.

(n2)Footnote 2. See generally Ferguson, Freeland & Ascher, *Federal Income Taxation of Estates, Trusts, and Beneficiaries* 6:1-6:132 2d ed (1993).

(n3)Footnote 3. *Treas Reg* § 1.663(a)-1(b)(2)(iii).

(n4)Footnote 4. *Treas Reg* § 1.662(a)-1.

(n5)Footnote 5. *IRC* § 316(a). The subject of dividend distributions is covered in chapter 4.

(n6)Footnote 6. *Treas Reg* § 1.662(a)-3(b).

(n7)Footnote 7. *IRC* § 662(a)(1). The term "income required to be distributed currently" includes any amount required to be paid out of income or corpus to the extent it is paid out of current income.

(n8)Footnote 8. *IRC* § 662(a)(2).

(n9)Footnote 9. *IRC* § 662(a)(1), (2). In determining whether the total amount of a first-tier distribution exceeds distributable net income, the computation of the latter is made without taking into account any charitable deduction to which the estate is entitled under § 642(c). Any apportionment within the first tier is made by attributing to the beneficiary the same fractional part of distributable net income as the amount of income required to be distributed currently to him bears to the amount of income required to be distributed currently to all beneficiaries.

(n10)Footnote 10. *IRC* § 662(b). The amount treated as income by the beneficiary is deemed to consist of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate, unless the will specifically allocates different classes of income to different beneficiaries. In applying § 662(b), distributable net income is computed without regard to the portion of any charitable deduction claimed by the estate that is not attributable to income of the taxable year.

(n11)Footnote 11. If the taxable year of a beneficiary is different from that of the estate, the amount to be included in the gross income of the beneficiary is based upon the distributable net income of the estate and the amount paid or required to be paid during the taxable year of the estate ending within the beneficiary's taxable year. *IRC* § 662(c). For example, suppose a calendar year taxpayer is a beneficiary of an estate with a taxable year ending on January 31, 1970. Distributions made to the beneficiary between February 1 and December 31, 1969 will be includable in his gross income for 1970. If the final year of the estate is a short year ending, say, on June 30, 1970, the distributions made between February 1 and June 30 will likewise be includable in 1970. *Rev Rul* 71-180, 1971-1 CB 204 .

(n12)Footnote 12. *IRC* § 643(e)(2). The provision does not apply to any distribution governed by *IRC* § 663. *IRC* § 643(e)(4).

(n13)Footnote 13. *IRC* § 643(e)(3). The election is made on the tax return of the estate for the year of distribution, and, once made, can be revoked only with the consent of the Service.

(n14)Footnote 14. *Treas Reg* § 1.661(a)-2(f)(3).

(n15)Footnote 15. *IRC* § 643(e)(1).

(n16)Footnote 16. The basis of the property in the hands of the estate will have been increased by the amount of gain or decreased by the amount of loss recognized by the estate resulting in a basis equal to fair market value.

(n17)Footnote 17. *Treas Reg* § 1.661(a)-2(f)(3).

(n18)Footnote 18. *Treas Reg* § 1.661(a)-2(f)(3).

(n19)Footnote 19. *Rev Rul* 64-314, 1964-2 CB 167 .

(n20)Footnote 20. Freeland, "Estate Distributions in Kind," 23 *Tax L Rev* 59 (1967).

(n21)Footnote 21. For discussion of split holding period in another context, see Ch 2.

(n22)Footnote 22. *IRC § 1223(2)*.

(n23)Footnote 23. *IRC § 662(b)*.

(n24)Footnote 24. *Treas Reg § 1.661(a)-2(f)(3)*.

(n25)Footnote 25. If the distribution were from a trust, the basis of the part not acquired by purchase would be determined under *IRC § 1015*.

(n26)Footnote 26. *Rev Rul 64-314, 1964-2 CB 167*. A downward adjustment was required if the fair market value of the securities was less than the estate's basis therefore.

(n27)Footnote 27. 30/46ths of the property would have a new holding period; the remainder would have a "tacked" holding period.

(n28)Footnote 28. Distributions of depreciable property may trigger the recapture provisions of *IRC §§ 1245 and 1250*. See Freeland, "Estate Distributions in Kind," *23 Tax L Rev 59, 78-84 (1967)*.

(n29)Footnote 29. *Rev Rul 64-314, 1964-2 CB 167*.

(n30)Footnote 30. The substituted basis of each item would be:

A Corp. stock	\$12,500
B Corp. stock	7,500
Bond	7,500

(n31)Footnote 31. The amount of the distribution, assuming no election, would be \$50,000, measured by the basis of the stock and the fair market value of the bond (because less than basis).

(n32)Footnote 32. Cf *Rev Rul 69-486, 1969-2 CB 159*.

(n33)Footnote 33. The same result would be obtained after 1983, since the basis in the hands of the beneficiaries would be the estate's basis, absent an election to recognize gain or loss.

(n34)Footnote 34. See § 16.03[1].

(n35)Footnote 35. *Treas Reg § 1.661(a)-2(f)(3)*.

(n36)Footnote 36. *Treas Reg § 1.661(a)-2(f)(3)*.

(n37)Footnote 37. See, eg, *Rev Rul 64-314*, N 19 *supra*.

(n38)Footnote 38. See § 16.03[2].

(n39)Footnote 39. *IRC § 643(e)(3)*; *Treas Reg § 1.661(a)-2(f)(1)*. If the distribution is in discharge of an obligation to distribute income currently, the estate is deemed to have sold the property at fair market value on the date of distribution.

(n40)Footnote 1. *IRC § 1211(b)(1)*; see Ch 2. This assumes that taxable income exceeds \$3,000.

(n41)Footnote 2. "The phrase 'beneficiaries succeeding to the property of the estate or trust' means those beneficiaries upon termination of the estate or trust who bear the burden of any loss for which a carryover is allowed, or of any excess of deductions for which a deduction is allowed, under section 642(h)." *Treas Reg § 1.642(h)-3(a)*. This excludes specific legatees or devisees, pecuniary legatees, and other nonresiduary beneficiaries. It also excludes the recipient of a specific sum of money payable out of the residuary, except to the extent it is not payable in full. *Treas Reg § 1.642(h)-3(c)*. In the case of a trust, it generally refers to a remainderman who receives all or a fractional part of the trust corpus. *Treas Reg § 1.642(h)-3(d)*. The phrase does not include anyone purchasing an interest in a testamentary trust. *Nemser v Commr*, 66 TC 780 (1976) , *affd* 556 F2d 558 (2d Cir 1977) , *cert denied*, 434 US 855 .

Under *IRC § 642(h)(2)*, the beneficiaries succeeding to the property of the estate or trust are entitled to a deduction if the estate has deductions (other than the charitable deduction and personal exemption) in excess of gross income for the year of termination. However, the excess deduction can be used in computing taxable income only; it cannot be used in computing adjusted gross income. *Treas Reg § 1.642(h)-2(a)*. Thus, it is available only to beneficiaries who itemize deductions. On the other hand, a beneficiary succeeding to the capital loss carryover of an estate or trust can take the loss into account in computing adjusted gross income and taxable income. *Treas Reg § 1.642(h)-1(b)*.

(n42)Footnote 3. *Treas Reg § 1.642(h)-1(b)*.

(n43)Footnote 4. *Treas Reg § 1.642(h)-1(b)*.

(n44)Footnote 5. *Treas Reg § 1.642(h)-1(b)*.

(n45)Footnote 6. *IRC § 1212(b)*.

(n46)Footnote 7. Corporations can carry capital losses forward for only five years. *IRC § 1212(a)*; see Ch 2. Because of this, capital losses carried over by an estate to any taxable year of the estate are treated as if they were incurred in its last taxable year. *Treas Reg § 1.642(h)-1(b)*; *Treas Reg § 1.642(h)-1(c)*, Ex (2).

The regulations contain a statement that, for the purpose of determining the number of years to which a carryover may be carried, the last taxable year of the estate (whether or not a short taxable year), and the first taxable year of the beneficiary to which the loss is carried, each constitute a taxable year. This is no longer important in the case of capital loss carryovers (an individual has an unlimited carryover; a corporate beneficiary considers the loss as having been incurred in the year of termination), but still is in the case of net operating loss carryovers of both individuals and corporations. The Second Circuit held the regulation invalid in a case concerned with a capital loss carryover passed through to an individual beneficiary at a time when the carryover period of individuals was limited. *Dorfman v Commr*, 394 F2d 651 (2d Cir 1968) .



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Taxation of Securities Transactions

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CHAPTER 16 The Taxpayer as the Beneficiary of an Estate or Trust

2-16 Taxation of Securities Transactions § 16.06

§ 16.06 n1 Distributions by Qualified Employees' Trusts

[1] Distributions of Securities of the Employer Corporation.

[a] In General. Under *IRC Section 402(a)*, the beneficiary of a qualified employees' trust (an employees' trust described in *IRC Section 401(a)* and exempt from taxation under *IRC Section 501(a)*) is taxed only in the year that amounts are distributed or made available to him.ⁿ¹ If property (including securities) is distributed by the trust, the measure of the distribution is ordinarily the fair market value of the property.ⁿ² However, if any part of the distribution consists of securities of the employer corporation, two special rules apply. If the employees' trust is a contributory trust (one to which both employer and employee make contributions), and the distribution is not a lump-sum distribution, the amount of the distribution does not include that portion of the net unrealized appreciation in such securities as is attributable to the employee's contributions.ⁿ³ If the distribution is a lump-sum distribution that includes securities of the employer corporation, the amount of the distribution is attributable to contributions by the employer.ⁿ⁴ For this purpose, only stock, and bonds or debentures issued with interest coupons attached or in registered form, qualify as "securities."ⁿ⁵ In contrast, the term "securities of the employer corporation" is not given restrictive meaning, for it includes securities of a parent or subsidiary of the employer corporation.ⁿ⁶

The amount of net unrealized appreciation in securities of the employer corporation is the excess of the market value of such securities at the time of distribution over their basis to the trust.ⁿ⁷ If the distribution consists in part of securities which have depreciated in value, the amount of net unrealized appreciation is limited to the net increase in value (aggregate appreciation less aggregate depreciation) of all of the securities of the employer corporation included in the distribution.ⁿ⁸ Moreover, for this purpose, two or more distributions made by a trust to an employee in a single year are treated as a single distribution.ⁿ⁹

For the purpose of determining the net unrealized appreciation on a distributed security of the employer corporation, the basis of the security is computed in accordance with whichever of the following four rules is applicable:

- (1) If the security was earmarked for the account of a particular employee at the time it was purchased by the trust, the basis of the security is its cost.ⁿ¹⁰
- (2) If all of the securities acquired by the trust during the taxable year are allocated among the accounts of all participating employees, the basis of any single security is the average cost to the trust of all securities of the same type purchased during the year.ⁿ¹¹

(3) If (a) neither (1) nor (2) is applicable; (b) all or a specified portion of the trust fund is invested in one particular type of security of the employer corporation; and (c) during the period that the distributee participated in the plan, none of such securities has been sold except to pay benefits under the plan or to enable the trustee to obtain funds with which to exercise rights; then the basis of the distributed securities is the total amount credited to the account of the distributee (or the portion thereof available for investment in such securities), reduced by the amount which could have been invested in such securities, but was not on the date of distribution.ⁿ¹²

(4) In all other cases, the basis is the average cost to the trust of all securities of the type distributed that the trust has on hand at the time of distribution, or that the trust had on hand on a specified inventory date that does not precede the date of distribution by more than twelve calendar months. The average cost can be determined either on a first-in, first-out basis (considering the securities most recently purchased to be those on hand), or by means of a moving average.ⁿ¹³

After the basis of the securities to the trust and the amount of net unrealized appreciation have been determined, the portion of the next unrealized appreciation attributable to the contributions made by the employee must then be ascertained. In doing so, only the amount actually contributed by the employee is taken into account; the employee's contribution does not include any part of the increment in the trust fund expended in the purchase of the securities.ⁿ¹⁴ If the distribution consists solely of securities of the employer corporation, the amount of the contribution which can be identified as having been used in the purchase of a particular security is allocated to that security; the portion of the contribution that cannot be so identified is allocated ratably to the distributed securities.ⁿ¹⁵ If only a part of the distribution consists of securities of the employer corporation, "appropriate allocation of a portion of the employee's contribution to [the cash or other property also distributed] shall be made unless such allocation is inconsistent with the terms of the plan or trust."ⁿ¹⁶

The following example illustrates the foregoing principles:

Example:

A qualified employees' trust distributes ten shares of Class B stock of the employer corporation to a participating employee. Each share has an average cost of \$200, consisting of employee contributions of \$120 and employer contributions of \$80, and on the date of distribution has a fair market value of \$300. The portion of the net unrealized appreciation attributable to the contributions of the employee with respect to each of the shares of stock is \$60, computed as follows:

Value of each share of stock	\$300
Employer contributions	80
Employee contributions	120
Total contributions	200
Net unrealized appreciation	\$100
Portion of net unrealized appreciation attributable to employee contributions (129/200ths of \$100) ⁿ¹⁷	\$ 60

The employee will realize gain when he disposes of the distributed securities in a taxable transaction.ⁿ¹⁸ His basis for the securities is the sum of (1) his contributions, (2) the employer's contributions (taxable as ordinary income in the year the securities are distributed), and (3) the portion of net unrealized appreciation attributable to contributions made by the employer (also taxable as ordinary income in the year of distribution).ⁿ¹⁹ Thus, in the last example, the employee's

basis for each share would be \$240 (\$120 plus \$80 plus \$40).

[b] Lump-Sum Severance Distributions. *IRC Section 402(d)(4)(A)* defines a lump-sum distribution as the distribution or payment within one taxable year of the recipient of the balance to the credit of the employee that becomes payable (1) on account of the employee's death; (2) after the employee attains age 59½; (3) on account of the employee's separation from service; or (4) after the employee has become disabled.

A 10-percent penalty is assessed on any distribution prior to age 59½.ⁿ²⁰ However, the penalty does not apply to distributions that are (1) made after the death of the employee, (2) attributable to the employee's being disabled, (3) part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and his beneficiary, (4) made to an employee after separation from service after attaining age 55, (5) applicable dividends paid with respect to applicable employer securities as defined in *IRC Section 404(k)* or (6) made after December 31, 1999, on account of an Internal Revenue Service levy on a qualified retirement account or IRA.ⁿ²¹ Moreover, the excise does not attach to any portion of the distribution that is not taxable, i.e., it does not apply to the amount of any unrealized appreciation in employer securities distributed to the taxpayer.

Additional exclusions from the 10-percent excise tax include distributions for certain medical expenses, distributions to alternate payees under qualified domestic relations orders, distributions to unemployed individuals for health insurance premiums, distributions for higher education expenses, and distributions for first home purchases.ⁿ²² There are limitations on the amount of the distribution that can qualify for the exception.

The impact of the ordinary income treatment of lump-sum distributions is lessened in part by a minimum distribution allowance of \$10,000 or one half of the amount of the distribution, whichever is less, reduced by 20 percent of the amount by which the distribution exceeds \$20,000.ⁿ²³ Thus, the maximum allowance is obtained when the distribution amounts to \$20,000. A distribution equal to or greater than \$70,000 eliminates the allowance entirely.

As mentioned above, lump-sum distributions are eligible for taxation under a special averaging rule if the taxpayer (individual, estate, or trust) so elects.ⁿ²⁴ However, unless the taxpayer attained age 50 by January 1, 1986, the election is allowed only if the lump-sum distribution is received on or after the employee has attained 59½ years of age and has participated in the plan for at least five taxable years before the taxable year in which the distribution is made.ⁿ²⁵ The election must be made for each taxable year in which it is to apply and must be made before the expiration of the period for making a claim for credit or refund for the taxable year.ⁿ²⁶ The election can be revoked only by filing an amended tax return containing a statement revoking the election and by the payment of any tax attributable to the revocation.ⁿ²⁷ Revocation of the election does not prevent the making of a new election within the applicable time period.ⁿ²⁸

A further consequence of the election arises whenever the lump-sum distribution is received on account of the death of an employee. In such case, *IRC Section 2039(f)(1)* requires inclusion of the distribution in the deceased employee's gross estate. The recipient treats the amount as income in respect of a decedent, giving rise to a deduction under *IRC Section 691(c)* for estate taxes attributable to the included amount. However, by virtue of *IRC Section 691(c)(5)*, the amount of such deduction reduces the amount of the distribution subject to the ten-year averaging.

The effect of the election is to treat the distribution as though it were the only income of the taxpayer for the distribution year and to do so on a five-year averaging basis.ⁿ²⁹ This is done by first computing an initial separate tax, a process that assumes that taxable income is an amount equal to one fifth of the excess of the total taxable amount of the lump-sum distribution for the taxable year over the minimum distribution allowance (defined by *IRC Section 402(d)(1)(C)* as an amount equal to the lesser of \$10,000 or one half of the total taxable amount of the lump-sum distribution, reduced by 20 percent of the amount by which such total taxable amount exceeds \$20,000) and that the taxpayer is subject to the rates imposed on single taxpayers. The resulting tax is then multiplied by five and the total

added to the employee's tax liability on all other income. The following example illustrates the mechanics of the new law:

Example:

An employee became a participant in a qualified noncontributory plan on January 1, 1981. He severed his service with the company on December 31, 1988, when he was 60, and received a lump-sum distribution in 1989 of \$90,000, part of which consisted of stock in the employer corporation with a fair market value of \$20,000 and a basis of \$10,000. The employee's other income consisted of a \$20,000 salary. Itemized deductions amounted to \$6,000. The employee was married, but had no children. The total taxable amount of the distribution for purposes of applying the averaging provision would be \$80,000 (\$90,000 less \$10,000 unrealized appreciation in employer securities).ⁿ³⁰ Taxable income for purposes of the tax would be \$16,000 (one fifth of the excess of the total taxable amount over the minimum distribution allowance).ⁿ³¹ The tax on this amount at single taxpayer rates yields a tax of \$2,400. This amount is then multiplied by five producing a tax of \$12,000.

The tax on the balance of the employee's income would be:

Salary	\$20,000
Less: Itemized deductions and personal exemptions	10,000
Taxable income	\$10,000
Tax on other income	1,500
Tax on lump-sum distribution	12,000
Total tax	\$13,500

The foregoing example assumed that the employee elects to take just a lump-sum distribution. If, in addition, the employee chooses to take a nontransferable annuity, an adjustment in the tax on the ordinary income portion of the distribution is called for inasmuch as the payments under the annuity will be taxed when received. In essence, the adjustment consists of a five-year averaging tax calculated on the value of the annuity alone (reduced by the minimum distribution allowance attributable to the annuity), which tax is then subtracted from the tax computed on the ordinary income element of the lump-sum distribution.ⁿ³²

Example:

Assume the same facts as given above, except that part of the distribution consisted of a nontransferable annuity contract valued at \$8,000. Computation of the tax on the ordinary income component would take the following form:

(1) Compute the tax on the aggregate distribution	\$12,000
(2) Subtract tax on annuity of \$8,000	
(a) Tax would be five times the tax on one fifth of the value of the annuity	
(b) Tax on \$1,600 equals \$240	
(c) Five times \$240 equals	\$1,200
Adjusted tax on lump-sum distribution	\$10,800

IRC Section 402(c)(1) permits a tax-free rollover (an exclusion from income) of any portion of an "eligible rollover

distribution"--any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust, except (1) a distribution that is one of a series of substantially equal periodic payments made either for the life of the employee or for a period of ten years or more, or (2) a distribution to a person over age 70½ required by *IRC Section 401(a)(9)*ⁿ³³ provided, within 60 days of the distribution, the employee transfers the property received, less the amount of the employee's contributions, to an individual retirement account,ⁿ³⁴ an individual retirement annuity,ⁿ³⁵ or to the qualified plan of another employer.ⁿ³⁶ (*IRC Section 402(c)(6)* allows the rollover of proceeds derived from a sale of property other than money received in a lump-sum distribution. *IRC Section 402(c)(9)* permits the spouse of a deceased employee to reinvest any lump-sum distribution received on account of the death of the employee in an individual retirement account.) The rollover into an individual retirement account or annuity has the effect of locking in the account or annuity.ⁿ³⁷ There can be no withdrawal of the amount in the account prior to age 59½ without a 10-percent excise on the amount of the premature distribution, unless that distribution is rolled over into another individual retirement account within 60 days.ⁿ³⁸ Moreover, a borrowing from the account results in the disqualification of the plan.ⁿ³⁹

In addition, amounts received from an individual retirement account or annuity are taxed as ordinary income.ⁿ⁴⁰ There is no capital gain component even if the original distribution was attributable, in part, to pre-1974 participation years. Moreover, the five-year averaging election available for the ordinary income component of a lump-sum distribution is inapplicable in the case of a distribution from an individual retirement account or annuity, or to any distribution following a partial eligible rollover distribution.

A post-1992 eligible rollover distribution from a qualified plan directly to the employee is subject to a 20-percent withholding tax, even though the distribution is, in fact, rolled over within the prescribed 60-day period.ⁿ⁴¹ However, no withholding is required if the trustee of the plan transfers the funds to the trustee of the rollover vehicle (a trustee-to-trustee transfer). The plan administrator must provide a written explanation to the employee of the distribution options (including a trustee-to-trustee transfer) within a reasonable period of time prior to the eligible rollover distribution.ⁿ⁴²

A rollover of a partial distribution by an employee stock ownership plan (ESOP) to meet diversification requirements is also permitted if the employee so elects.ⁿ⁴³ In this case, the employee is not prohibited from electing income averaging for a subsequent lump-sum distribution.

FOOTNOTES:

(n1)Footnote 1. For a general discussion of qualified employees' trusts, see 3 Rabkin & Johnson, *Federal Income, Gift and Estate Taxation*, Ch 15 (Matthew Bender).

(n2)Footnote 1. The extent to which the distribution is taxable is determined in accordance with the annuity rules of *IRC* § 72.

(n3)Footnote 2. *Treas Reg* § 1.402(a)-1(a)(1)(iii).

(n4)Footnote 3. *IRC* § 402(e)(4)(A).

There is no statutory provision permitting a loss deduction when the value of the portion attributable to the employee's contribution is less than the amount of the contribution. *Rev Rul* 71-251, 1971-1 CB 129 . There is also no deduction when an employee receives a distribution of stock in corporations other than the employer corporation and the stock has a value less than the employee's contribution. *Rev Rul* 72-15, 1972-1 CB 114 . A different result was reached in *Rev Rul* 72-305, 1972-2 CB 43 , where the participant received a cash distribution of his entire interest in an amount less than his aggregate contribution under the plan, and in *Rev Rul* 72-328, 1972-2 CB 296 , where the distribution in satisfaction of the employee's interest consisted of worthless stock in the employer corporation. *Rev Ruls* 71-251 and 72-15 were distinguished on the ground that the transactions in those rulings were not closed and completed transactions and would

not be considered as such until the employee disposed of the distributed stock or it became worthless.

(n5)Footnote 4. *IRC § 402(e)(4)(B)*. For this purpose, a lump-sum distribution is the distribution or payment within one taxable year (1) on account of the employee's death, (2) after the employee attains age 59½, (3) on account of the employee's separation from service, or (4) after the employee has become disabled. *IRC § 402(e)(4)(D)*.

(n6)Footnote 5. *IRC § 402(e)(4)(E)(i)*.

(n7)Footnote 6. *IRC § 402(e)(4)(E)(ii)*. A parent corporation is any corporation (other than the employer corporation) in an unbroken chain of corporations ending with the employer corporation, provided each of the corporations in the chain (other than the employer corporation) owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain. *IRC § 424(e)*. The definition of "subsidiary corporation" is the same with one exception--the chain begins with the employer corporation. *IRC § 424(f)*.

Shares of a successor corporation into which the employer corporation was merged were exchanged for shares of the employer corporation. Distribution of the new stock was a distribution of "securities of the employer corporation." *Rev Rul 73-312, 1973-2 CB 142*.

(n8)Footnote 7. *Treas Reg § 1.402(a)-1(b)(2)(i)*. The use of a unit basis in determining the value of an employee's interest in a trust was approved in *Rev Rul 68-32, 1968-1 CB 171*.

In a distribution of S corporation stock by an employee stock ownership plan (ESOP) to a participant, the stock's net unrealized appreciation is determined using the ESOP's adjusted basis in the stock. *Rev Rul 2003-27, 2003-1 CB 597*.

(n9)Footnote 8. *Treas Reg § 1.402(a)-1(b)(2)(i)*.

(n10)Footnote 9. *Treas Reg § 1.402(a)-1(b)(2)(i)*.

(n11)Footnote 10. *Treas Reg § 1.402(a)-1(b)(2)(ii) (a)*. If the security was contributed to the trust, so that a basis other than cost is reflected in the account of the employee, such other basis is properly used as the basis of the security.

(n12)Footnote 11. *Treas Reg § 1.402(a)-1(b)(2)(ii) (b)*.

(n13)Footnote 12. *Treas Reg § 1.402(a)-1(b)(2)(ii) (c)*. A temporary investment of funds government obligations pending an investment in securities of the employer corporation will not make this basis computation method inapplicable. *Rev Rul 66-57, 1966-1 CB 89*.

In *Rev Rul 55-354, 1955-1 CB 396* (applying Section 165(b) of the 1939 Code), the Service approved a method of determining the basis of the distributed securities that included the increase or decrease in the value of a participating employee's account at the time of a conversion from one optional investment account to another as part of the total amount credited to the participant's account.

(n14)Footnote 13. *Treas Reg § 1.402(a)-1(b)(2)-(ii)(d)(1)*. The following example illustrates the moving average method:

On December 31, 1987, the trust had on hand 1,000 shares of Class B stock of the corporation purchased at a total cost of \$50,000. In 1988, the trust distributed 100 shares to a participating employee and purchased 100 new shares at a cost of \$8,000. In 1989, it distributed 20 shares to E. The average cost of the shares distributed to E is \$53, computed as follows:

Shares	Total Cost	Average Cost

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On hand Dec. 31, 1987	1,000	\$50,000	\$50
Distributed during 1988 (at an average cost of \$50)	- 100	- 5,000	--
	900	\$45,000	
Purchased during 1988	+ 100	+ 8,000	--
	1,000	\$53,000	\$53

(n15)Footnote 14. *Treas Reg § 1.402(a)-1(b)(3)(ii); Rev Rul 80-258, 1980-2 CB 137 .*

(n16)Footnote 15. *Treas Reg § 1.402(a)-1(b)(3)(iv).*

(n17)Footnote 16. *Treas Reg § 1.402(a)-1(b)(3)(iv).*

(n18)Footnote 17. *Treas Reg § 1.402(a)-1(b)(3)(iii).*

(n19)Footnote 18. Net unrealized appreciation that is not included in income at the time of distribution is considered long-term capital gain when it is realized in a later taxable transaction. *Notice 98-24, 1998-1 CB 929 .*

The taxpayer involved in *Ltr Rul 199919039* was able to avoid all tax on the net unrealized appreciation by transferring the stock to a charitable remainder trust.

(n20)Footnote 19. *Treas Reg § 1.402(a)-1(b)(1)(i) (b)*; *Treas Reg § 1.402(a)-1(b)(3)(vi)*. In *Rev Rul 57-514, 1957-2 CB 261* , the Service held that all of the shares of stock received by the employee had the same basis (aggregate basis divided by number of shares received) even though they had varying costs for the purpose of determining net unrealized appreciation.

(n21)Footnote 20. *IRC § 72(t)(1).*

(n22)Footnote 21. *IRC § 72(t)(2)(A)*. An employee is separated from service when he is no longer an employee for payroll tax purposes. *Ltr Rul 8721106 .*

The taxpayers in *Aronson v Commr, 98 TC 283 (1992)* , sought to avoid the penalty on premature distributions by claiming that their individual retirement accounts were involuntarily distributed to them when the savings and loan association in which the accounts were maintained failed. The Tax Court refused to grant the relief. The taxpayers could have avoided the tax by rolling the accounts over to new accounts within 60 days.

(n23)Footnote 22. *IRC § 72(t)(2)(B), (C), (D), (E), and (F).*

(n24)Footnote 23. *IRC § 402(d)(1)(B), (C).*

(n25)Footnote 24. *IRC § 402(d)(4)(B)*. Only one election can be made by any taxpayer with respect to any employee.

(n26)Footnote 25. *IRC § 402(d)(4)(B), (F).*

(n27)Footnote 26. *(B)-1 Temp Treas Reg § 11.402(e)(4) (B)-1(c)(1)*. The election is made by filing Form 4972 as part of the taxpayer's return for the year. *(B)-1 Temp Treas Reg § 11.402(e)(4) (B)-1(c)(2)*.

(n28)Footnote 27. *Temp Treas Reg § 11.402(e)(4)(B)-1(c)(3).*

(n29)Footnote 28. *Temp Treas Reg § 11.402(e)(4)(B)-1(c)(3)*.

(n30)Footnote 29. *IRC § 402(d)(1)(A), (B)*. If an employee had attained age 50 before January 1, 1986, the recipient of the lump-sum distribution with respect to the employee can elect to use ten-year averaging, but must do so at the rates applicable for 1986, taking into account the zero bracket amount then in effect.

(n31)Footnote 30. *IRC § 402(d)(4)(D)*. The employee's basis in the employer's securities would be \$10,000.

The taxpayer can elect to waive the special treatment for net unrealized appreciation in employer securities with respect to a lump-sum distribution. The waiver is made on the tax return on which the distribution is required to be included because of the waiver. An election to waive does not preclude an election for income averaging. HR Rep No 795, 100th Cong, 2d Sess 166 (1988).

(n32)Footnote 31. The minimum distribution allowance would be zero, determined by subtracting 20 percent of \$60,000 (the excess of \$80,000 over \$20,000) from \$10,000 (the lesser of \$10,000 or one half of the total taxable amount).

(n33)Footnote 32. *IRC § 402(d)(2)*.

(n34)Footnote 33. *IRC § 402(c)(4)*.

(n35)Footnote 34. *IRC § 408(a)* describes individual retirement accounts.

The 60-day period does not include any period during which the amount transferred to the employee is a "frozen deposit." It cannot end earlier than ten days after the amount ceases to be a frozen deposit. A frozen deposit is one that cannot be withdrawn because of (1) the bankruptcy or insolvency of a financial institution, or (2) any requirement imposed by the state in which the institution is located by reason of the bankruptcy or insolvency (or threat thereof) of any financial institution in the state. *IRC § 402(c)(7)*.

According to the Service, no relief is available if a clerical error causes the transfer of funds to occur after the expiration of the 60-day period. *Ltr Rul 9211035* ; *Ltr Rul 8824047* . The Tax Court reached a different conclusion in *Wood v Commr*, 93 TC 114 (1989) . However, in *Wood*, the taxpayer delivered the qualified plan payout check to the bank with instructions to deposit it in an individual retirement account opened that day.

The Tax Court originally took the position that distributions from a retroactively disqualified plan can be rolled over tax free to an individual retirement account to the extent of predisqualification contributions and earnings. *Baetens v Commr*, 82 TC 152 (1984) . The Sixth Circuit reversed, holding that the status of the plan at the time of distribution controls. 777 F2d 1160 (6th Cir 1985) . The Fifth and Seventh Circuits also take the position that the tax status of the plan at the time of distribution controls. *Benbow v Commr*, 774 F2d 740 (7th Cir 1985) , *rev'g* 82 TC 941 (1984) ; *Woodson v Commr*, 651 F2d 1094 (5th Cir 1981) . The Tax Court reconsidered its position in *Fazi v Commr*, 102 TC 695 (1994) and will no longer adhere to its prior holding in *Baetens*, except in cases appealable to the Second Circuit, the only circuit that permits tax-free rollovers of predisqualification contributions and accumulations. See *Greenwald v Commr*, 366 F2d 538 (2d Cir 1966) .

The Tax Court has also held that a tax-free rollover to an individual retirement account requires that the account be one that was established for the individual employee who received the distribution from the employee's trust. *Rodoni v Commr*, 105 TC 29 (1995) . In *Rodoni*, the taxpayer turned the distribution over to his wife who deposited the distribution in individual retirement accounts she established. Although the parties were in the midst of a divorce proceeding, the distribution to the spouse was not made pursuant to a qualified domestic relations order.

(n36)Footnote 35. See *IRC § 408(b)*.

(n37)Footnote 36. The amount that can be rolled over tax free is limited to the portion that would have been includable in income absent the special rollover provision. *IRC § 402(c)(2)*.

(n38)Footnote 37. The election to rollover the distribution is irrevocable. *Barnes v Commr, TC Memo 1994-95* .

(n39)Footnote 38. *IRC §§ 72(t), 408(d)(3)*. A distribution that is not rolled over is taxable in the year received, even if the 60-day period does not expire until the subsequent taxable year. *Welander v Commr, 92 TC 866 (1989)* .

A taxable distribution to a beneficiary of a decedent's individual retirement account is income in respect of a decedent under *IRC § 691, Rev Rul 92-47, 1992-1 CB 198* .

A rollover contribution from a distribution of money must consist only of money. *Lemishow v Commr, 110 TC 110 (1998)* .

(n40)Footnote 39. *IRC § 72(t)*.

(n41)Footnote 40. *IRC § 408(d)*.

(n42)Footnote 41. *IRC § 3405(c)*. For example, if the amount in the qualified plan is \$100,000, the trustee of the plan is required to withhold \$20,000, causing the distribution to the employee to be limited to \$80,000. If all that is rolled over is the \$80,000, the employee has a \$20,000 taxable distribution, and may be subject to the 10 percent penalty on early withdrawals if under age 59½. The employee can avoid taxation on the distribution by adding \$20,000 of his own funds to the rollover.

Since the withholding tax is applied only to eligible rollover distributions, it has no effect on those distributions that cannot qualify as such. Also excepted are distributions not includable in income (other than net unrealized appreciation on employer securities) and distributions to any beneficiary other than a surviving spouse. Temp Treas Reg § 1.402(c)-2T, Q & A-3(b), Q & A-10(b).

Additional guidance with respect to rollovers and the 20 percent withholding tax can be found in *IRS Notice 93-3, 1993-1 CB 293* .

(n43)Footnote 42. *IRC § 402(f)*. Under IRS Notice 93-26, 1993-1 CB 308 , if a participant, after having received the notice, affirmatively elects to make or not make a direct rollover, the reasonable time period requirement will not be violated solely because the election is implemented less than 30 days after the notice is given.

(n44)Footnote 43. The election is irrevocable. *Barrett v Commr, TC Memo 1992-611 ; Hall v Commr, TC Memo 1991-133* .



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CHAPTER 16 The Taxpayer as the Beneficiary of an Estate or Trust

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§ 16.07 Common Trust Funds

[1] Defined.

According to *IRC Section 584(a)*, a common trust fund is a fund maintained by a bank (1) exclusively for the collective investment and reinvestment of moneys contributed to the fund by the bank in its capacity (a) as a trustee, executor, administrator, or guardian, or (b) as a custodian of an account established under a state law substantially similar to the Uniform Gifts to Minors Act, and (2) in conformity with rules and regulations of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency pertaining to the collective investment and reinvestment of contributions to the fund.ⁿ¹ Two or more banks that are members of the same affiliated bank are treated as one bank during the period of their affiliation.

[2] Admission and Withdrawal of Participants.

[a] Effect on the Common Trust Fund. No gain or loss is realized by a common trust fund by the admission or withdrawal of a participant.ⁿ¹ The basis of the assets and the period for which they have been held by the common trust fund are unaffected by a participant's admission or withdrawal.ⁿ²

[b] Effect on the Participant. A participant treats admission into the common trust fund as the purchase of, or exchange for, the participating interest.ⁿ³ The withdrawal of any participating interest by a participant is treated as a sale or exchange of the withdrawn interest.ⁿ⁴

A participant is not deemed to have withdrawn any part of a participating interest in the common trust fund so as to have completed a closed transaction because of the segregation and administration of the trust fund for the benefit of all participants.ⁿ⁵ Any income or loss arising from the administration and liquidation of the segregated investment constitutes income or loss to the common trust fund apportionable among the participants for whose benefit the investment was segregated.ⁿ⁶

When a participating interest is transferred by a bank, or by two or more banks that are members of the same affiliated group (within the meaning of *IRC Section 1504*), as a result of the combination of two or more common trust funds or the division of a single common trust fund, the transfer to the surviving or divided common trust fund is not considered to be an admission or withdrawal if (1) the combining, divesting, and resulting common trust funds have a diversified portfolio within the meaning of *IRC Section 368(a)(2)(F)(ii)*, and (2) in the case of a division, each participant's interest

in each of the resulting common trust funds is substantially the same as was the participant's pro rata interest in the dividing fund.ⁿ⁷ However, in the case of the division of a common trust fund maintained by two or more banks that are members of the same affiliated group resulting from the termination of the affiliation, the division will be treated as meeting the substantially same interest requirement if the written plan of operation of the resulting common trust funds is substantially identical to the plan of operation of the divided common trust fund, each of the assets of the divided common trust fund is distributed substantially pro rata to each of the resulting common trust funds, and each participant's aggregate interest in the assets of the resulting common trust funds is substantially the same as was the participant's pro rata interest in the assets of the dividing common trust fund.ⁿ⁸

The participant's gain or loss upon withdrawal of a participating interest or portion thereof is measured by the difference between the amount received upon the withdrawal and the adjusted basis of the withdrawn interest.ⁿ⁹ The amount realized by the participant on the withdrawal is the sum of money plus the fair market value of any property (other than money) received by the participant.ⁿ¹⁰ The basis of the withdrawn interest is equal to the sum of money and property (other than money) contributed by the participant to the common trust fund to acquire the interest, increased by the income of the common trust fund properly allocated to the participant for a taxable year of the common trust fund and not distributed to the participant prior to withdrawal, and reduced by the net amount of net short-term capital loss, net long-term capital loss, and ordinary net loss of the common trust fund allocable to the participant with respect to the withdrawn interest.ⁿ¹¹

[3] Taxation of Common Trust Funds and Participants.

A common trust fund is neither subject to tax on its income nor treated as a corporation.ⁿ¹ Instead, each participant in the fund must include the participant's proportionate share of the net short-term capital gains and losses, net long-term capital gains and losses, and ordinary taxable income or ordinary net loss of the common trust fund, whether or not distributed and whether or not distributable.ⁿ² The proportionate share of each participant's short-term capital gains and losses, long-term capital gains and losses, and ordinary taxable income or ordinary net loss is determined under the method of accounting adopted by the bank in accordance with the written plan by which the common trust fund is established and administered, provided the method clearly reflects the income of each participant.ⁿ³ Items of income and deductions are allocated to the periods between valuation dates established by the plan within the taxable year in which they are realized.ⁿ⁴ Ordinary taxable income or ordinary net loss, short-term capital gains and losses, long-term capital gains and losses, and any tax withheld at the source are computed for each period. The participants' proportionate shares of income and losses for each period are then determined.ⁿ⁵

The taxable income of a common trust fund is computed in the same manner and on the same basis as in the case of an individual, except that: (1) no charitable deduction is allowed; (2) capital gains and losses are segregated and no capital loss carryover is allowed; and (3) after segregating capital gains and losses, the ordinary taxable income or ordinary net loss of the common trust fund is computed.ⁿ⁶ The common trust fund must use the calendar year as its taxable year.ⁿ⁷ If the taxable year of the common trust fund is different from that of a participant, the inclusion by the participant for the participant's taxable year is based upon the taxable income of the common trust fund for any taxable year ending within or with the taxable year of the participant.ⁿ⁸

The foregoing rules can be illustrated by the following example:

Example:

The plan of a common trust fund provides for quarterly valuation dates and for the computation and distribution of income (other than capital gains) on a quarterly basis. The participants in the common trust fund, all with equal interests are:

First quarter: A, B, C, and D.

Second quarter: A, B, C, and E.

Third and fourth quarters: A, B, F, and G.

The common trust fund's ordinary taxable income, short-term capital gain, and long-term capital gain for the taxable year are as follows:

Quarter	Ordinary taxable income	Short-term capital gain	Long-term capital gain
First	\$ 40,000	\$ 40,000	\$ 20,000
Second	60,000	20,000	40,000
Third	40,000	40,000	20,000
Fourth	80,000	20,000	40,000
Total	\$220,000	\$120,000	\$120,000

Each participant's quarterly share of ordinary taxable income, short-term capital gain and long-term capital gain is:

Quarter	Ordinary taxable income	Short-term capital gain	Long-term capital gain
First	\$ 10,000	\$ 10,000	\$ 5,000
Second	15,000	5,000	10,000
Third	10,000	10,000	5,000
Fourth	20,000	5,000	10,000

resulting in the participant's having to include the following amounts in income for the taxable year:

Participant	Ordinary taxable income	Short-term capital gain	Long-term capital gain
A	\$ 55,000	\$ 30,000	\$ 30,000
B	55,000	30,000	30,000
C	25,000	15,000	15,000
D	10,000	10,000	5,000
E	15,000	5,000	10,000
F	30,000	15,000	15,000
G	30,000	15,000	15,000

[4] Transfers by Common Trust Funds to Regulated Investment Companies.

If a common trust fund transfers substantially all of its assets to one or more regulated investment companies in exchange solely for stock in the transferee company or companies, and the stock is distributed by the common trust fund to the participants in the fund in exchange for their interests in the fund, no gain or loss will be recognized by the common trust fund on the transfer or distribution, and no gain or loss will be recognized by any participant by reason of the exchange.ⁿ¹ As a general rule, in determining whether the transfer is solely in exchange for stock in one or more regulated investment companies, the assumption by the transferee of a liability of the common trust fund is disregarded.ⁿ² However if the aggregate of the assumed liabilities exceed the aggregate adjusted bases of the

transferred property, gain will be recognized to the common trust fund in an amount equal to the excess.ⁿ³

If no gain or loss is recognized on the transaction, the basis of any asset received by a transferee regulated investment company is the same as it would be in the hands of the common trust fund.ⁿ⁴ The basis of the stock received by participants in the exchange is the same as that of the property exchanged, allocated, in the case of multiple transferees, among the stock of each regulated investment company on the basis of respective fair market values.ⁿ⁵

When excess liabilities result in the recognition of gain, the basis of the assets received by the regulated investment company is increased by the amount of gain recognized;ⁿ⁶ any adjustment to the basis of a participant's interest in the common trust fund as a result of the recognition of gain is treated as occurring immediately before the exchange by the participants.ⁿ⁷

FOOTNOTES:

(n1)Footnote 1. A bank is defined as a bank or trust company incorporated and doing business under the laws of the United States or of any state, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks by the Comptroller of the Currency, and which is subject by law to supervision and examination by state or federal authority having supervision over banking institutions. The term also includes a domestic building and loan association. *IRC § 581*.

The Service will not ordinarily rule whether a common trust fund plan meets the requirements of *IRC § 584(a)*. *Rev Proc 2010-3, 2010-1 IRB 110, 117 (§ 4.01(35))*. For plan drafting guidance, see *Rev Proc 92-51, 1992-1 CB 988*.

(n2)Footnote 1. *IRC § 584(e)*.

(n3)Footnote 2. *Treas Reg § 1.584-4(a)*.

(n4)Footnote 3. *IRC § 584(e)*.

(n5)Footnote 4. *IRC § 584(e)*.

(n6)Footnote 5. *Treas Reg § 1.584-4(a)*. If an investment is withdrawn in kind from a common trust fund for the benefit of all participants in the fund at the time of withdrawal, and the investment is not distributed ratably in kind, the investment must be segregated and administered or realized upon for the benefit ratably of all participants in the common trust fund at the time of withdrawal. *12 CFR § 9.18(b)(7)*.

(n7)Footnote 6. *Treas Reg § 1.584-4(a)*.

(n8)Footnote 7. *Treas Reg § 1.584-4(a)*. A common trust fund meets the diversification requirements of *IRC § 368(a)(2)(F)(ii)* if not more than 25 percent of the value of its total assets is invested in the stock and securities of any one issuer and not more than 50 percent of its total assets is invested in the stock of five or fewer issuers. In making this determination, all members of a controlled group (within the meaning of *IRC § 1563(a)*) are treated as a single issuer, and a fund that holds stock in a regulated investment company, a real estate investment trust, or a diversified investment company is treated as holding its proportionate share of the assets held by the company or trust. Under present law, a common trust fund cannot treat Government securities held by it as part of its total assets. *IRC § 368(a)(2)(F)(iv)*. Prop *Treas Reg § 1.584-4(a)* will change that rule and treat Government securities as part of the common trust fund's assets, unless acquired to meet the diversification requirement.

(n9)Footnote 8. *Treas Reg § 1.584-4(a)*.

(n10)Footnote 9. *Treas Reg § 1.584-4(b)*.

(n11)Footnote 10. *Treas Reg § 1.584-4(b)*.

(n12)Footnote 11. *Treas Reg § 1.584-4(b), (c), (d)*. The income of the common trust fund includes wholly tax-exempt income, net short-term and long-term capital gains, and ordinary net or taxable income.

(n13)Footnote 1. *IRC § 584(b)*.

(n14)Footnote 2. *IRC § 584(c)*. Any tax withheld at the source from income of the common trust fund is deemed to have been withheld proportionately from the participants to whom the income is allocated. *Treas Reg § 1.584-2(b)(2)*.

(n15)Footnote 3. *Treas Reg § 1.584-2(c)(1)*.

(n16)Footnote 4. *Treas Reg § 1.584-2(c)(2)*.

(n17)Footnote 5. *Treas Reg § 1.584-2(c)(2)*. A tax-exempt organization that is a participant in a common trust fund must treat any amount of income or loss of the common trust fund as unrelated trade or business income or loss if it would have been such were it realized directly by the organization. *Treas Reg § 1.584-2(c)(3)*.

The Service has announced that it will challenge the purported tax benefits of a transaction involving the use of a common trust fund that invests in economically offsetting gain and loss positions in foreign currencies and allocates the gain to one or more tax indifferent parties and the losses to another taxpayer. *Notice 2003-54, 2003-2 CB 363*.

(n18)Footnote 6. *IRC § 584(d); Treas Reg § 1.584-3*. A common trust fund is not allowed a net operating loss deduction; the deduction is allowed to the participants. *IRC § 584(g)*.

(n19)Footnote 7. *IRC § 584(i)*.

(n20)Footnote 8. *IRC § 584(f)*.

(n21)Footnote 1. *IRC § 584(h)(1)*. Nonrecognition treatment will not apply to any common trust fund that would not meet the requirements of *IRC § 368(a)(2)(F)(ii)* if it were a corporation. In determining whether the diversification requirements have been met, Government securities are not treated as securities in applying the 25 percent- and 50 percent-tests and are not excluded from the computation of total assets under *IRC § 368(a)(2)(F)(iv)*. *IRC § 584(h)(4)*.

(n22)Footnote 2. *IRC § 584(h)(3)(A)*.

(n23)Footnote 3. *IRC § 584(h)(3)(B)(i)(I), (ii)*. In determining the amount of the liability assumed, the rules of *IRC § 357(d)* apply. *IRC § 584(h)(3)(C)*.

(n24)Footnote 4. *IRC § 584(h)(2)(A)*.

(n25)Footnote 5. *IRC § 584(h)(2)(B)*. The holding period will be tacked under *IRC § 1223(1)*. *Ltr Rul 9839035*.

(n26)Footnote 6. *IRC § 584(h)(3)(B)(i)(II)*. If the transfer is to two or more regulated investment companies the basis increase is allocated among the companies on the basis of the respective fair market values of the assets received by each.

(n27)Footnote 7. *IRC § 584(h)(3)(B)(i)(III)*.



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CHAPTER 16A Employee Stock Ownership Plans

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CHAPTER 16A Employee Stock Ownership Plans

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§ 16A.01 Introduction

An Employee Stock Ownership Plan (ESOP) is a qualified plan designed to give employee participants an ownership interest in their employer through the plan's investment in the employer's securities. In addition, an ESOP can serve the following objectives: create a ready market for stock of retiring owners of company stock who generally wish to convert their stock into cash; solve post-death liquidity problems of substantial stockholders; increase corporate growth through increased employee motivation; increase cash flow when the employer corporation maintains another qualified retirement plan; serve as an anti-takeover device; and finance the acquisition of another corporation.ⁿ¹

This chapter will discuss the requirements of an ESOP and the tax consequences of an ESOP. It will not cover the taxation of distributions from an ESOP to a participant thereof.ⁿ²

FOOTNOTES:

(n1)Footnote 1. Helm, "ESOPs and Their Tax Planning Uses, 41 *Practical Lawyer* 85 (1995).

(n2)Footnote 2. The taxation of distributions from qualified employees' trusts is the subject of § 16.06.



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CHAPTER 16A Employee Stock Ownership Plans

2-16A Taxation of Securities Transactions § 16A.02

§ 16A.02 Requirements of an Employee Stock Ownership Plan

[1] Employee Stock Ownership Plan Defined

An ESOP is a defined contribution plan¹ that is either a qualified stock bonus plan or a combination qualified stock bonus² and qualified money purchase plan that is designed to invest primarily in qualifying employer securities,³ and meets the requirements specified in the regulations.⁴ A plan cannot be treated as an ESOP unless it satisfies the provisions of *IRC Sections 409(h)* (right to demand distribution in company stock and to put securities not readily tradable to the employer) and 409(o) (ESOP distribution and payment requirements), and, if applicable, *IRC Sections 409(n)* (prohibited allocation rules) and 664(g) (gratuitous transfer of qualified employer securities). If the employer has a registration-type class of securities (as defined in *IRC Section 409(e)(4)*), the plan must meet the requirements of *IRC Section 409(e)* (voting rights). Effective for plan years beginning after 2004, an ESOP must also comply with *IRC Section 409(p)* (ESOP established by an S corporation must prohibit the allocation of employer securities held by the ESOP to disqualified individuals during nonallocation years). These requirements are discussed below.

IRC Section 409(l)(1) defines the term "employer securities" as common stock issued by the employer that is readily tradable on an established securities market. If such common stock does not exist, the term is defined as common stock issued by the employer having a combination of voting power and dividend rights equal to or exceeding the class of common stock of the employer having the greatest voting power and the class of common stock having the greatest dividend rights.⁵ Noncallable preferred stock is treated as employer securities if the stock is convertible at any time into common stock that qualifies as employer securities at a conversion price that (as of the date of acquisition by the ESOP) is reasonable.⁶ Employer securities also include stock issued by a corporation that is a member of the same controlled group as the employer.⁷

[2] Formal Requirements

The regulatory requirements begin with the necessity that a plan must be formally designated as an ESOP in order to be one.¹ Next, the terms of the ESOP must formally provide participants with certain protections and rights with respect to plan assets acquired with the proceeds of an exempt loan.²

The terms of an ESOP must also formally provide that these protections and rights are nonterminable.³ Thus, if a plan holds or has distributed securities acquired with the proceeds of an exempt loan and either the loan is repaid or the plan ceases to be an ESOP, these protections and rights must continue to exist under the terms of the plan. However, the

protections and rights will not fail to be nonterminable merely because they are not exercisable under Regulations Section 54.4975-7(b)(11) and (12), relating to put options. For example, if after a plan ceases to be an ESOP, securities acquired with the proceeds of an exempt loan cease to be publicly traded, the 15-month period during which a put option must be exercised includes the time when the securities are publicly traded.

A plan satisfies the regulatory requirements as of the date that it is designated as an ESOP if it is amended retroactively to meet, and in fact does meet, the requirements at any of the following times:

- (1) 12 months after the date on which the plan is designated as an ESOP;
- (2) 90 days after a determination letter is issued with respect to the qualification of the plan as an ESOP, but only if the determination is requested within 12 months after the date on which the plan is designated as an ESOP; or
- (3) a later date approved by the district director.ⁿ⁴

[3] Additional Regulatory Requirements

[a] Investment Primarily in Qualifying Employer Securities. A plan constitutes an ESOP only if the plan specifically states that it is designed to invest primarily in qualifying employer securities.ⁿ¹ Thus, a stock bonus plan or a money purchase pension plan constituting an ESOP may invest part of its assets in other than qualifying employer securities, in which case the plan will be treated the same as other stock bonus plans or money purchase pension plans qualified under *IRC Section 401(a)* with respect to those investments.

[b] Suspense Account. All assets acquired by an ESOP with the proceeds of an exempt loan under *IRC Section 4975(d)(3)* must be added to and maintained in a suspense account.ⁿ² They are to be withdrawn from the suspense account by treating all securities in the account as if they were encumbered.ⁿ³ Assets in the suspense account are assets of the ESOP.

[c] Allocation to Accounts of Participants. An ESOP must provide a definite plan for allocating contributions made to the plan among the participants.ⁿ⁴ As of the end of each year, the ESOP must consistently allocate in the participants' accounts non-monetary units representing participants' interests in assets withdrawn from the suspense accounts.ⁿ⁵ Income with respect to securities acquired by an exempt loan must be allocated as income of the plan except when the ESOP provides for the use of that income to repay the loan.ⁿ⁶ If a portion of a participant's account is forfeited, qualifying employer securities allocated to the account must be forfeited only after other assets.ⁿ⁷

Generally, qualifying employer securities acquired by the ESOP must be allocated in accordance with the rules governing other qualified defined contribution plans.ⁿ⁸ However, if the securities are acquired with the proceeds of an exempt loan, they must be placed in a suspense account as mentioned above.

[d] Distributions. In general, when it comes to distributions, the portion of an ESOP consisting of a stock bonus plan or money purchase plan is not to be distinguished from other such plans under *IRC Section 401(a)*.ⁿ⁹ Thus, for example, benefits distributed from a stock bonus plan are distributable only in stock of the employer. Benefits distributed from a money purchase plan may be distributable in qualifying employer securities, but need not be. If securities acquired with the proceeds of an exempt loan available for distribution consist of more than one class, a distributee must receive substantially the same proportion of each class, unless the distribution is from the portion of the ESOP consisting of a stock bonus plan.ⁿ¹⁰

Income paid with respect to qualifying employer securities acquired by an ESOP in taxable years beginning after December 31, 1974, may be distributed at any time after receipt by the plan to participants on whose behalf the securities have been allocated.ⁿ¹¹ However, if an ESOP is a stock bonus plan, income held by the plan for two years or

longer must be distributed in the form of stock of the employer.

[e] Loans. *IRC Sections 4975(a) and (b)* impose an excise tax on any disqualified person who engages in a prohibited transaction with a qualified plan.ⁿ¹² Included in the list of prohibited transactions is any lending of money or other extension of credit between a plan and a disqualified person.ⁿ¹³ However, *IRC Section 4975(d)(3)* provides an exemption from the excise tax for any loan (exempt loan) to a leveraged ESOP if (i) the loan is primarily for the benefit of participants and beneficiaries of the plan, and (ii) the loan is at a reasonable rate of interest, and any collateral that is given to a disqualified person by the plan consists only of qualifying employer securities.

The regulations contain other conditions for an exempt loan. At the time the loan is made, the interest rate for the loan and the price of securities to be acquired by the loan proceeds should not be such that plan assets are drained off.ⁿ¹⁴ The terms of the loan must, at the same time the loan is made, be at least as favorable as the terms of a comparable term loan resulting from arm's-length negotiations between independent parties.ⁿ¹⁵

The proceeds of an exempt loan must be used within a reasonable time after their receipt by the borrowing ESOP only for any or all of the following purposes: to acquire qualifying employer securities; to repay such loan; or to repay a prior exempt loan.ⁿ¹⁶ No security acquired with the proceeds of an exempt loan may be subject to a put, call, or other option, or buy-sell or similar arrangement while held by and when distributed from a plan, whether or not the plan is then an ESOP.ⁿ¹⁷

An exempt loan must be without recourse against the ESOP.ⁿ¹⁸ The only assets that can be used as collateral for an exempt loan are qualifying employer securities acquired with the proceeds of the loan and those that were used as collateral on a prior exempt loan repaid with the proceeds of the current exempt loan. No person entitled to payment under the exempt loan can have any rights to assets of the ESOP other than (i) collateral given for the loan; (ii) contributions (other than contributions of employer securities) that are made under an ESOP to meet its obligations under the loan, and (iii) earnings attributable to the collateral and the investment of such contributions. The loan must be provide for the release from encumbrance of the plan assets used as collateral for the loan in accordance with a schedule that is at least as quick as one of two methods, namely, the principal-and-interest method or the principal-only method.ⁿ¹⁹

Payment made with respect to an exempt loan by the ESOP during a plan year cannot exceed the sum of contributions made and earnings received during the plan year and prior years, less payments made in prior years.ⁿ²⁰ If there is a default in the exempt loan, the value of plan assets transferred in satisfaction of the loan must not exceed the amount of the default. If the lender is a disqualified person, the amount of plan assets that can be transferred is limited to the extent of the failure of the ESOP to meet the payment schedule of the loan.ⁿ²¹

[4] Special Statutory Requirements

[a] Voting Rights. If the employer has a class of securities required to be registered under Section 12 of the Securities Exchange Act of 1934, or a class of securities that would be required to be registered except for the exemption from registration provided by Section 12(g)(2)(H) of that Act, each participant in the plan must be permitted to direct the manner in which the securities allocated to the participant's account should be voted.ⁿ¹ If the ESOP does not have a registration-type class of securities, each participant is entitled to vote on any corporate matter that involves the voting of shares for approval or disapproval of a corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets of a trade or business, or such other similar transactions as may be prescribed in the regulations.ⁿ²

[b] Right to Demand Employer Securities--Put Option. *IRC section 409(h)(1)(A)* requires an ESOP to give a participant entitled to a distribution from the plan the right to demand that the participant's benefits be distributed in the form of employer securities.ⁿ³ If the employer is (i) a corporation whose charter or bylaws restrict the ownership of substantially all outstanding employer securities to employees or to a trust qualified under *IRC Section 401(a)*, or (ii) an

S corporation, the ESOP may distribute all benefits in cash without giving participants the right to demand stock or distribute employer securities subject to a requirement that the securities may be resold to the employer under the put option described below.ⁿ⁴

If the employer securities distributed to the participant are not readily tradable on an established market, the participant must have the right to require that the employer repurchase employer securities under a fair valuation formula (the put option).ⁿ⁵

The put option period must be at least 60 days following the date of distribution of the stock. If the put option is not exercised during that period, there must be an additional exercise period of at least 60 days in the following plan year.ⁿ⁶ If employer securities are distributed to the employee as part of a total distribution and the employee exercises the put option, the amount to be paid for the employer securities may be paid in substantially equal periodic payments at least annually over a period beginning not later than 30 days after the exercise of the put option and not exceeding five years.ⁿ⁷ If payments are made in installments, there must be adequate security provided and reasonable interest paid on the unpaid balance.ⁿ⁸ If an employer is required to repurchase employer securities as part of an installment distribution, the employer must pay the option price within 30 days of exercise of the put option.ⁿ⁹

[c] Prohibited Allocations. Under *IRC Section 1042*, a taxpayer can elect nonrecognition treatment for certain sales of stock to an ESOP. *IRC Section 409(n)(1)* provides that no portion of the plan attributable to employer securities acquired by the ESOP in a sale to which *IRC Section 1042* applies may accrue (or be allocated directly or indirectly) to the electing taxpayer, any individual related to the taxpayer (within the meaning of *IRC Section 267(b)*), or any other shareholder owning more than 25 percent of (i) any class of stock of the employer corporation or a corporation that is a member of the same controlled group, or (ii) the total value of any class of outstanding stock of the corporation.ⁿ¹⁰ A person is not treated as a 25-percent shareholder if the person fails to meet the stock ownership limitation at any time during the one-year period ending on the date of sale to the ESOP, or on the date on which the qualified securities are allocated to participants in the plan.ⁿ¹¹

The prohibition against allocation for the benefit of the electing taxpayer and related individuals begins on the date of sale of the securities and ends on the later of (a) ten years after the date of sale, or (b) the date of the allocation attributable to the final payment of the acquisition indebtedness incurred in connection with the sale.ⁿ¹² The prohibition against allocation to a more-than-25-percent shareholder is indefinite.

A violation of the prohibited allocation under *IRC Section 409(n)(1)* produces two consequences. First, the person to whom the allocation is made is taxed immediately on the gain realized on the sale.ⁿ¹³ Second, an excise tax of 50 percent of the amount involved is imposed on the employer corporation.ⁿ¹⁴

A second prohibited allocation, effective for plan years beginning after December 31, 2004, requires that an ESOP created by an S corporation provide that no portion of the plan assets attributable to (or allocable in lieu of) employer securities can accrue (or be allocated directly or indirectly) under any qualified plan maintained by the S corporation for a disqualified person during a nonallocation year.ⁿ¹⁵ There is a prohibited allocation if there is either an impermissible accrual or an impermissible allocation.^{n15.1} There is an impermissible accrual to the extent (and only to the extent) that employer securities consisting of stock in an S corporation owned by the ESOP and any assets attributable thereto are held under the ESOP for the benefit of a disqualified person during a nonallocation year.^{n15.2} An impermissible allocation is any allocation for a disqualified person directly or indirectly under any plan of the employer qualified under *IRC Section 401(a)* that occurs during a nonallocation year to the extent that a contribution or other annual addition is made, or the disqualified person otherwise accrues additional benefits under the ESOP or any other plan of the employer qualified under *IRC Section 401(a)* (including a release and allocation of assets from a suspense account) that, for the nonallocation year, would otherwise have been added to the account of the disqualified person under the ESOP and invested in employer securities consisting of stock in an S corporation owned by the ESOP but for a provision in the ESOP to comply with *IRC Section 401(p)*.^{n15.3}

A nonallocation year is any plan year of an ESOP that holds shares of stock in an S corporation if, at any time during the plan year, disqualified persons own at least 50 percent of the outstanding shares of the S corporation.ⁿ¹⁶ In addition, the Service, in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin, may provide that a nonallocation year occurs in any case in which the principal purpose of the ownership structure of an S corporation constitutes and avoidance or evasion of *IRC Section 409(p)*.^{n16.1} For any year so treated as a nonallocation year, the Service may treat any person as a disqualified person.

A person is a disqualified person if (i) the aggregate number of deemed-owned shares of the person and members of the person's family is at least 20 percent of the number of deemed-owned shares of stock in the S corporation, or (ii) if not a member of the preceding group, the number of the person's deemed-owned shares is at least 10 percent of the number of deemed-owned shares of stock in the corporation.ⁿ¹⁷ A person's deemed-owned shares include employer stock allocated to the person under the ESOP and the person's share of unallocated employer stock held by the ESOP.ⁿ¹⁸

The attribution rules of *IRC Section 318(a)* generally apply for purposes of *IRC Section 409(p)*. However, here members of an individual's family include (a) the individual's spouse, (b) an ancestor or lineal descendant of the individual or the individual's spouse, (c) a brother or sister of the individual or the individual's spouse, and any lineal descendant of the sibling, and (d) the spouse of any person described in (b) or (c).ⁿ¹⁹ In addition, the normal option attribution rule does not apply, but special attribution provisions apply with respect to "synthetic equity."

If a person owns a synthetic equity in the S corporation, stock on which the synthetic equity is based is treated as outstanding stock in the corporation and deemed-owned shares of the person holding the synthetic equity if such treatment results in the treatment of any person as a disqualified person, or the treatment of any year as a nonallocation year.ⁿ²⁰ Synthetic equity is defined as any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future.ⁿ²¹ Except to the extent provided in regulations, synthetic equity also includes a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of the stock or appreciation in value.

Synthetic equity also includes a right to acquire stock or other similar interests in a related entity if the interests in the related entity are the only significant assets of the S corporation and the S corporation is the only significant owner of the related entity.^{n21.1} A related entity is one in which the S corporation holds an interest and which is a partnership, a trust, an eligible entity that is disregarded as an entity that is separate from its owner under *Regulation Section 301.7701-3*, or a qualified Subchapter S subsidiary.^{n21.2} Synthetic equity does not include rights to acquire goods or services at fair market value in the ordinary course of business.^{n21.3} However, it does include any nonqualified deferred compensation for services rendered to the S corporation, or a related entity.^{n21.4}

If there is a prohibited allocation under *IRC 409(p)*, the value of the allocation is includable in the income of the disqualified person to whom it was made.ⁿ²² In addition, the S corporation is liable for an excise tax equal to 50 percent of the allocation, or, if any synthetic equity is owned by a disqualified person during a nonallocation year, the corporation is liable for another 50 percent excise tax based on the value of the shares on which the synthetic equity is based.ⁿ²³

An ESOP may prevent a nonallocation year or a prohibited allocation during a nonallocation year by permitting assets (including S corporation securities) allocated to the account of a disqualified person (or a person reasonably expected to become a disqualified person) to be transferred into a separate portion of the plan that is not an ESOP or to another plan of the employer that satisfies the requirements of *IRC Section 401(a)* (and that is not an ESOP).^{n23.1} The nondiscrimination requirement normally applicable to qualified plans need not be met with respect to the transferred assets.^{n23.2}

[d] Distributions and Payments. An ESOP must provide that, at the election of the participant, the distribution of

the participant's account balance must commence not later than one year after the close of the plan year (1) in which the employee retires at the normal retirement age, dies, or becomes disabled, or (2) the fifth plan year following the plan year in which the employee separates from service (unless reemployed before that year).ⁿ²⁴ The plan must also provide that, unless the participant elects otherwise, the distribution of the participant's account balance will be in substantially equal periodic payments (not less frequently than annually) over a period not longer than five years, unless the participant has an account balance of more than \$800,000.ⁿ²⁵ If the employee has an account balance of that magnitude, the distribution is extended by one year (but not more than five additional years) for each \$160,000 or fraction thereof by which the balance exceeds \$800,000.ⁿ²⁶

[e] Investment Diversification Election. An ESOP must allow each qualified participant to elect to diversify by directing the investment of at least 25 percent of the participant's account balance in the plan in other investments within 90 days after the close of each plan year in the qualified election period.ⁿ²⁷ A qualified participant is an employee who has completed at least 10 years of participation in the plan and is at least 55 years of age.ⁿ²⁸ The qualified election period is the six-plan-year period beginning with the later of the first plan year in which the employee becomes a qualified participant or the first plan year beginning after December 31, 1986.ⁿ²⁹

There are two methods to meet the diversification requirement.ⁿ³⁰ First, the portion of the participant's account subject to the diversification requirement can be distributed to the employee within 90 days after the period during which the election can be made. Second, the plan can offer at least three investment options other than employer stock to the qualified participant, and, within 90 days after the period during which the election can be made, invest the portion of the participant's account covered by the election in accordance with the election.ⁿ³¹

Employer securities acquired by or contributed to an ESOP on or before December 31, 1986, are not subject to the diversification requirement.ⁿ³² However, dividends paid to an ESOP after 1986 with respect to those exempted securities are subject to diversification if paid in cash or other property that is used to acquire employer securities. Employer securities actually acquired by or contributed to an ESOP after 1986, will be deemed to have been acquired by or contributed to the ESOP on or before December 31, 1986, in the following circumstances:ⁿ³³

- (1) Cash or other assets derived from the disposition of employer securities in a corporate reorganization or acquisition attempt (whether or not successful) are used to purchase other employer securities and the period of time between disposition and reinvestment does not exceed 90 days.ⁿ³⁴
- (2) Employer securities were acquired with cash contributions made to the ESOP on or before December 31, 1986, if the contributions were used to purchase the employer securities within 60 days after the date of contribution.
- (3) Employer securities were acquired with earnings and dividends paid in cash to the ESOP on or before December 31, 1986, if the earnings and dividends were used to purchase the employer securities within 60 days from the date of payment to the ESOP.
- (4) Employer securities were purchased with the proceeds of an exempt loan received by the ESOP in cash on or before December 31, 1986, if the proceeds were invested in employer securities within 60 days of the receipt of the proceeds by the ESOP.
- (5) Employer securities were purchased with amounts transferred to the ESOP on or before December 31, 1986, after a reversion of a qualified plan to the employer, if the securities were purchased 90 days after the transfer (or such longer period as the Service may prescribe).

If the fair market value (determined at the plan valuation date immediately preceding the first day on which a qualified participant can make a diversification election) of employer securities acquired by or contributed to an ESOP after

1986, and allocated to the participant's account is \$500 or less, those employer securities will be considered a *de minimis* amount that is not subject to the diversification requirement.ⁿ³⁵ An ESOP may elect to use a *de minimis* amount of less than \$500. In determining whether the allocated amount is *de minimis*, employer securities held in accounts of all ESOPs maintained by the employer corporation and members of the controlled group of corporations that includes the employer corporation are considered to be held by the same plan. If the fair market value of the employer securities acquired by or contributed to the plan after 1986 and allocated to a qualified participant's account exceeds the *de minimis* amount for any year of a participant's qualified election period, then all shares allocated to the account of the qualified participant that were acquired or contributed after 1986 are subject to the diversification requirement in each remaining year of a participant's qualified election period.ⁿ³⁶

The portion of a qualified participant's account subject to the diversification election in all years during the qualified election period, other than the final year of the period, is equal to: 25 percent of the total number of shares of employer securities acquired by or contributed to the ESOP after 1986 that have ever been allocated to the qualified participant's account on or before the most recent plan allocation date, less the number of shares of employer securities distributed, transferred, or diversified pursuant to a post-1986 election.ⁿ³⁷ For a qualified participant's final diversification election, "50 percent" is substituted for "25 percent" in determining the amount subject to the diversification election.

The shares of employer securities that are diversified pursuant to a diversification election need not consist of securities acquired by or contributed to the ESOP after 1986.ⁿ³⁸ This is the case even though the determination of the number of shares that must be available for diversification is limited to shares acquired by or contributed to the ESOP after 1986. However, the shares of employer securities that are diversified pursuant to a diversification election must consist of employer securities that, immediately before the election, are subject to the put option requirement of *IRC Section 409(h)*. If the ESOP permits participants to receive distributions of employer securities that have been held by the plan for at least 84 months in circumstances other than those described in *IRC Section 409(d)(1)-(3)* (applicable to ESOPs that were formed under the former tax credit ESOP rules), *IRC Section 401(a)(28)(B)* overrides the 84-month rule of *IRC 409(d)* only to the extent that the shares of employer securities allocated to a qualified participant and diversified pursuant to a diversification election actually consist, first, of employer securities that have satisfied the 84-month rule and, then, of employer securities that continue to be subject to the 84-month rule and have been held by the plan for longer periods of time than other employer securities subject to the 84-month rule.

An ESOP can permit diversification of amounts in excess of those required by *IRC Section 401(a)(28)(B)*.ⁿ³⁹ However, amounts in excess of the minimum amount required to be available for diversification under *IRC Section 401(a)(28)(B)* are not treated as available for diversification or as diversified. Thus, employer securities subject to *IRC Section 409(d)* and in excess of the minimum amount required to be available for diversification may not be diversified to the extent that such securities may not be distributed under *IRC Section 409(d)*. In addition, amounts subject to the put option requirements of *IRC Section 409(h)* in excess of the minimum amount required to be available for diversification remain subject to the requirements of *IRC Section 409(h)* even if such amounts are diversified.

Amounts that are required to be available for diversification and are diversified by means of distribution generally are treated as amounts that are not held by an ESOP.ⁿ⁴⁰ Thus, a distribution in satisfaction of a diversification election is not subject to the right to demand employer securities under *IRC 409(h)* and may be made notwithstanding the 84-month holding period requirement under *IRC 409(d)*. However, a distribution in satisfaction of a diversification election is subject to the put option requirement of *IRC § 409(h)* to the extent the distribution consists of employer securities. A distribution in satisfaction of a diversification election does not fail to satisfy the rules of *IRC § 411(d)(6)* (accrued benefit cannot be decreased by plan amendment) merely because it is not available in the form of employer securities or is available only as a single-sum distribution.

A distribution or transfer in satisfaction of a diversification election is eligible for the special exception for ESOP benefits under the qualified joint and survivor annuity rules of *IRC Section 401(a)(11)*.ⁿ⁴¹ Finally, a distribution in satisfaction of a diversification election must satisfy *IRC Section 411(a)(11)* concerning the consent of the participant to

a distribution, but is not subject to the rules under *IRC Section 401(a)*, restricting the distribution of plan benefits before the termination of employment (in the case of a pension plan) or the occurrence of other events (in the case of a profit-sharing plan).

Amounts that have been diversified by giving a qualified participant three distinct investment options also are treated as amounts that are not held by an ESOP.ⁿ⁴² Thus, *IRC Section 409(h)* does not apply to a distribution of such amounts, nor is *IRC Section 411(d)(6)* violated if the amounts are not available for distribution in the form of employer securities. If the ESOP is a money purchase pension plan, amounts that have been previously diversified in accordance with the three distinct investment option alternative may not be distributed prior to the participant's separation from service and do not qualify for the special ESOP benefit exception to the qualified joint and survivor rule under *IRC Section 401(a)(11)(C)*.

[f] Independent Appraiser. Under *IRC Section 401(a)(28)(C)*, all valuations of employer securities acquired after 1986 that are not readily tradable on an established securities market must be made by an independent appraiser. The term "independent appraiser" means any appraiser meeting requirements similar to those contained in the regulations under *IRC Section 170(a)(1)* (the charitable deduction provision).ⁿ⁴³

FOOTNOTES:

(n1)Footnote 1. A defined contribution plan is a plan in which benefits are based solely on the amount contributed to the participant's account, any income, expenses, gains, and losses allocated to the account, and any forfeitures of accounts of other participants that may be allocated to the participant's account. *IRC § 414(i)*.

(n2)Footnote 2. A stock bonus plan is a plan to provide employees benefits similar to those of profit-sharing plans, except that the benefits are distributed in the employer's stock and benefits are not necessarily dependent upon profits. *Treas Reg §§ 1.401-1(a)(2)(iii), 1.401-1(b)(1)(iii)*.

(n3)Footnote 3. A qualifying employer security is an employer security as defined in *IRC § 409(l)*. *IRC § 4975(e)(8)*.

(n4)Footnote 4. *IRC § 4975(e)(7)*. A plan is qualified if it meets the conditions specified in *IRC § 401(a)*.

(n5)Footnote 5. *IRC § 409(l)(2)*.

(n6)Footnote 6. *IRC § 409(l)(3)*.

(n7)Footnote 7. For this purpose, a "controlled group of corporations" has the meaning given to that term by *IRC § 1563(a)*, determined without regard to *IRC § 1563(a)(4)* and *IRC § 1563(e)(3)(C)*. *IRC § 409(l)(4)*. However, the common parent need own only 50% of the voting power of all classes of stock and at least 50% of each class of stock in a first-tier subsidiary for that subsidiary (and all other corporations below it in the chain that would meet the 80% test of *IRC § 1563(a)* if the first-tier subsidiary were the common parent) to be treated as members of the controlled group. If the common parent owns directly all of the voting power of all classes of stock and all of the nonvoting stock in a first-tier subsidiary, the first-tier subsidiary need only own directly 50% of the voting and nonvoting stock in a second-tier subsidiary of the common parent for the corporations in the chain to be treated as includable corporations.

In the case of limited partnerships that were wholly owned by a parent corporation and its subsidiaries who elected to be classified as associations taxable as corporations under *Treas Reg § 301.7701-2(b)(2)*, the Service ruled that the partnerships were to be treated as members of the same controlled group as the parent, so that the parent corporation's stock held by an ESOP maintained by the parent constituted employer securities with respect to the employees of the partnerships. This meant that those employees could participate in the ESOP. Ltr Rul 200008040 .

In the case of limited liability companies (LLC's) owned by members of a controlled group of corporations that did

not elect to be treated as corporations pursuant to *Treas Reg* § 301.7701-3(b), the Service ruled that they were to be disregarded as entities separate from their corporate owners. This meant that the LLC's could not be part of the controlled group. However, a disregarded entity's assets and liabilities are considered to be the assets and liabilities of the entity's owner. This led to the conclusion that the employees of the LLC's owned by the members of the controlled group were to be treated as employees of the corporations so that the common stock of the parent company owned by an ESOP maintained by one of its subsidiaries constituted employee securities with respect to the employees of the LLC's. Ltr Rul 200116051 .

(n8)Footnote 1. *Treas Reg* § 54.4975-11(a)(2).

(n9)Footnote 2. *Treas Reg* § 54.4975-11(a)(3)(i). See § 16A.02[3] for a discussion of exempt loans.

(n10)Footnote 3. *Treas Reg* § 54.4975-11(a)(3)(ii). The formal requirements of *Treas Reg* § 54.4975-11(a)(3)(i) and (ii) must be set forth in the plan. Mere references to the provisions of the regulations is not sufficient. *Treas Reg* § 54.4975-11(a)(3)(iii).

(n11)Footnote 4. *Treas Reg* § 54.4975-11(a)(4).

(n12)Footnote 1. *Treas Reg* § 54.4975-11(b).

(n13)Footnote 2. *Treas Reg* § 54.4975-11(c).

(N14)Footnote 3. See *Treas Reg* § 54.4975-7(b)(8) for rules relating to the release from encumbrance of plan assets used as collateral for an exempt loan.

(n15)Footnote 4. *Treas Reg* §§ 54.4975-11(d)(1), 1.401-1(b)(1)(ii), (iii).

(n16)Footnote 5. *Treas Reg* § 54.4975-11(d)(2).

(n17)Footnote 6. *Treas Reg* § 54.4975-11(d)(3).

(n18)Footnote 7. *Treas Reg* § 54.4975-11(d)(4). If interests in more than one class of qualifying employer securities have been allocated to the participant's account, the participant must be treated as forfeiting the same proportion of each class.

(n19)Footnote 8. *Treas Reg* §§ 54.4975-11(d)(1), 1.401-1(b)(2)(ii).

(n20)Footnote 9. *Treas Reg* § 54.4975-11(f)(1).

(n21)Footnote 10. *Treas Reg* § 54.4975-11(f)(2).

(n22)Footnote 11. *Treas Reg* § 54.4975-11(f)(3).

(n23)Footnote 12. The term "disqualified person" is defined in *IRC* § 4975(e)(2).

(n24)Footnote 13. *IRC* § 4975(c)(1)(B).

(n25)Footnote 14. *Treas Reg* § 54.4975-7(b)(3)(ii).

(n26)Footnote 15. *Treas Reg* § 54.4975-7(b)(3)(iii), (13). The loan cannot be payable on demand.

Relevant factors to be considered in determining whether an interest rate is a reasonable rate include the amount and duration of the loan, the security and any guarantee involved, the credit rating of the ESOP and any guarantor, and the interest rate prevailing for comparable loans. *Treas Reg* § 54.4975-7(b)(7). When these factors are considered, a

variable interest rate may be a reasonable rate.

(n27)Footnote 16. *Treas Reg § 54.4975-7(b)(4)*.

(n28)Footnote 17. The no-put rule does not apply to the ability of a participant to require the corporation to repurchase employer securities that are not readily tradable.

(n29)Footnote 18. *Treas Reg § 54.4975-7(b)(5)*.

(n30)Footnote 19. *Treas Reg § 54.4975-7(b)(8)(i), (ii)*.

(n31)Footnote 20. *Treas Reg § 54.4975-7(b)(5)*.

(n32)Footnote 21. *Treas Reg § 54.4975-7(b)(6)*.

(n33)Footnote 1. *IRC § 409(e)(1), (2), (4)*. A corporation must register securities if it has total assets exceeding \$1 million and 750 or more shareholders. The specified exemption applies to any interest or participation in collective trust funds maintained by a bank or in a separate account maintained by an insurance company if the interest or participation is issued in connection with a qualified stock bonus, pension, profit sharing, or employee annuity plan.

(n34)Footnote 2. *IRC § 409(e)(3)*. A plan meets the requirements of *IRC § 409(e)(3)* with respect to an issue if the plan permits each participant one vote with respect to the issue, and the trustee votes the shares held by the plan in the proportion determined by that vote. *IRC § 409(e)(5)*.

An ESOP does not fail to comply with the pass-through voting requirements of *IRC § 409(e)(2)* or (3) merely because the trustee of the ESOP votes shares of stock allocated to participants' or beneficiaries' accounts for which no directions regarding voting are timely received from the participants or beneficiaries. *Rev Rul 95-57, 1995-2 CB 62*.

(n35)Footnote 3. A plan can provide that benefits may be distributed in cash or in the form of employer securities. *IRC § 409(h)(2)(A)*. There is no demand right with respect to that portion of the participant's account that the employee elects to have reinvested under *IRC § 401(a)(28)(B)*, dealing with diversification of investments, discussed below. There is also no demand right if employer stock held by the ESOP is not considered employer securities. *Ltr Rul 200010060*.

(n36)Footnote 4. *IRC § 409(h)(2)(B)*.

(n37)Footnote 5. *IRC § 409(h)(1)(B)*. The fair valuation formula requires the use of an independent appraiser. *IRC § 401(a)(28)(C)*,

The put option requirement does not apply if the employer is a bank that is prohibited by law from redeeming or purchasing its own securities and participants have a right to receive a distribution in cash. *IRC § 409(h)(3)*.

(n38)Footnote 6. *IRC § 409(h)(4)*.

(n39)Footnote 7. *IRC § 409(h)(5)(A)*. A total distribution is a distribution within one taxable year of the balance in the distributee's account.

(n40)Footnote 8. *IRC § 409(h)(5)(B)*. The Code does not define adequate security for this purpose. However, the Service believes that the definition of adequate security in the regulations to *IRC § 503* should apply for this purpose. *TAM 9438002*. Those regulations provide that adequate security means something in addition to and supporting a promise to pay, that is so pledged that it may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, and that the value and liquidity of which security is such that it may reasonably be anticipated that loss of principal or interest will not result from the loan. *Treas Reg § 1.503(b)-1(b)(1)*.

(n41)Footnote 9. *IRC § 409(h)(6)*.

(n42)Footnote 10. The amount of stock ownership is determined using the attribution rules of *IRC § 318(a)* without regard to the employee trust exception of *IRC § 318(a)(2)(B)(i)*.

An allocation can be made to a lineal descendant of the electing taxpayer if the aggregate amount allocated does not exceed more than 5% of the amount sold in the transaction. *IRC § 409(n)(3)(A)*. The exception does not apply to lineal descendants of a more-than-25-percent shareholder.

(n43)Footnote 11. *IRC § 409(n)(3)(B)*.

(n44)Footnote 12. *IRC § 409(n)(1), (3)(C)*.

(n45)Footnote 13. *IRC § 409(n)(2)(A)*.

(n46)Footnote 14. *IRC §§ 409(n)(2)(B), 4979A(a)(1), (c)(1)*.

(n47)Footnote 15. *IRC § 409(p)(1)*. The provision is effective for plan years beginning after March 14, 2001, for any ESOP established after that date or any ESOP established on or before March 14, 2001, if the employer maintaining the plan was not an S corporation of that date.

For purposes of the effective date of *IRC § 409(p)*, an ESOP is not established until it is adopted by an employer for the purpose of enabling its employees to participate in a more than insubstantial manner in the ownership of the employer's business and to provide its employees with more than insubstantial benefits under the ESOP. *Rev Rul 2003-6, 2003-1 CB 286*.

(n48)Footnote 15.1. *Treas Reg § 1.409(p)-1(b)(2)(i)*.

(n49)Footnote 15.2. *Treas Reg § 1.409(p)-1(b)(2)(ii)*.

(n50)Footnote 15.3. *Treas Reg § 1.409(p)-1(b)(2)(iii)*.

(n51)Footnote 16. *IRC § 409(p)(3)(A)*. An ESOP can be a shareholder in an S corporation. *IRC § 1361(c)(6)*. S corporation stock held by an ESOP is not treated as an interest in an unrelated trade or business under *IRC §§ 512(e)(1)(A) and 512(e)(3)*. *Ltr Rul 200029055*.

(n52)Footnote 16.1. *Treas Reg § 1.409(p)-1(c)(3)(ii)*. Using this authority, the Service has ruled that a nonallocation year occurs and the individual is a disqualified person in any case in which (i) the shares of an S corporation are employer securities held by an ESOP, (ii) the profits of the S corporation generated by the business activities of a specific individual are accumulated and held for the benefit of that individual in a qualified S subsidiary or similar entity (such as a limited liability company), (iii) the profits are not paid to the individual as compensation within 2 1/2 months after the end of the year in which earned, and (iv) the individual has rights to acquire shares of stock (or similar interests) representing 50% or more of the value of the stock of the subsidiary or similar entity. *Rev Rul 2004-4, 2004-1 CB 414*.

(n53)Footnote 17. *IRC § 409(p)(4)(A)*. In the case of a 20% deemed-owned shareholder, any member of that shareholder's family is treated as a disqualified person if not otherwise treated as a disqualified person under *IRC 409(p)(4)(A)*. *IRC § 409(p)(4)(B)*.

(n54)Footnote 18. *IRC § 409(p)(4)(C)*. A person's share of unallocated S corporation stock held by the ESOP is determined using the same proportions as the most recent allocation of stock.

(n55)Footnote 19. *IRC § 409(p)(3)(B), (4)(D)*. An individual is treated as owning deemed-owned shares of the

individual. This attribution rule is applied after the rules relating to synthetic stock.

(n56)Footnote 20. *IRC § 409(p)(5)*. Synthetic equity is treated as owned by a person in the same manner as stock is treated as owned under *IRC §§ 318(a)(2) and (3)*.

(n57)Footnote 21. *IRC § 409(p)(6)(C)*.

(n58)Footnote 21.1. *Treas Reg § 1.409(p)-1(f)(2)(iii)*. Whether an asset is the only significant asset of the S corporation or the S corporation is the only significant owner of the related entity depends on the relevant facts and circumstances.

(n59)Footnote 21.2. *Treas Reg § 1.409(p)-1(f)(3)*.

(n60)Footnote 21.3. *Treas Reg § 1.409(p)-1(f)(2)(iii)*.

(n61)Footnote 21.4. *Treas Reg § 1.409(p)-1(f)(2)(iv)*.

(n62)Footnote 22. *IRC § 409(p)(2)*. In addition, the plan ceases to be an ESOP. *Treas Reg § 1.409(p)-1(b)(2)(iv)(B)*.

(n63)Footnote 23. *IRC § 4979A(a)(3), (4), (c)(2)*.

(n64)Footnote 23.1. *Treas Reg § 1.409(p)-1(b)(2)(v)(A)*. If the transfer involves S corporation securities, the recipient plan is subject to tax on unrelated business income under *IRC § 512*.

(n65)Footnote 23.2. *Treas Reg § 1.409(p)-1(b)(2)(v)(B)*.

(n66)Footnote 24. *IRC § 409(o)(1)(A)*. The consent of the participant's spouse may be required. See *IRC §§ 401(a)(11), 417*.

(n67)Footnote 25. *IRC § 409(o)(1)(C)(i)*. For this purpose, the account balance does not include any employer securities acquired with the proceeds of a securities acquisition loan until the end of the plan year in which the loan is repaid in full. *IRC § 409(o)(1)(B)*.

(n68)Footnote 26. *IRC § 409(o)(1)(C)(ii)*. The \$100,000 and \$500,000 amounts are subject to cost-of-living adjustments at the same time and in the same manner as the dollar limits for defined benefit and defined contribution plans under *IRC § 415(d)*. *IRC § 409(o)(2)*. The amounts for 2008 are \$185,000 and \$935,000, respectively.

(n69)Footnote 27. *IRC § 401(a)(28)(B)(i)*. During the last year of the election period, the plan must offer the participant the right to direct investment of at least 50% of the account balance.

An ESOP satisfies the diversification of investments requirement with respect to a qualified participant for a given year when the plan has made available to the participant a distribution of the participant's account subject to the diversification election regardless of whether the participant actually receives a distribution of employer securities. *Notice 88-56, 1988-1 CB 540*, Q & A-15.

(n70)Footnote 28. *IRC § 401(a)(28)(B)(iii)*.

(n71)Footnote 29. *IRC § 401(a)(28)(B)(iv)*.

(n72)Footnote 30. *IRC § 401(a)(28)(B)(ii)*.

(n73)Footnote 31. The ESOP need only offer the three distinct investment opportunities; a qualified participant

does not have to actually elect to diversify. *Notice 88-56*, Q & A-15.

The plan can also offer the option to direct the plan to transfer the portion of the participant's account subject to the diversification election to another qualified defined contribution plan of the employer that offers at least three distinct investment options, provided the transfer is made no later than 90 days after the last day of the qualified election period. *Notice 88-56*, Q & A-13.

(n74)Footnote 32. *Notice 88-56*, Q & A-1. Unless an ESOP separately accounts for employer securities acquired by or contributed to a plan after December 31, 1986, it is presumed that employer securities allocated to participants' accounts after December 31, 1986, consist of employer securities acquired by or contributed to the ESOP after December 31, 1986, and employer securities acquired by or contributed to the ESOP on or before December 31, 1986. *Notice 88-56*, Q & A-4.

(n75)Footnote 33. *Notice 88-56*, Q & A-3.

(n76)Footnote 34. The period can be extended by the Service but no extensions will be granted unless applied for within 90 days after the disposition.

(n77)Footnote 35. *Notice 88-56*, Q & A-7.

(n78)Footnote 36. *Notice 88-56*, Q & A-8.

(n79)Footnote 37. *Notice 88-56*, Q & A-9. The resulting number of shares can be rounded to the nearest whole number.

(n80)Footnote 38. *Notice 88-56*, Q & A-10.

(n81)Footnote 39. *Notice 88-56*, Q & A-11.

(n82)Footnote 40. *Notice 88-56*, Q & A-14.

(n83)Footnote 41. *Notice 88-56*, Q & A-14.

(n84)Footnote 42. *Notice 88-56*, Q & A-16.

(n85)Footnote 43. An appraiser is independent if requirements similar to those found under *IRC 170(a)(1)* and *Treas Reg § 1.170A-13(c)(5)* for a "qualified appraiser" are satisfied. Ann 92-182, 1992-52 *IRB* 45. According to Ann 94-101, 1994-35 *IRB* 53, an appraiser is not independent if (a) the appraiser is the taxpayer that maintains the ESOP (or a member of the controlled group of corporations that includes the taxpayer); (b) the appraiser is a party to the transaction in which the ESOP acquired the property; (c) the appraiser is employed by the taxpayer maintaining the ESOP (or a member of the same controlled group) or by a party to the transaction in which the ESOP acquired the property; or (d) the appraiser is regularly used by any entity described above and does not perform a majority of his or her appraisals for entities other than those described above.



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Taxation of Securities Transactions

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CHAPTER 16A Employee Stock Ownership Plans

2-16A Taxation of Securities Transactions § 16A.03

§ 16A.03 Tax Consequences of Employee Stock Ownership Plans

[1] Contributions by the Employer Corporation.

Contributions by an employer corporation to an ESOP are deductible in the year that they are actually made to the plan.ⁿ¹ The contribution can be made in cash or in the form of the corporation's own stock. If stock of the employer corporation is used to fund the contribution, the corporation does not recognize any gain or loss because of the contribution, even if the contributed stock is treasury stock.ⁿ²

The employer contribution is limited to 25 percent of the compensation paid or accrued during the taxable year to beneficiaries under the plan.ⁿ³ Any excess contribution can be carried forward to succeeding years.ⁿ⁴ If contributions are made to more than one plan, the contributions must be aggregated when applying the limitation.ⁿ⁵ In computing the limitation, the amount of annual compensation taken into account cannot exceed \$200,000.ⁿ⁶

The \$200,000 limitation is to be adjusted annually for inflation in increments rounded to the next lowest multiple of \$5,000, using the calendar quarter beginning July 1, 2001, as the base period.ⁿ⁷

[a] Dividends on Employer Securities. A C corporation is allowed an additional deduction for the amount of any "applicable dividend" paid in cash with respect to employer securities held by an ESOP maintained by it or by a member of a controlled group of corporations.ⁿ⁸ An applicable dividend is one that:

- (1) is paid in cash to the participants in the plan or their beneficiaries;
- (2) is paid to the plan and distributed in cash to participants in the plan or their beneficiaries within 90 days after the close of the plan year in which paid;
- (3) is, at the election of the participants or their beneficiaries, payable as described above or paid to the plan and reinvested in qualifying employer securities; or
- (4) is used to make payments on a loan that was used to pay for the stock on which the dividend is paid.ⁿ⁹

A dividend paid on stock that has been allocated to a participant and then used to repay a loan will not be an applicable

dividend unless the participant is allocated additional stock with a fair market value not less than the amount of the dividend.ⁿ¹⁰

In order for dividends subject to an election to be applicable dividends, a participant must be given a reasonable opportunity before a dividend is paid or distributed to the participant to make the election.ⁿ¹¹ In addition, a participant must have a reasonable opportunity to change a dividend election at least annually. If there is a change in the plan terms governing the manner in which dividends are paid or distributed to participants, a participant must be given an opportunity to make an election under the new plan terms prior to the date on which the first dividend subject to the new plan terms is paid or distributed. An ESOP does not fail to comply with these requirements solely because it provides that, if a particular participant fails to make an affirmative dividend election, one of the options offered to participants is treated as a default election.

The deduction is allowable in the taxable year of the corporation in which the dividend is paid or distributed to a participant or his beneficiary.ⁿ¹² If the dividend is reinvested in qualifying employer securities at the election of the participant, the dividend is treated as paid in the year in which the dividend is reinvested or the election is made, whichever is later.ⁿ¹³ If the dividend is used to repay a loan, the deduction is allowable in the year of repayment.ⁿ¹⁴

Earnings on dividends held in the plan do not constitute dividends under *IRC Section 404(k)* and are not deductible under that section.ⁿ¹⁵ Investment losses attributable to the dividends, or the reduction of the dividend amount paid to the ESOP by the corporation through tax withholding (eg, by a foreign corporation with respect to dividends paid by a foreign corporation) or other means, reduce the amount of the dividend that is available for reinvestment or distribution and, thus, the amount deductible under *IRC Section 404(k)*.ⁿ¹⁶

For taxable years beginning on or after January 1, 2002, an ESOP must provide that a participant is fully vested in any dividend with respect to which the participant is offered a reinvestment election.ⁿ¹⁷ An ESOP can comply with this requirement by providing that participants are fully vested in dividends with respect to which the election is offered, without regard to whether the participant is vested in the stock on which the dividend is paid. Alternatively, an ESOP can comply with the vesting requirement by offering the election only to vested participants.ⁿ¹⁸ In addition, an ESOP may provide that the same election is offered to all participants, including both active participants and participants who are no longer active participants in the ESOP, and the corporation is allowed a deduction with respect to all dividends subject to the election.ⁿ¹⁹

The Service can disallow the deduction if it determines that the dividend constitutes, in substance, an avoidance or evasion of taxation.ⁿ²⁰ This includes the authority to disallow a deduction for unreasonable dividends.ⁿ²¹ With respect to dividends reinvested under the reinvestment election, a dividend paid on common stock that is primarily and regularly traded on an established securities market (within the meaning of *Regulations Section 54.4975-7(b)(1)(iv)*) is presumed to be a reasonable dividend. In the case of a corporation with no outstanding common stock (determined on a controlled group basis) that is primarily and regularly traded on an established market, a determination regarding whether the dividend is reasonable is made by comparing the dividend rate on the stock held by the ESOP with the dividend rate of comparable corporations whose stock is primarily and regularly traded on an established securities market.ⁿ²²

Payments in redemption of stock held by an ESOP that are used to make distributions to terminating ESOP participants constitute an avoidance or evasion of taxation under *IRC Section 404(k)(5)(A)* and are not applicable dividends.ⁿ²³ In addition, any deduction for such payments is disallowed by *IRC Section 162(k)*.^{n23.1}

An ESOP has to be amended to provide for the reinvestment election within a remedial amendment period ending not prior to the last day of the first plan year beginning on or after January 1, 2005.ⁿ²⁴ The availability of the remedial amendment period is conditioned on the timely adoption of a good faith plan amendment by the end of the plan year in which the first taxable year of the corporation for which the deduction is sought ends.ⁿ²⁵

[b] Leveraged Employee Stock Ownership Plans. If an employer corporation's contributions to a leveraged ESOP---an ESOP that has borrowed funds to purchase qualifying employer securities---is used to pay interest on an ESOP's securities acquisition loan, the deduction for the employer corporation is unlimited.ⁿ²⁶ In order to secure the deduction for the year of contribution, the contribution to the ESOP must be made by the due date (including extensions) of the employer's tax return for the year.

IRC Section 415(c)(1) limits the amount of an annual addition to a participant in a plan to the lesser of \$40,000 or 100 percent of the participant's compensation. Annual additions consist of (a) employer contributions, (b) employee contributions, and (c) forfeitures.ⁿ²⁷ However, if not more than one-third of the employer contributions to a leveraged ESOP are allocated to highly compensated employees (within the meaning of *IRC Section 414(q)*), the limitation does not apply to (i) forfeitures of employer securities that were acquired with the proceeds of a ESOP securities loan, or (ii) employer contributions used to pay interest on a securities loan and charged against the participant's account.ⁿ²⁸

[2] Gain Deferral Election.

No gain is recognized on a sale of qualified securities to an ESOP if the seller so elects and (i) immediately after the sale, the ESOP owns at least 30 percent of (a) each class of outstanding stock of the employer corporation (other than certain preferred stock), or (b) the total value of all outstanding stock of the corporation (other than certain preferred stock), and (ii) within a period beginning three months before the sale and ending twelve months thereafter, the seller purchases qualified replacement securities.ⁿ¹ The employer corporation must also file a verified written statement consenting to the application of *IRC Sections 4978* (tax on certain dispositions by the ESOP) and *4979A* (tax on prohibited allocations).ⁿ² Nonrecognition is not available if the seller is a C corporation, or an underwriter who sells securities to the ESOP as part of the underwriter's trade or business as an underwriter.ⁿ³

Qualified securities are employer securities (as defined in *IRC 409(l)*) that meet the following requirements:

- (1) the securities must be issued by a domestic C corporation;
- (2) for at least one year before and immediately after the sale, the issuing corporation (and each member of the same controlled group) has no stock outstanding that is readily tradable on an established securities market;
- (3) at the time of the sale, the securities had been held by the seller for at least three years (determined as of the date of the sale); and
- (4) the securities were not received by the seller in a distribution from a qualified retirement plan or a transfer pursuant to an option or other right granted by the employer corporation to acquire its stock.ⁿ⁴

The term "qualified replacement property" means any security issued by a domestic operating company that did not have passive investment income greater than 25 percent of its gross receipts for the taxable year preceding the year of sale, and is not the corporation that issued the stock that was sold to the ESOP (or a member of the same controlled group).ⁿ⁵ For this purpose, a security means (a) stock in a corporation, (b) a right to subscribe for, or to receive, stock in a corporation, or (c) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a domestic corporation.ⁿ⁶

To be an operating corporation, more than 50 percent of the corporation's assets must be used in the active conduct of a trade or business at the time the security is purchased or before the end of the 15-month replacement period.ⁿ⁷ Banks (as defined in *IRC § 581*) and insurance companies subject to tax under Subchapter L are treated as operating corporations.ⁿ⁸ In determining whether a corporation is a domestic operating corporation, (i) if the corporation issuing

the qualified replacement property owns stock representing control of one or more other corporations, (ii) one or more other corporations own stock representing control of the issuing corporation, or (iii) both, then all the corporations will be treated as one corporation.ⁿ⁹

The nonrecognition election must be made by the taxpayer in a statement of election attached to the taxpayer's income tax return filed no later than the due date (with extensions) for the year of sale.ⁿ¹⁰ The statement of election must provide that the taxpayer elects to treat the sale of securities as a sale of qualified securities under *IRC Section 1042(a)*, and contain the following information:

- (1) a description of the qualified securities sold, including the type and number of shares;
- (2) the date of sale of the qualified securities;
- (3) the adjusted basis of the qualified securities;
- (4) the amount realized on the sale;
- (5) the identity of the ESOP to which the qualified securities were sold; and
- (6) if the sale was part of a single, interrelated transaction under a prearranged agreement between taxpayers involving other sales of qualified securities, the names and taxpayer identification numbers of the other taxpayers under the agreement and the number of shares sold by them.

The seller's basis in qualified replacement property is reduced by the amount of gain not recognized under *IRC Section 1042(a)*.ⁿ¹¹ If more than one item of qualified replacement property is purchased, the basis of each item is reduced by an amount determined by multiplying the total gain not recognized by a fraction, the numerator of which is the cost of the item, and the denominator of which is the total cost of all of the qualified replacement property.ⁿ¹²

Gain will be recognized to the extent of the previously unrecognized gain when the electing seller disposes of qualified replacement property.ⁿ¹³ However, no gain need be recognized on a transfer of qualified replacement property (a) in a tax-free reorganization under *IRC Section 368* unless the electing seller owns stock representing control in the acquiring or acquired corporation and the property is substituted basis property in the hands of the transferee, (b) by reason of the death of the electing taxpayer, (c) by gift, or (d) in any transaction to which another election under *IRC Section 1042(a)* applies.ⁿ¹⁴ If a taxpayer owns stock representing control of a corporation that issued qualified replacement property, the taxpayer is treated as having disposed of the qualified replacement property if the corporation disposes of a substantial portion of its assets other than in the ordinary course of its trade or business.ⁿ¹⁵

A special three-year statute of limitations is applied whenever there is an election under *IRC Section 1042(a)*. The period begins whenever the Service receives (i) a notarized statement of purchase of qualified replacement property, (ii) a written statement of the taxpayer's intention not to purchase qualified replacement property within the replacement period, or (iii) a written statement of the taxpayer's failure to purchase qualified replacement property within the replacement period.ⁿ¹⁶

[a] Excise Taxes. The election of nonrecognition treatment under *IRC Section 1042* has the potential of triggering two excise tax provisions. One, *IRC Section 4979A*, applies if there is a prohibited allocation of qualified securities, and is discussed in § 16A.02[4][c]. The second, *IRC Section 4978*, applies if there is a disposition of qualified securities before the end of the minimum three-year holding period.

Under *IRC Section 4978*, if during the three-year period after an ESOP acquired qualified securities in a sale with

respect to which an election under *IRC Section 1042* was made, the ESOP disposes of any qualified securities and (1) the total number of shares held by the ESOP after the disposition is less than the total number of shares held immediately after the sale, or (2) except to the extent provided in regulations, the value of the qualified securities held by the ESOP after the disposition is less than 30 percent of the total value of all employer securities after the disposition, a tax equal to 10 percent of the amount realized is imposed on the employer.ⁿ¹⁷ The amount realized taken into account in determining the amount of tax cannot exceed the portion allocable to qualified securities acquired in the sale to which *IRC Section 1042* applied. This is determined as if the securities were disposed of (1) first from the qualified securities acquired during the three-year period ending on the date of disposition, on a first-in, first-out basis, and (2) then from any other employer securities.ⁿ¹⁸ The amount realized on any distribution to an employee for less than fair market value is determined as if the qualified security had been sold to the employee at fair market value.ⁿ¹⁹

The excise tax does not apply to any distribution or sale of qualified securities made because of (i) the death of the employee, (ii) the retirement of the employee after attaining 59 1/2 years of age, (iii) the disability of the employee (within the meaning of *IRC Section 72(m)(7)*), or (iv) the separation of the employee from service for any period that results in a one-year break in service.ⁿ²⁰ Furthermore, any exchange of qualified securities in a tax-free exchange is not treated as a disposition for purposes of the imposition of the excise tax.ⁿ²¹ Finally, the provision does not apply to any disposition to meet the diversification requirements of *IRC Section 401(a)(28)*.ⁿ²²

[3] Qualified Gratuitous Transfers of Qualified Employer Securities.

IRC Section 664(g) permits the transfer of qualified employer securities to an ESOP by a charitable remainder trust if (a) the transferred securities passed to the charitable remainder trust from a decedent dying before January 1, 1999, (b) no deduction under *IRC Section 404* is allowable with respect to the transfer, (c) the plan contains the provisions discussed below; (d) the plan treats the securities as being attributable to employer contributions without regard to the limitations otherwise applicable to such contributions under *IRC Section 404*, and (e) the employer whose employees are covered by the plan files a verified written statement consenting to the application of *IRC Sections 4978* and *4979A* with respect to the employer.ⁿ¹ In addition, (1) the plan must have been in existence on August 1, 1996, (2) at the time of the transfer, the decedent and members of the decedent's family did not own (directly or indirectly) more than 10 percent of the value of the stock of the employer corporation, and (3) immediately after the transfer, the ESOP owns at least 60 percent of the value of the outstanding stock of the corporation.ⁿ²

The plan must provide the following:

- (1) the qualified employer securities transferred to it are allocated to plan participants in a manner consistent with *IRC Section 401(a)(4)*;
- (2) plan participants are entitled to direct the plan as to the manner in which the securities that are entitled to vote and are allocated to the account of each participant are to be voted;
- (3) an independent trustee votes any securities not allocated to plan participants;
- (4) each participant who is entitled to a distribution from the plan has the right to demand that benefits be distributed in the form of employer securities and that a put option with respect to employer securities that are not traded on an established market be granted;
- (5) the transferred securities are held in a suspense account under the plan to be allocated each year, up to the limitation under *IRC Section 415(c)*, after first allocating all annual additions for the limitation year, up to the limitations under *IRC Sections 415(c)* and (e); and
- (6) on termination of the plan, all securities that are not allocated to plan participants as of the

termination are to be transferred to, or for the use of, an organization described in *IRC Section 170(c)*.ⁿ³

The independent trustee cannot be a member of the decedent's family or a 5-percent shareholder.ⁿ⁴

If any portion of the assets of an ESOP attributable to securities acquired by the plan in a qualified gratuitous transfer are allocated to the account of a person related to the decedent (within the meaning of *IRC Section 267(b)*) or a member of the decedent's family, or to any person who is a 5-percent shareholder of the employer corporation, the plan is treated as having distributed the amount so allocated to such person.ⁿ⁵ This results in that person having to include the amount of the distribution in income. In addition, a tax equal to 50 percent of the amount involved is imposed on the employer corporation.ⁿ⁶

FOOTNOTES:

(n1)Footnote 1. *IRC § 404(a)(1)*. No deduction is allowed for a mere accrual of the amount of the contribution. A deposit into a temporary depository or escrow fund also does not meet the actual payment requirement. *Rev Rul 55-310, 1955-1 CB 45*.

A payment is deemed to have been made on the last day of the preceding taxable year if the payment is on account of that year and is made by the due date for filing the return for the year (including extensions). *IRC § 404(a)(6)*.

(n2)Footnote 2. *IRC § 1032*.

(n3)Footnote 3. *IRC § 404(a)(3)(A)(i)(I)*, effective for taxable years beginning after Dec 31, 2001. For years prior to Jan 1, 2002, the limitation for contributions to an ESOP that was a qualified stock bonus plan was 15%.

(n4)Footnote 4. *IRC § 404(a)(3)(A)(ii)*. Amounts carried over to subsequent years are subject to the 25% limitation. *IRC § 404(a)(7)(B)*.

(n5)Footnote 5. *IRC § 404(a)(3)(A)(iv), (v)*.

(n6)Footnote 6. *IRC 401(a)(17)(A)*, effective for taxable years beginning after Dec 31, 2001. For years beginning after 1993, and ending before 2002, the maximum compensation amount was \$150,000. It was \$200,000 for plan years beginning before 1994. All amounts were adjusted for inflation.

(n7)Footnote 7. *IRC §§ 401(a)(17)(B), 404(l)*.

(n8)Footnote 8. *IRC § 404(k)(1), (3)*. In order to satisfy the requirements of *IRC § 404(k)(1)* and (3), the ESOP must be designated as an ESOP no later than the record date for the dividend; a retroactive designation does not suffice. *Notice 2002-2, 2002-1 CB 285*, Q & A-10.

A plan is not treated as in violation of the requirements of *IRC §§ 401, 409, or 4975(e)(7)*, or as engaging in a prohibited transaction under *IRC § 4975(d)(3)*, merely by paying or distributing an applicable dividend. *IRC § 404(k)(5)(B)*. The distribution of amounts not attributable to dividends from a participant's account does not constitute a payment or distribution under *IRC § 404(k)(2)* and could be treated as violating the requirements of *IRC § 401, 409, or 4975*. *Notice 2002-2*, Q & A-5.

In addition, a plan is not treated as violating the requirements of *IRC §§ 401, 409, or 4975(e)(7)*, or as engaging in a prohibited transaction under *IRC § 4975(d)(3)*, merely by reason of a distribution with respect to S corporation stock that constitutes qualifying employer securities, that in accordance with the plan provisions is used to make payments on a loan described in *IRC § 4975(d)(3)* the proceeds of which were used to acquiring the qualifying employer securities (whether or not allocated to participants). The preceding sentence does not apply in the case of a distribution that is paid with respect to any employer security that is allocated to a participant unless the plan provides that employer securities

with a fair market value of not less than the amount of the distribution are allocated to the participant for the year that (but for the preceding sentence) the distribution would have been allocated to the participant. *IRC § 4975(f)(7)*.

The Service has ruled that no deduction is allowable under *IRC § 404(k)(1)* for payments in redemption of stock held by an ESOP that are used to make distributions to terminating ESOP participants because such payments fall within the provisions of *IRC § 162(k)(1)* (disallowing a deduction for any amount paid or incurred by a corporation in connection with the reacquisition of its stock - See § 5.05[3]). *Rev Rul 2001-6, 2001-1 CB 491* . Although the Court of Appeals for the Ninth Circuit disagreed with *Rev Rul 2001-6* in *Boise Cascade Corp v US*, 329 F3d 751 (9th Cir 2003) , the Service believes *Boise Cascade* was wrongly decided and continues to litigate the issue. Chief Counsel Notice 2004-38 . Its record since then has noticeably improved, with the Courts of Appeals for the Third Circuit, the Eighth Circuit, and the Tax Court, endorsing the Government's position. *Conopco, Inc v US*, 572 F3d 162 (3rd Cir 2009) ; *General Mills, Inc v US*, 554 F3d 727 (8th Cir 2009) ; *Ralston Purina Co v Commr*, 131 TC 29 (2008) , *affd sub nom Nestle Purina Petcare Co v Commr*, 594 F3d 968 (8th Cir 2010) .

(n9)Footnote 9. *IRC § 404(k)(2)(A)*. The participants' election to reinvest the dividend in qualifying employer securities applies only to dividends paid or distributed in tax years beginning after Dec 31, 2001.

The payment or reinvestment of dividends does not constitute an employer contribution, employee contribution, or forfeiture under *IRC § 415(c)(2)*. Therefore, the dividends are not annual additions subject to the annual addition limitation of *IRC § 415(c)(1)*.

(n10)Footnote 10. *IRC § 404(k)(2)(B)*.

(n11)Footnote 11. *Notice 2002-2* , Q & A-3.

(n12)Footnote 12. *IRC § 404(k)(4)(A)*.

(n13)Footnote 13. *IRC § 404(k)(4)(B)*. An election is not considered made until the date the election becomes irrevocable. *Notice 2002-2* , Q & A-4.

(n14)Footnote 14. *IRC § 404(k)(4)(C)*.

(n15)Footnote 15. *Notice 2002-2* , Q & A-5. The guidance provided by Q & A-5 is not applicable for deductions taken in taxable years beginning before Jan 1, 2003.

(n16)Footnote 16. *Notice 2002-2* , Q & A-5.

(n17)Footnote 17. *Notice 2002-2* , Q & A-9.

(n18)Footnote 18. *Id*, citing *Treas Reg § 1.401(a)(4)-4(b)(2)(ii)(2)(B)*.

(n19)Footnote 19. *Notice 2002-2* , Q & A-12.

(n20)Footnote 20. *IRC § 404(k)(5)(A)*.

(n21)Footnote 21. *Notice 2002-2* , Q & A-11.

(n22)Footnote 22. *Id*. The comparison entails an examination of relevant corporate characteristics such as industry, size of the corporation, earnings, debt-equity structure, and dividend history.

(n23)Footnote 23. *Treas Reg § 1.404(k)-3*; *Rev Rul 2001-6, 2001-1 CB 491* .

(n24)Footnote 23.1. The Ninth Circuit allowed the deduction in *Boise Cascade Corp v US*, 329 F3d 751 (9th Cir

2003) . Notwithstanding the position of the Ninth Circuit, the Service has issued regulations under *IRC § 162(k)* that continue to deny the availability of the deduction. *Treas Reg § 1.162(k)-1(a)*. The disallowance provision does not apply to deductions for any of the following: interest, any amount properly allocable to indebtedness and amortized over the term of the indebtedness, dividends paid, or amounts paid or incurred in connection with the redemption of any stock in a regulated investment company that issues only stock that is redeemable upon the demand of the shareholder. *Treas Reg § 1.162(k)-1(a)*.

(n25)Footnote 24. *Notice 2002-2* , Q & A-13.

(n26)Footnote 25. *Id*; *Notice 2001-42*, 2001-2 CB 70 . An amendment does not fail to be a timely good faith amendment solely because it does not address the vesting of dividends with respect to which an election is provided. However, the plan must operate in accordance with the guidance provided by *Notice 2002-2* .

(n27)Footnote 26. *IRC § 404(a)(9)(B)*. Prior to 2002, the deduction limit for contributions made to a stock bonus plan ESOP was 15% of compensation paid or accrued during the taxable year to employees under the plan. However, *IRC § 404(a)(9)(A)* increased the limit to 25% if the contribution was used to repay principal on the securities loan. *IRC § 404(a)(9)(A)* is no longer important because the deduction limitation has been increased to 25% of compensation for all plans.

(n28)Footnote 27. *IRC § 415(c)(2)*.

(n29)Footnote 28. *IRC § 415(c)(6)*.

(n30)Footnote 1. *IRC § 1042(a), (b)(1)(A), (2), (c)(3)*. The excepted preferred stock must be nonvoting and nonconvertible, not participate in corporate growth to any significant extent, and have redemption and liquidation rights that do not exceed the issue price of the stock (except for a reasonable redemption or liquidation premium). *IRC § 1504(a)(4)*.

The 30% ownership test is applied after application of *IRC § 318(a)(4)* (option attribution rule).

(n31)Footnote 2. *IRC § 1042(b)(3)*.

(n32)Footnote 3. *IRC § 1042(c)(5), (7)*.

(n33)Footnote 4. *IRC § 1042(b)(4), (c)(1)*; *Temp Treas Reg § 1.1042-1T*, Q & A-1(b).

The term "readily tradable on an established securities market" generally has the same meaning as "publicly traded" under *Treas Reg § 54.4975-7(b)(1)(iv)*, referring to a security that is listed on a national securities exchange registered under § 6 of the Securities Exchange Act of 1934 or that is quoted on a system sponsored by a national securities association registered under § 15A(b) of the Securities Exchange Act. *Ltr Rul 200052014* ; *Ltr Rul 9036039* .

(n34)Footnote 5. *IRC § 1042(c)(4)(A)*.

(n35)Footnote 6. *IRC §§ 165(g)(2), 1042(c)(4)(D)*.

(n36)Footnote 7. *IRC § 1042(c)(4)(B)(i)*.

(n37)Footnote 8. *IRC § 1042(c)(4)(B)(ii)*.

(n38)Footnote 9. *IRC § 1042(c)(4)(C)(i)*. Control, here, has the meaning given to it in *IRC § 304(c)*, disregarding any qualified replacement property of the taxpayer with respect to the sale being tested. *IRC § 1042(c)(4)(C)(ii)*.

(n39)Footnote 10. *IRC § 1042(c)(6)*; *Temp Treas Reg § 1.1042-1T*, Q & A-3. If the taxpayer has purchased

qualified replacement property at the time of the election, the taxpayer must attach a notarized statement of purchase to the statement of election.

Gain recognition was not allowed in *Estate of Clause v Commr*, 122 TC 115, because the taxpayer did not file the election within the required time period. The taxpayer argued that there had been substantial compliance with the requirements. The court answered by stating that there is no defense of substantial compliance for failure to comply with the essential requirements of the governing statute.

The election to defer gain is a statutory election. Except for the automatic six-month extension under *Treas Reg* § 301.9100-2(b), no other extension can be granted. See, eg, *Ltr Rul* 200519030.

(n40)Footnote 11. *IRC* § 1042(d). The basis of qualified replacement property acquired from a decedent is determined under *IRC* § 1014. *Ltr Rul* 9109024.

The holding period of the qualified securities sold by the taxpayer is tacked onto the holding period of the qualified replacement property. *IRC* § 1223(12).

(n41)Footnote 12. If the qualified replacement property is a debt instrument, the reduction in basis is not treated as market discount under *IRC* § 1278(a)(2)(A)(ii).

(n42)Footnote 13. *IRC* § 1042(e)(1). A transfer of qualified replacement property to a grantor trust will not cause the recapture of deferred gain. *Ltr Rul* 9130027.

(n43)Footnote 14. *IRC* § 1042(e)(3). If a taxpayer who creates a grantor retained annuity trust (GRAT) is treated as the owner of the qualified replacement property held in the GRAT under the grantor trust rules, the transfer of the qualified replacement property to the GRAT is not a disposition of the property under *IRC* § 1042(e). *Ltr Rul* 200709011.

(n44)Footnote 15. *IRC* § 1042(e)(2). Control is determined by applying the rules of *IRC* § 304(c).

(n45)Footnote 16. *IRC* § 1042(f); *Temp Treas Reg* § 1.1042-1T, Q & A-5.

(n46)Footnote 17. *IRC* § 4978(a), (b)(1), (c)(1). *IRC* § 4978 also imposes an excise tax on premature dispositions of qualified employer securities acquired in a qualified gratuitous transfer under *IRC* § 664(g) (see § 16A.03[3]). However, the value of the employer securities held by the ESOP after the disposition cannot be less than 60% of the total value of all employer securities.

(n47)Footnote 18. *IRC* § 4978(b)(2). If the excise tax does not apply because of one of the exceptions specified in *IRC* § 4978(d), the disposition is treated as made from employer securities in the opposite order from the one described in the text.

(n48)Footnote 19. *IRC* § 4978(b)(3).

(n49)Footnote 20. *IRC* § 4978(d)(1).

(n50)Footnote 21. *IRC* § 4978(d)(2).

(n51)Footnote 22. *IRC* § 4978(d)(4).

(n52)Footnote 1. *IRC* § 664(g)(1).

(n53)Footnote 2. *IRC* § 664(g)(2). The decedent's family includes only the decedent's ancestors, spouse, lineal descendants of the decedent and of the decedent's parents and spouse, and spouses of those lineal descendants. Legally

adopted children are treated as children by blood. *IRC § 2032A(e)(2)*.

Indirect ownership by the decedent or the decedent's family is determined under all of the provisions of *IRC § 318(a)*. Ownership by the ESOP is determined after application of *IRC § 318(a)(4)*.

(n54)Footnote 3. *IRC § 664(g)(3)*. If, upon the termination of the ESOP, securities not allocated to plan participants are not transferred to an organization described in *IRC § 170(c)*, a tax is imposed on the employer corporation in an amount equal to the amount of tax that would be imposed if the securities were not transferred to the ESOP, plus interest. *IRC § 664(g)(6)*.

(n55)Footnote 4. A person is a 5% shareholder if, at any time during the one-year period ending on the date of acquisition of qualified employer securities by the ESOP, the person owns (directly or indirectly through application of *IRC § 318(a)*) 5% of the outstanding stock of the employer corporation or a member of the same controlled group. The exception for attribution from an qualified employee trust is disregarded when applying *IRC § 318(a)*. *IRC § 664(g)(5)(B)*.

(n56)Footnote 5. *IRC § 664(g)(5)(A)*.

(n57)Footnote 6. *IRC § 4979A(a)(2), (c)(1)*. See § 16A.03[2][a] for a discussion of the excise tax imposed by *IRC § 4978* in the case of a premature disposition of employer securities acquired in a qualified gratuitous transfer.



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Taxation of Securities Transactions

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CHAPTER 17 Transactions in Bonds and Other Debt Instruments

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§ 17.syn Synopsis to Chapter 17: Transactions in Bonds and Other Debt Instruments

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CHAPTER 17 Transactions in Bonds and Other Debt Instruments

2-17 Taxation of Securities Transactions § 17.01

§ 17.01 Taxable Interest Bonds

[1] Interest Income--Year of Inclusion.

[a] Accrual Basis Taxpayers. It will be remembered that a dividend distribution becomes part of the gross income of the shareholders "when the cash or other property is unqualifiedly made subject to their demands."ⁿ¹ Thus, as a general rule, a dividend is income when received, whether the recipient uses the cash method or accrual method of accounting.

A different rule governs the inclusion of interest by an accrual basis taxpayer who must account for the income in the year in which it accrues, that is, in the taxable year "when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."ⁿ² But even though interest has accrued and the amount thereof accurately determined, there will be no income to include in the year of accrual where collection has become doubtful, as when the debtor has become insolvent or been placed in receivership.ⁿ³ In such case, the interest is returned as income when collectability is assured,ⁿ⁴ a situation which is likely to occur when collection is actually made.

A second departure from the rules governing the reporting of income by an accrual basis taxpayer comes when the debtor pays the interest before it is due. Prepayments are included in gross income for the year in which they are received by the taxpayer, notwithstanding that the accrual of interest is properly made in a subsequent year.ⁿ⁵

[b] Cash Basis Taxpayers.

[i] General Rule. Interest received by a cash basis taxpayer is includable in gross income when actually or constructively received.ⁿ⁶ The payment need not be made in cash; but if made in property, income is received only to the extent that the property received has a fair market value. Thus, in *Andrews v. Commr*,ⁿ⁷ the receipt of scrip in payment of an existing interest obligation was income to the taxpayers since the scrip had an established fair market value, while in *Laing v. Commr*,ⁿ⁸ the payment of accrued interest by the distribution of worthless bonds produced no income for the recipient. However, where the taxpayer received new corporate notes having a face amount equal to the original debt and the unpaid interest thereon, but with a fair market value no greater than the principal of the debt, no income was received until the obligations were satisfied and the interest due paid in cash.ⁿ⁹ Finally, there are instances in which the receipt of a new obligation covering the old debt plus past due interest has been held not to result in income on the ground that the new note represented nothing more than an extension of the prior debt.ⁿ¹⁰

[ii] Constructive Receipt. Income is constructively received by a cash basis taxpayer if "it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given."¹¹ Thus, interest coupons which have matured and are payable, but have not been cashed, are constructively received in the year they mature, unless the obligor had no funds available for the payment of interest during that year.¹² The fact that the taxpayer is physically unable to cash the coupons, say, because of illness, does not change this result.¹³

Holders of certificates of deposit, bonus passbook accounts, or other deposit arrangements involving the deferral of interest for more than one year, must report the interest when credited unless the holder will suffer a penalty for early withdrawal.¹⁴ Any amount forfeited constitutes a loss incurred in a transaction for profit and should be deducted as such.¹⁵

Six-month time deposits that extend beyond the end of the taxable year stand on a different footing. Although the Service first used the doctrine of constructive receipt to hold that a portion of the interest was reported in each of the taxable years in which the six-month term fell, it now takes the position that the existence of a substantial penalty for early withdrawal prevents application of the doctrine and causes all of the income to be earned at maturity.¹⁶ However, if interest is credited throughout the term of the certificate and can be withdrawn without penalty even though the principal cannot, the interest must be included in gross income for the taxable year in which it is credited or made available for withdrawal.¹⁷

An interesting situation--receipt, but not actual or constructive receipt--was presented in *Bates v. Commissioner*,¹⁸ a case involving a deposit of unmatured coupons for collection. The deposit was made in late December of one year; the coupons were to mature on the first day of the succeeding year. The taxpayer reported interest income for the year of deposit pointing to the fact that the bank had credited her account in that year. The Board of Tax Appeals agreed with the Commissioner that the subsequent year was the proper year of inclusion; the action by the bank in crediting the taxpayer's account before maturity was viewed as a loan by the bank to its depositor.

[c] Assignment of Income Problems.

"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."

Thus did Justice Stone begin his opinion in *Helvering v. Horst*,¹⁹ one of the most famous cases in the assignment of income anthology and, for that matter, in all of tax litigation. He concluded by saying:

"When, by the gift of the coupons, [the taxpayer] has separated his right to interest payments from his investment and procured the payment of 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."²⁰

Horst was not concerned with the proper year of inclusion, only with the proper taxable entity; the delivery of the coupons and the payment of interest to the donee occurred in the same year. But suppose they occur in different years. Is the income includable by the donor in the year of gift or in the year in which the donee collects the interest? The answer depends on the taxpayer's method of accounting. If the taxpayer is an accrual basis taxpayer, the interest is includable as it accrues; if a cash basis taxpayer, it is income in the year that it is paid.²¹

The taxpayer cannot completely escape taxation even when there is a gift of the "tree," that is, a gift of the bond itself. Unlike dividends which become income on the date on which the shareholder becomes entitled to the dividend, usually

the record date, interest accrues ratably over the interest period. An assignment of the bond or other evidence of indebtedness between interest dates produces income for the taxpayer to the extent of the interest accrued from the last payment date to the date of assignment.ⁿ²² The year in which the assignor must report this income will again be determined by his method of accounting.

[d] Bonds Purchased "Flat."

The taxpayer who purchases bonds which are in default as to the payment of interest generally purchases them "flat," that is, at a single price with no attempt made to segregate the cost of the bond from the amount of interest in arrears. Because of this, a payment made on account of the past due interest is treated as a return of capital, not as taxable interest income.ⁿ²³ But interest which accrues after the date of purchase will be taxable as interest income in the year accrued or received, depending on the taxpayer's method of accounting.ⁿ²⁴

Does the "flat" purchase doctrine apply where the liability of the obligor to pay interest was contingent? The Third Circuit, in a case involving interest in arrears which could be paid only if interest was paid on certain collateral bonds, held that the payment of the back interest constituted taxable income to the recipient.ⁿ²⁵ The court found support for its position in the fact that a deduction for the interest could not have been taken by an accrual basis taxpayer until the liability therefore was fixed. The Fifth Circuit disagreed.ⁿ²⁶ It thought a decision that declined to make a distinction based upon an inapplicable analogy (whether or not a deduction could be taken) to be better reasoned, and so applied the "flat" purchase rule in a situation in which the back interest could be paid only "if, as, and when earned."

What of the recovery of non-contingent interest accrued before the "flat" purchase, when the recovery exceeds the amount paid for the security by the taxpayer? The Service originally held the excess recovery to be ordinary income, inasmuch as the gain produced thereby was neither gain derived from a sale or exchange of the bond nor an amount received upon the retirement of the bond.ⁿ²⁷ The Government now takes a different position--the excess recovery is treated as an amount received on the retirement of the bond and, thus, as an amount received on the sale or exchange of the bond. And this result obtains "regardless of any expectancy that the principal or face amount of the bonds ultimately will be collected."ⁿ²⁸

Interest which accrues after the acquisition is always taxable as ordinary income, a situation that prevails even when the interest is realized through a sale to a third party rather than by a payment from the obligor.ⁿ²⁹ (Viewed from the purchaser's side, the acquisition is probably a "flat" purchase, permitting him to recover tax-free all of the interest accrued to the date of purchase by him.)

An allocation problem is presented when the amount received on the sale is more than the taxpayer's adjusted basis, but less than the sum of (1) the principal of the bonds, (2) the unpaid portion of the interest in default at the time of purchase, and (3) the interest accrued following purchase. This was the situation presented to the Tax Court in *Jaglom v. Commissioner*,ⁿ³⁰ where proceeds of \$59,747.50 had to be spread across the right to receive a principal sum of \$50,000, unpaid interest in arrears at acquisition of \$2,604.17, and post-acquisition interest of \$11,854.83, or a total of \$64,459. The court found it appropriate to treat \$ 10,988.24 of the amount received from the sale of bonds as ordinary income, arriving at this amount by means of the following formula:

Unpaid interest accrued after purchase	Total recovery on sale of bonds
$\frac{\text{Principal amount of bond} + \text{unpaid portion of interest in default at time of purchase} + \text{unpaid interest accrued after purchase}}{\text{Total recovery on sale of bonds}}$	

[2] Amortization of Bond Premium.

[a] The Election to Amortize Bond Premium. Bond premium is the additional amount a purchaser pays when he acquires a bond at a cost in excess of the face value or call value of the bond, a situation that may occur when the interest rate on the bond exceeds the yield on similar securities in the current market. When a bond is purchased at a premium, the actual interest received is not a true reflection of the bond's yield, but represents, in part, a return of the premium. Because of this, the Code permits a taxpayer, corporate or individual, purchasing wholly taxable bonds at a premium to elect to amortize the premium over the life of the bond.ⁿ¹ This election only relates to taxable interest bonds; there can be no deduction for amortization when the interest on the bond is wholly exempt from tax.ⁿ²

A slightly different treatment applies to taxable obligations acquired after December 31, 1987 (or, if the taxpayer elects, after October 22, 1986). The amount of any bond premium on such obligations must be allocated among the interest payments under rules similar to those in *IRC Section 171(b)(3)* (discussed in § 17.02[5][c]), and in lieu of a deduction, the amount of any premium allocated to any interest payment is applied against (and operates to reduce) the amount of the interest payment.ⁿ³

The regulations recognize only one method of electing to amortize bond premium--the taxpayer must claim a deduction for the premium in his return filed for the first taxable year to which the election is to apply.ⁿ⁴ (This is done by attaching a statement showing the computation of the deduction.ⁿ⁵) The election applies to all wholly taxable bonds owned by the taxpayer at the beginning of the year of election and thereafter acquired by him, and is binding for all subsequent years unless revocation is permitted by the Commissioner.ⁿ⁶ If a holder elects to amortize bond premium and holds a bond acquired before the taxable year in which the election is made, the holder cannot amortize amounts that would have been amortized in prior years had an election been in effect for those prior years.ⁿ⁷

[b] Determining the Amount of Amortizable Bond Premium. In general, bond premium is the excess of the basis for determining loss on the sale or exchange of the bond over the amount payable at maturity, or if the bond is callable, at the earlier call date.ⁿ⁸ However, the computation of bond premium can be made with reference to the earlier date only "if it results in a smaller amortizable bond premium attributable to the period of earlier call date."ⁿ⁹

A holder determines bond premium on a variable rate debt instrument by reference to the stated redemption price at maturity of the equivalent fixed rate debt instrument constructed for the variable rate debt instrument.ⁿ¹⁰ The holder also allocates any bond premium among the accrual periods by reference to the equivalent fixed rate debt instrument. The holder constructs the equivalent fixed rate debt instrument, as of the date the holder acquires the variable rate debt instrument, by using the principles of *Section 1.1275-5(e) of the regulations*, discussed in § 17.02A[2][d].

A holder determines bond premium on an inflation-indexed debt instrument by assuming that there will be no inflation or deflation over the remaining term of the instrument.ⁿ¹¹ The holder also allocates any bond premium among the accrual periods by assuming that there will be no inflation or deflation over the remaining term of the instrument. The bond premium allocated to an accrual period offsets qualified stated interest allocable to the period. If the bond premium allocated to an accrual period exceeds the qualified stated interest allocable to the period, the excess is treated as a deflation adjustment under the rules applicable to inflation-indexed debt instruments.

Special rules apply to determine the yield and remaining payment schedule of bonds subject to contingencies, if the timing and amounts of the payments that comprise the payment schedule are known as of the date the holder acquires the bond (the acquisition date).ⁿ¹² These rules do not apply merely because there is a possibility of impairment of a payment (or payments) by insolvency, default, or similar circumstances.

If, based on all the facts and circumstances as of the acquisition date, a single remaining payment schedule is more likely than not to occur, this remaining payment schedule is used to determine and amortize bond premium.ⁿ¹³ However, the existence of a mandatory sinking fund provision is ignored.ⁿ¹⁴

Special operating rules come into play if the holder or the issuer has an unconditional option or options, exercisable on

one or more dates during the remaining term of the bond, to alter the bond's remaining payment schedule, namely:

- (1) The issuer is deemed to exercise or not exercise an option or combination of options in the manner that minimizes the holder's yield on the obligation. However, the issuer of a taxable bond is deemed to exercise or not exercise a call option or combination of call options in the manner that maximizes the holder's yield on the bond.ⁿ¹⁵
- (2) A holder is deemed to exercise or not exercise an option or combination of options in the manner that maximizes the holder's yield on the bond.ⁿ¹⁶
- (3) If both the issuer and the holder have options, the above rules are applied to the options in the order that they may be exercised.ⁿ¹⁷

If a contingency actually occurs or does not occur, contrary to the assumption originally made, the bond is treated as retired and reacquired on the date of the change in circumstances for an amount equal to the adjusted acquisition price of the bond as of that date.ⁿ¹⁸ If, however, the change in circumstances results in a substantially contemporaneous pro rata prepayment, the pro rata prepayment is treated as a payment in retirement of a portion of the bond.ⁿ¹⁹ Finally, if a change in circumstances results from an issuer's call of a taxable bond or a partial call that is a pro rata prepayment, the holder may deduct as bond premium an amount equal to the excess of the holder's adjusted acquisition price of the bond over the greater of (a) the amount received on redemption, and (b) the amounts that would have been payable under the bond (other than qualified stated interest) if no change in circumstances had occurred.ⁿ²⁰

The premium on a convertible bond can be amortized if the option to convert rests with the holder and the bond is convertible into stock of the issuer, stock or debt of a related party (within the meaning of *IRC Section 267(b)* or *IRC Section 707(b)(1)*), or into cash or other property in an amount equal to the approximate value of the stock or debt.ⁿ²¹ However, the amount of bond premium taken into account cannot include any amount attributable to the conversion features of the bond.ⁿ²² The value of the conversion feature of a particular bond can be determined under any reasonable method.ⁿ²³ For example, the holder of the bond can determine the value of the conversion option by comparing the price of the bond in question with the price of bonds of similar character, but without conversion features, sold on the open market.ⁿ²⁴

There can be no premium to amortize unless the instrument involved is a "bond," a term defined by *IRC Section 171(d)* as "any bond, debenture, note, or certificate or other evidence of indebtedness, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."ⁿ²⁵ Thus, since bonds held by a dealer are not bonds for purposes of *IRC Section 171*, a dealer is not permitted to amortize bond premiumⁿ²⁶ except when the bonds are held for investment and not as inventory. The regulations also exclude a bond described in *IRC Section 1272(a)(6)(C)* (regular interests in a REMIC, qualified mortgages held by a REMIC, and certain other debt instruments, with payments subject to acceleration), a bond to which *Section 1.1275-4 of the regulations* applies (relating to certain debt instruments that provide for contingent payments), and a bond held by a holder that has made an election under *Section 1.1272-3* to treat all interest on the bond as original issue discount.ⁿ²⁷

[c] The Operation of Section 171. *IRC Section 171(b)(2)* provides that "the amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year." For bonds issued after September 27, 1985, amortizable bond premium is determined on the basis of the taxpayer's yield to maturity using the basis of the obligation, and compounding at the close of each accrual period, as defined in *IRC Section 1272(a)(5)*.ⁿ²⁸ If the amount payable on an earlier call date is used in determining the amortizable bond premium attributable to the period before the call date, the bond is treated as maturing on the call date for the amount so payable and then reissued on such date for the amount so payable.ⁿ²⁹

The bond premium allocable to an accrual period is determined under a three-step process.ⁿ³⁰ Within an accrual period, the bond premium allocable to the period accrues ratably.

The first step is to determine the holder's yield, namely, the discount rate that, when used in computing the present value of all remaining payments to be made on the bond (including payments of qualified stated interest), produces an amount equal to the basis in the bond under *Regulations Section 1.171-1(e)*, discussed above.ⁿ³¹ For this purpose, the remaining payments include only payments to be made after the date the holder acquires the bond. The yield is calculated as of the date the holder acquires the bond, must be constant over the term of the bond, and must be calculated to at least two decimal places when expressed as a percentage.

The second step is to determine the holder's accrual period for the bond.ⁿ³² This determination is made in the same manner as the determination of the accrual period for original issue discount.ⁿ³³

The third step calls for determining the bond premium allocable to the accrual period.ⁿ³⁴ The premium so allocable is the excess of the qualified stated interest allocable to the accrual period over the product of the holder's adjusted acquisition price at the beginning of the accrual period and the holder's yield.ⁿ³⁵

If the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, and the bond is a taxable bond, the excess is treated by the holder as a bond premium deduction for the accrual period. However, the amount of the deduction is limited to the amount by which the holder's total interest inclusions on the bond in prior accrual periods exceed the total amount treated by the holder as a bond premium in those periods.ⁿ³⁶ If the bond premium allocable to the accrual period exceeds both the sum of the qualified stated interest allocable to the period and the deduction mentioned in the preceding sentence, the excess is carried forward to the next accrual period and is treated as bond premium allocable to that period.ⁿ³⁷

In addition to the deduction under *IRC Section 171*, the amount of bond premium attributable to the taxable year is applied as an adjustment to the basis of the bond pursuant to *IRC Section 1016(a)(5)*. Thus, it can be seen that no gain or loss will be realized if the taxpayer elects to amortize bond premium and holds the bond to maturity or its earlier call date; the basis of the bond will equal the amount paid on redemption. (This assumes that the election is made for the taxable year in which the bond is acquired; if made in a later year, there is no adjustment to basis on account of the unamortized premium attributable to the period between acquisition and election.) If the election to amortize were not made, there would be no basis adjustment and the difference between the shareholder's cost for the bond and the amount received on redemption would be treated as a capital loss. Clearly, then, the election to amortize bond premium will almost always produce the better tax result, inasmuch as it offsets ordinary income rather than capital gains.

The foregoing rules can be illustrated by the following examples, each of which assumes (1) a calendar year taxable year; (2) the use of the cash receipts and disbursements method of accounting in the first two examples and the accrual method in the third; (3) a 30-day month; and (4) a 360-day year:

Example 1:

On March 1, 2000, A paid \$2,200,000 for a \$2 million taxable bond, payable at maturity on March 1, 2007, and providing for the payment of qualified stated interest of \$200,000 on March 1 of each year. A decided to use an annual accrual period ending on March 1 of each year. Payments on the bond other than interest amount to \$200,000, causing the amount of bond premium to be \$200,000.

Based upon the remaining payment schedule and A's basis in the bond, A's yield to maturity is approximately 8.07 percent, compounded annually.ⁿ³⁸ The bond premium allocable to the accrual period ending on March 1, 2001 is the excess of the \$200,000 qualified state interest allocable to the

period over \$177,637 (the product of the \$2,200,000 adjusted acquisition price at the beginning of the period and A's yield, compounded annually), or \$22,363. Thus, A need only include in income \$177,637 of the qualified stated interest payment received on March 1, 2001. A's basis in the bond is reduced by the \$22,363 amortizable bond premium on March 1, 2001.

Example 2:

The facts are the same as in Example 1, except that A decided to use semiannual accrual periods ending on March 1 and September 1 of each year. This causes A's yield to maturity to be approximately 7.92 percent, compounded semiannually. The bond premium allocable to the period ending September 1, 2000 is the excess of the \$100,000 qualified stated interest allocable to the period over \$87,094 (the product of the \$2,200,000 adjusted acquisition price at the beginning of the period and A's yield adjusted for the length of the period), or \$12,906. Although the accrual period ends on September 1, 2000, the qualified stated interest of \$100,000 and the bond premium or \$12,906 are not taken into account until March 1, 2001. However, the basis of the bond is adjusted on September 1, 2000 to reflect the amount of bond premium allocable to the six-month period (\$2,200,000 less \$12,906, or \$2,187,094).

Because the time between payments of qualified stated interest contains more than one accrual period, the adjusted acquisition price at the beginning of the second accrual period must be adjusted for the accrued but unpaid interest. Thus, the adjusted acquisition price on September 1, 2000 (\$2,187,094) must be increased by \$100,000. The bond premium allocable to the period ending March 1, 2001 is the excess of the \$100,000 qualified interest payment allocable to the period over the product of the \$2,287,094 adjusted acquisition price at the beginning of the period and the yield to maturity taking into account the length of the accrual period, or \$9,458. Although A received an interest payment of \$200,000 on March 1, 2001, the amount that A must include in income is only \$177,636 (\$200,000 qualified stated interest, less \$12,906 bond premium allocable to the first accrual period and \$9,458 bond premium allocable to the second accrual period). It should be noted that, except for a miniscule difference due to rounding off to the nearest dollar, the amount and timing of income is the same as in Example 1.

Example 3:

Assume the same facts as in Example 1, except that A uses the accrual method of accounting. Because the accrual period ending March 1, 2001 extends beyond the end of A's taxable year, the amount of qualified stated interest and the amount of bond premium must be allocated between two taxable years.

The qualified stated interest for the first taxable year (2000) is \$152,778 ($\$200,000 \times 10/12$). The bond premium allocable to the first taxable year is \$18,636 ($\$22,363 \times 10/12$). For that year A's interest income from the bond is \$134,142 (\$152,778 stated interest less \$18,636 bond premium). A's basis in the bond is reduced by \$18,636 in 2000. The remaining amounts of qualified stated interest and bond premium for the accrual period ending March 1, 2001 are taken into account for the taxable year ending December 31, 2001.

Where the amortizable bond premium of a bond with a call date has been computed with reference to the maturity date and not the earlier call date, and the bond is in fact called before maturity, the taxpayer is allowed an ordinary deduction for any unamortized premium.ⁿ³⁹ This has the effect of placing the taxpayer in the position he would have been in had he fully amortized the bond to maturity.

The foregoing discussion has assumed that the purchase of the bond at a premium was a bona fide transaction. It is axiomatic that there can be no deduction for amortization of bond premium where the transaction is so lacking in substance that it is a mere sham.ⁿ⁴⁰ For example, the purchase of a bond at a premium, followed by a sale to the taxpayer's wife at a higher price six months and one day later, and then by a sale from wife to taxpayer less than two

months thereafter, netted the taxpayer in *Lieb v. Commissioner*,ⁿ⁴¹ an amortization deduction just for the premium on the original purchase.

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.301-1(b)*.

(n2)Footnote 2. *Treas Reg § 1.451-1(a)*. However, even an accrual basis taxpayer does not report the discount earned on a short-term, noninterest-bearing government obligation issued at a discount until paid at maturity or earlier sold. *IRC § 454(b)*; *Treas Reg § 1.454-1(b)*.

(n3)Footnote 3. Eg, *Corn Exchange Bank v US*, 37 F2d 34 (2d Cir 1930) ; *Turners Falls Power and Elec Co v Commr*, 15 BTA 983 (1929) , *nonacq* VIII-2 CB 72 (1929).

Nonpayment on the due date is not the equivalent of doubtful collection if the corporation is a going concern and the evidence establishes a reasonable expectancy of payment in the future. See, eg, *Greer-Robbins Co v Commr*, 119 F2d 92 (9th Cir 1941) . Nor is collection placed in doubt merely because payment cannot be made until another obligation is satisfied. *Missisquoi Corp v Commr*, 1943 Tax Ct Memo LEXIS 68 .

(n4)Footnote 4. *Clifton Mfg Co v Commr*, 137 F2d 290 (4th Cir 1943) .

(n5)Footnote 5. *Jefferson Standard Life Ins Co v US*, 408 F2d 842 (4th Cir 1969) , *cert denied* 396 US 828 ; *Rev Rul 58-225*, 1958-1 CB 258 .

(n6)Footnote 6. *Treas Reg § 1.451-1(a)*. Interest on money deposited with a stock broker, that could be used only to offset commissions due the broker on subsequent stock transactions in the investor's account, was not includable in the investor's account until applied towards the commissions. *Rev Rul 79-247*, 1979-2 CB 247 . The ruling applies both to cash basis and accrual method taxpayers.

(n7)Footnote 7. 46 BTA 607 (1942) , *nonacq* on the issue of value 1942-1 CB 19 , *remanded for a new determination of value*, 135 F2d 314 (2d Cir 1943) , *cert denied* 320 US 748 .

(n8)Footnote 8. 22 BTA 380 (1931) , *acq* X-1 CB 36 (1931).

(n9)Footnote 9. *Paine v Commr*, 25 BTA 764 (1932) , *acq* XI-1 CB 5 (1932).

(n10)Footnote 10. *Mellinger v US*, 21 F Supp 964 (Ct Cl 1938) ; IT 3342, 1940-1 CB 58. See also § 8.08[4][a][ii].

(n11)Footnote 11. *Treas Reg § 1.451-2(a)*.

(n12)Footnote 12. *Treas Reg § 1.451-2(b)*. The holder of a long-term savings certificate, who loses his right to all accrued interest if he makes a premature withdrawal, constructively receives income in the year in which the original term of the certificate expires. *Rev Rul 73-220*, 1973-1 CB 297 . The taxpayer holding an unmatured short-term savings certificate on the last day of a taxable year is in constructive receipt of income in the amount he would have received if he redeemed the certificate on the last day of such year. *Rev Rul 73-221*, 1973-1 CB 298 ; see also *Rev Rul 66-45*, 1966-1 CB 95 .

(n13)Footnote 13. *Loose v US*, 74 F2d 147 (8th Cir 1934) ; but see *Suhr v Commr*, 4 BTA 1198 (1926) where the taxpayer was not required to include interest until received since the bonds and coupons were located in Germany and could not be obtained until the end of World War I.

(n14)Footnote 14. *Treas Reg § 1.451-2(a)(2)*. A penalty exists if a withdrawal of funds during the taxable year would result in the receipt of substantially less earnings than would be realized if the deposit remained intact until

maturity.

(n15)Footnote 15. *Rev Rul 73-511, 1973-2 CB 402* . The deduction reduces gross income to arrive at adjusted gross income. *IRC § 62(a)(11)*.

(n16)Footnote 16. *Rev Rul 80-157, 1980-1 CB 186* , superseding *Rev Rul 79-72, 1979-1 CB 278* ; *Treas Reg § 1.451-2(a)(2)*.

(n17)Footnote 17. *Rev Rul 80-157* , N 16, *supra*.

(n18)Footnote 18. *4 BTA 1079 (1926)* .

(n19)Footnote 19. *311 US 112 (1940)* .

(n20)Footnote 20. *311 US at 120 (1940)* . The same result was reached in *Rev Rul 58-275, 1958-1 CB 22* , where the taxpayer held a refunded bond and "back-interest" coupons issued by the Japanese government in replacement of certain defaulted bonds and interest. Since the coupons represented interest income that was due the taxpayer, a gift of the coupons was an anticipatory assignment of that interest.

(n21)Footnote 21. *Rev Rul 58-275, 1958-1 CB 22* ; *Rev Rul 72-312, 1972-1 CB 22* .

If the gift is of matured coupons, the proper year of inclusion is the year in which the cash basis taxpayer had a right to collect the interest (the year of constructive receipt).

(n22)Footnote 22. *Austin v Commr, 161 F2d 666 (6th Cir 1947)* , *cert denied 332 US 767* ; *Rev Rul 72-312, 1972-1 CB 22* . A contrary result was reached in *Commr v Timken, 141 F2d 625 (6th Cir 1944)* , where the taxpayer gave a charity a note issued by his brother. The interest then accrued on the note could not have been paid by the brother, but was paid in the two years following the year of gift. The no-income result was based on the ground that, in view of the brother's financial condition at the time of gift, the taxpayer had not received an economic benefit in the year of gift. The result seems unsound, especially in light of the short period between gift and payment of interest.

(n23)Footnote 23. *Treas Reg § 1.61-7(b)(3)(C)*; *Horst v US, 331 F2d 879 (Ct Cl 1964)* ; *Hewitt v Commr, 30 BTA 962 (1934)* , *acq XIII-2 CB 9 (1934)*. The rule has been applied with respect to municipal bonds purchased "flat." *Clyde C Pierce Corp v Commr, 120 F2d 206 (5th Cir 1941)* ; *R O Holton & Co v Commr, 44 BTA 202 (1941)* .

(n24)Footnote 24. *Treas Reg § 1.61-7(b)(3)(C)*; *Tobey v Commr, 26 TC 610 (1956)*, *acq 1956-2 CB 8*.

(n25)Footnote 25. *National City Lines, Inc v US, 197 F2d 754 (3d Cir 1952)* .

(n26)Footnote 26. *Campbell v Sailer, 224 F2d 641 (5th Cir 1955)* .

(n27)Footnote 27. *Rev Rul 55-433, 1955-2 CB 515* .

(n28)Footnote 28. *Rev Rul 60-284, 1960-2 CB 464, 465* , revoking *Rev Rul 55-433* . The reversal of position came after the Tax Court's decision in *Estate of Rickaby v Commr, 27 TC 886 (1957)*, *acq 1960-2 CB 6*.

(n29)Footnote 29. See, eg, *First Kentucky Co v Gray, 309 F2d 845 (6th Cir 1962)* ; *US v Langston, 308 F2d 729 (5th Cir 1962)* ; *Fisher v Commr, 209 F2d 513 (6th Cir 1954)*, *cert denied 347 US 1014*. In *Fisher*, the taxpayer was the original holder, not a person who purchased the bonds "flat."

(n30)Footnote 30. *36 TC 126 (1961)*, *affd 303 F2d 847 (2d Cir 1962)*.

(n31)Footnote 1. An exempt private foundation that amortizes bond premium pursuant to *IRC § 171* can deduct the

amortized amount in computing its net investment income under *IRC* § 4940 and its adjusted net income under *IRC* § 4942. *Rev Rul* 76-248, 1976-1 CB 353 . *IRC* § 171(a)(1), (c)(1)(B).

See § 19.05[1][j] for a discussion of the treatment of bond issuance premium by the issuer of the bond.

(n32)Footnote 2. *IRC* § 171(a)(2). There is a limited exception applicable to dealers. See Ch 18.

(n33)Footnote 3. *IRC* § 171(e).

(n34)Footnote 4. *Treas Reg* § 1.171-4(a)(1). An election made in a timely filed refund claim was held to be improperly made in *Barnhill v Commr*, 241 F2d 496 (5th Cir 1957) .

If the bonds are owned by a partnership, common trust fund, estate, or trust, the election is exercisable by the fund or fiduciary. *IRC* § 171(c)(2).

(n35)Footnote 5. *Treas Reg* § 1.171-4(a)(1).

(n36)Footnote 6. *Treas Reg* § 1.171-4(d). Where taxable bonds are sold at a profit and similar bonds are immediately purchased at a premium, the taxpayer may elect to amortize the premium paid on the newly purchased bonds. *Rev Rul* 55-353, 1955-1 CB 381 .

(n37)Footnote 7. *IRC* § 171(b)(1)(C); *Treas Reg* § 1.171-4(c)(1).

(n38)Footnote 8. *IRC* § 171(b)(1)(A), (B)(i). Payments of qualified stated interest do not figure into the determination of bond premium. *Treas Reg* § 1.171-1(d).

(n39)Footnote 9. *IRC* § 171(b)(1)(B)(ii).

(n40)Footnote 10. *Treas Reg* § 1.171-3(a).

(n41)Footnote 11. *Treas Reg* § 1.171-3(b). See § 17.02B for a discussion of inflation-indexed debt instruments.

(n42)Footnote 12. *Treas Reg* § 1.171-3(c)(1). Contingent debt instruments are the subject of § 17.02A[2][b].

(n43)Footnote 13. *Treas Reg* § 1.171-3(c)(2).

(n44)Footnote 14. *Treas Reg* § 1.171-3(c)(3).

(n45)Footnote 15. *Treas Reg* § 1.171-3(c)(4)(ii)(A).

(n46)Footnote 16. *Treas Reg* § 1.171-3(c)(4)(ii)(B).

(n47)Footnote 17. *Treas Reg* § 1.171-3(c)(4)(ii)(C).

(n48)Footnote 18. *Treas Reg* § 1.171-3(c)(5)(i).

(n49)Footnote 19. A pro rata prepayment is a payment on a debt instrument made prior to maturity that (a) is not made pursuant to the instrument's payment schedule, and (b) results in a substantially proportional reduction in each payment remaining to be paid on the debt instrument. *Treas Reg* § 1.1275-2(f)(2).

(n50)Footnote 20. *Treas Reg* § 1.171-3(c)(5)(ii).

(n51)Footnote 21. *Treas Reg* § 1.171-1(e)(1)(iii)(C).

(n52)Footnote 22. *IRC § 171(b)(1)*; *Treas Reg § 1.171-1(e)(1)(iii)(A)*. If the convertible bond is acquired in an exchange that is not a reorganization, the holder's basis in the bond cannot exceed its fair market value immediately after the exchange reduced by the value of the conversion feature. *Treas Reg § 1.171-1(e)(1)(iii)(B)*.

(n53)Footnote 23. *Treas Reg § 1.171-1(e)(1)(iii)(A)*.

(n54)Footnote 24. *Treas Reg § 1.171-1(e)(1)(iii)(A)*.

(n55)Footnote 25. Premium on obligations issued on or before Sept 27, 1985 is amortizable only if the obligation is an interest-bearing obligation issued by a corporation, or government or political subdivision.

(n56)Footnote 26. Dealers in securities can take a deduction with respect to bond premium on certain tax-exempt municipal bonds. *IRC § 75*, discussed in § 18.04[3][a].

(n57)Footnote 27. *Treas Reg § 1.171-1(b)(2)(i), (ii), (iii)*.

(n58)Footnote 28. *IRC § 171(b)(3)(A)*. If a bond is acquired after May 6, 1986, in exchange for property and the bond has a substituted basis, the basis of the bond is limited to its fair market value. A similar rule applies if the bond is transferred to another who must retain the transferor's basis (as in the case of a gift). *IRC § 171(b)(4)(A)*. The last-mentioned rule does not apply to a bond-for-bond exchange that is part of a tax-free reorganization. *IRC § 171(b)(4)(B)*.

A distribution by a partnership of a taxable bond, issued by an unrelated corporation, to a partner in liquidation of a partnership interest is an exchange for purposes of *IRC § 171(b)(4)*. Therefore, for purposes of *IRC § 171(b)*, the partner's basis in the bond is limited to the bond's fair market value immediately after the exchange. The partner's basis in the bond for other purposes is determined under *IRC § 732*. *Rev Rul 95-24, 1995-1 CB 14*.

In the case of bonds issued on or before Sept 27, 1985, the amount of amortization depends on whether the taxpayer regularly employs a reasonable method of amortizing bond premiums.

(n59)Footnote 29. *IRC § 171(b)(3)(B)*.

(n60)Footnote 30. *Treas Reg § 1.171-2(a)(3)*.

(n61)Footnote 31. *Treas Reg § 1.171-2(a)(3)(i)*.

(n62)Footnote 32. *Treas Reg § 1.171-2(a)(3)(ii)*.

(n63)Footnote 33. See *Treas Reg § 1.1272-1(b)(1)(ii)*.

(n64)Footnote 34. *Treas Reg § 1.171-2(a)(3)(iii)*.

(n65)Footnote 35. The adjusted acquisition price of a bond at the beginning of the first accrual period is the holder's basis. Thereafter, the adjusted acquisition price is the holder's basis decreased by the amount of any bond premium allocable to an accrual period and the amount of any payment previously made on the bond other than a payment of qualified stated interest. *Treas Reg § 1.171-2(b)*.

(n66)Footnote 36. *Treas Reg § 1.171-2(a)(4)(i)(A)*. The deduction is not subject to the 2-percent floor on miscellaneous itemized deductions.

(n67)Footnote 37. *Treas Reg § 1.171-2(a)(4)(i)(B)*.

(n68)Footnote 38. The yield to maturity is approximate because it has been rounded to two decimal places. The

dollar amounts in the examples use the correct yield, with the amounts rounded to the nearest dollar.

(n69)Footnote 39. *IRC § 171(b)(2)*. A taxpayer, who had not amortized all of the premium not attributable to the conversion feature of a convertible bond, was not allowed to deduct the unamortized portion in the year that the bond was converted into common stock. The application of § 171(b)(2) was limited to the situation in which the bond was called by the issuer. *Ades v Commr*, 38 TC 501 (1962) , *affd per curiam* 316 F2d 734 (2d Cir 1963) .

(n70)Footnote 40. *Treas Reg §§ 1.171-1(a)(1), 1.1275-2(g)*; see also *Rev Rul 62-127, 1962-2 CB 84* .

(n71)Footnote 41. *40 TC 161 (1963)* .



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Taxation of Securities Transactions

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CHAPTER 17 Transactions in Bonds and Other Debt Instruments

2-17 Taxation of Securities Transactions § 17.02

§ 17.02 Tax-Exempt Interest Bonds

[1] State and Local Bonds--In General.

Interest on state and local bonds--obligations issued by a state or political subdivision thereof, or by the District of Columbia or any possession of the United States,ⁿ¹ is excluded from gross income by Section 103(a).ⁿ² For this purpose, a political subdivision denotes any governmental division delegated the right to exercise part of the sovereign power of a state or possession of the United States.ⁿ³ Thus, the term "political subdivision" may include special assessment districts,ⁿ⁴ bridge and tunnel authorities,ⁿ⁵ turnpike authorities,ⁿ⁶ as well as public corporations formed to promote public purposes (e.g., rapid transit or other community improvements).ⁿ⁷

To be exempt, the interest must be interest on an obligation issued in the exercise of the borrowing power of the states.ⁿ⁸ Therefore, the exemption does not extend to interest on a tax refundⁿ⁹ or to interest on a condemnation award.ⁿ¹⁰ Moreover, it might not apply even though the interest is derived from an obligation issued by a local government unit; for example, interest on bonds issued by New York City and guaranteed by the federal government under title I of the New York City Loan Guarantee Act of 1978 is taxable.ⁿ¹¹ But this does not mean that interest will automatically be taxable because the obligation is issued by a private corporation formed to facilitate borrowing. If the obligation can still be considered as issued in the exercise of the borrowing power of a state or local government, the interest derived therefrom will be exempt.ⁿ¹² (*IRC Section 7478* allows the issuer of prospective obligations to petition the Tax Court for a declaratory judgment in a case of actual controversy involving a determination by the Service, or the failure of the Service to make a determination whether the obligations will be tax exempt.ⁿ¹³ The declaratory judgment cannot be issued unless the issuer has exhausted all available administrative remedies within the Service.)

The exclusion provided by *IRC Section 103* is applicable only when the item received can be classified as interest or its equivalent.ⁿ¹⁴ Thus, bond discount earned to maturity is interest, but a redemption premium, or a payment on account of interest in arrears when a bond is purchased "flat," is not.ⁿ¹⁵

Interest on a registration-required bond cannot be tax-exempt unless the bond is in registered form.ⁿ¹⁶ A registration-required bond is any bond other than a bond which (1) is not of a type offered to the public, or (2) has a maturity at issue, of not more than 1 year.ⁿ¹⁷

An obligation is in registered form if one of the following 3 requirements is met:ⁿ¹⁸

(1) The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder.

(2) The right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer (or its agent). An obligation is transferable through a book entry system if the ownership of an interest in the obligation is required to be reflected in a book entry, whether or not physical securities are issued. A book entry is a record of ownership that identifies the owner of an interest in the obligation.ⁿ¹⁹

(3) The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred through both of the methods described in paragraphs (1) or (2) above.

An obligation not registered in accordance with the rules described above is in bearer form.ⁿ²⁰

A number of special exceptions affect the application of the interest exclusion. The first limits the exemption to obligations that meet the rules prescribed by the Code.ⁿ²¹ Bonds issued before 1984 were sometimes made tax exempt by the act authorizing their issuance.ⁿ²²

The second, with some exceptions,ⁿ²³ removes tax-exempt status from municipal obligations that are federally guaranteed.ⁿ²⁴ An obligation is federally guaranteed if (1) the payment of principal or interest on the obligation is guaranteed in whole or in part by the United States (or an agency or instrumentality thereof), or (2) 5 percent or more of the proceeds of the issue of which the obligation is a part is to be used to make loans that are guaranteed or is to be invested in federally insured deposits or accounts.ⁿ²⁵

By far the most important exceptions are those relating to private activity bonds that are not qualified bonds and arbitrage bonds. A discussion of private activity bonds and arbitrage bonds follows.

[2] Private Activity Bonds.

[a] The Scope of Section 141.ⁿ¹ With certain exceptions, private activity bonds cannot be categorized as obligations issued by a governmental unit,^{n1.1} causing the interest on such bonds to be fully taxable.ⁿ² Under *IRC Section 141*, an obligation is a private activity bond when either (1) (a) more than 10 percent of the proceeds of the issue of which the obligation is a part are to be used, directly or indirectly, in a trade or business carried on by a person other than a governmental unitⁿ³ (the "private business use" test),ⁿ⁴ and (b) the payment of the principal of or interest on, more than 10 percent of the issue the bond is, directly or indirectly (i) secured by any interest in property used in a private trade or business, (ii) secured by any interest in payments in respect of such property, or (iii) to be derived from payments made in respect of property or borrowed money used for a private business use (the "private security or payment" test)ⁿ⁵ or (2) more than 5 percent of the proceeds of the issue, or \$5 million if less, are used to make loans to persons other than governmental units (the "private loan financing test").ⁿ⁶

According to the regulations, a bond is a private activity bond if the issuer reasonably expects, as of the issue date, that the issue will meet either the private business use test or the private loan financing test over the entire stated term of the issue.ⁿ⁷ In general, the reasonable expectations test must take into account reasonable expectations about events and actions over the entire term of the lease.ⁿ⁸ An action that is reasonably expected as of the issue date, to occur after the issue date and to cause either of the tests to be met may be disregarded if:

(1) the issuer expects, as of the issue date, that the financed property will be used for a governmental

purpose for a substantial period before the action;

(2) the issuer is required to redeem all nonqualifying bonds (regardless of the amount of disposition proceeds actually received) within six months of the date of the action;

(3) the issuer does not enter into any arrangement with a nongovernmental person, as of the issue date, with respect to that specific action; and

(4) the mandatory redemption of the bonds meets all of the conditions for remedial action under *Regulations Section 1.141-12(a)*.ⁿ⁹

A bond is also a private activity bond if the issuer takes a deliberate action, subsequent to the issue date, that causes either the private business use test or the private loan financing test to be met.ⁿ¹⁰ A deliberate action is any action taken by the issuer that is within its control and occurs when the issuer enters into a binding contract with a nongovernmental person for the use of the financed property that is not subject to any material contingencies.^{n10.1} However, an action is not treated as a deliberate action if it would be treated as an involuntary or compulsory conversion under *IRC Section 1033*, or it is taken in response to a regulatory directive made by the federal government.^{n10.2} In addition, remedial action, as defined in *Regulations Section 1.141-12* can prevent a deliberate action from causing an issue to meet the private business use or private loan financing tests.^{n10.3}

In determining whether an issue meets the private security or payment test, the present value of the payments or property taken into account is compared to the present value of the debt service to be paid over the term of the issue.ⁿ¹¹ Present values are determined using the yield on the issue as the discount rate and by discounting all amounts to the issue date.^{n11.1} For a fixed yield issue, yield is determined on the issue date and is not adjusted to take into account subsequent events.^{n11.2} The yield on a variable yield issue is determined over the term of the issue.^{n11.3}

Both direct and indirect payments made by a nongovernmental person using the proceeds of an issue are taken into account as private payments to the extent allocable to the proceeds used by that person and only to the extent that they are made for the period of time that proceeds are used for a private business purpose.^{n11.4} Payments for the use of proceeds include payments (whether or not to the issuer) in respect of property financed (directly or indirectly) with those proceeds, even if not made by a private business user. Payments are not made in respect of financed property if those payments are not directly allocable to other property being directly used by the person making the payments and those payments represent fair market value compensation for that other use.

Payments with respect to proceeds that are used for a private business use are not taken into account to the extent that the present value of those payments exceeds the present value of the debt service on those proceeds.^{n11.5} Payments for the use of proceeds do not include the portion of any payment that is properly allocable to the payment of ordinary and necessary expenses directly attributable to the operation and maintenance of the financed property used by that person.^{n11.6}

Payments of debt service on an issue to be made from the proceeds of a refunding issue are taken into account as private payments in the same proportion that the present value of the payments for the refunding issue bears to the present value of the debt service to be paid on the refunding issue.^{n11.7} This rule does not apply to deliberate actions that occur more than three years after the retirement of the prior issue that are not reasonably expected on the issue date of the refunding issue.

Private payments for the use of property are allocated to the source or different sources of funding of property based upon all of the facts and circumstances, including whether an allocation is consistent with the purposes of *IRC Section 141*.^{n11.8} As a general rule, a private payment is allocated to a source of funding based upon the nexus between the funding and both the financed property and the source of funding. Payments for the use of a discrete facility are

allocated to the source or different sources of funding of that discrete property.^{n11.9}

Under the private security test, property that is the security for, or the source of, the payment of debt service on an issue need not be financed with the proceeds of an issue.^{n11.10} However, private security (other than financed property and private payments) for an issue is taken into account only to the extent it is provided, directly or indirectly, by a user of the financed property. Generally, property or payments from the disposition of that property that are taken into account as private security are allocated to each issue secured by the property or payments on a reasonable basis that takes into account bondholders' rights to the payments or property upon default.^{n11.11}

For purposes of the private security or payment test, generally applicable taxes are not treated as payments from a nongovernmental person and are not payments in respect of property used for a private business use.^{n11.12} A generally applicable tax is defined as an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue to be used for governmental purposes.^{n11.13} It must have a uniform tax rate that is applied to all persons of the same classification in the appropriate jurisdiction and a generally applicable manner of determination and collection.^{n11.14} A special charge or special charge or special assessment is not a generally applicable tax.^{n11.15}

Any transaction that is generally characterized as a loan for federal income tax purposes is a loan for purposes of the private loan financing test.^{n11.16} In addition, a loan may arise from the direct lending of bond proceeds or may arise from transactions that provide indirect benefits that are the economic equivalent of a loan.

A prepayment for property or services, including a prepayment for property or services that is made after the date the contract is entered into, is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller.ⁿ¹² A prepayment is not treated as a loan for purposes of the private loan financing test if (1) prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing (customary payment); (2) the prepayment is made within 90 days of the reasonably expected date of delivery of all of the property or services for which the prepayment is made; or (3) the prepayment is made to acquire a supply of natural gas or electricity. The determination of whether a prepayment is a customary payment is generally based on all the facts and circumstance. In addition, a prepayment is treated as a customary payment if it is made for certain maintenance, repair, or extended warranty purposes.

Special 5 percent private business use and private security tests are applied if the amount of private use being financed with an issue is unrelated or disproportionate to a governmental use also being financed.ⁿ¹³ The related use restriction can be illustrated by the following example:

Example:

County X issues \$20 million of bonds for the construction of a new school building and decides to use \$18 million of the proceeds for the construction of the new building and \$2 million for the construction of a privately owned cafeteria in the county's office building. More than 5 percent of the proceeds are being devoted to a use that is not related to the governmental use (school construction) being financed with the bonds; the interest on the bonds is taxable. Had only \$1 million been used to finance construction of the cafeteria, the related use restriction would have been satisfied since the amount of unrelated use financing would not have exceeded 5 percent.

The interplay of the related use restriction and the private loan financing test can be seen in the following example:

Example:

County Y issues \$50 million of bonds for construction of a new public safety building (\$32 million) and for improvements to an existing courthouse (\$15 million). The county also decides to use \$3 million of

the bond proceeds for renovation of an existing privately operated cafeteria in the courthouse. County Y's use of the \$3 million for the cafeteria does not cause the interest on the bonds to be taxable. The expenditures for the cafeteria are treated as being derived first from the permitted related private use portion (\$2.5 million) and then from the unrestricted private use portion (\$500,000).

In determining whether the private business activity, private security or payment, or private loan financing tests are met, the portion of the proceeds of an issue that, if issued as a separate issue would be treated as a qualified 501(c)(3) bond, are not taken into account if the issuer elects to treat such portion as a qualified 501(c)(3) bond.ⁿ¹⁴

Incidental uses of a facility are disregarded in determining whether the private business tests are met.ⁿ¹⁵ A use of a facility by a person is an incidental use if (a) the use does not involve the transfer to the person of possession and control over space that is separated from other area of the facility by walls, partitions or other physical barriers, (b) the use is not related to another use of the facility by the same person, other than the type of use described in (a), and (c) all incidental uses do not involve the use of more than 2 1/2 percent of the facility. A newsstand in a common area of an office building is an example of an incidental use that can be disregarded for purposes of the private business test.

Proceeds of an issue to be used to finance any qualified improvement are not treated as proceeds devoted to a private business use.ⁿ¹⁶ An improvement is a qualified improvement if:

- (1) The building was placed in service more than one year before the construction or acquisition of the improvement is begun;
- (2) No portion of the improved facility or any payments in respect thereof are taken into account under *IRC Section 141(b)(2)(A)* (the private security interest test);
- (3) The improvement does not result in the enlargement of the facility;
- (4) No more than 15 percent of the facility is used for any private business use; and
- (5) The improvement is not made to any interior space occupied exclusively for any private business use.

Use as a member of the general public (general public use) is not private business use.^{n16.1} Use of financed property by nongovernmental persons in their trades or businesses is treated as general public use only if the property is intended to be available, and, in fact, is reasonably available for use on the same basis by natural persons not engaged in a trade or business.

The regulations provide three special rules for use by nongovernmental persons under short-term arrangements. The first provides that an arrangement is not treated as general public use if the term of use of the arrangement, including renewal options, is greater than 200 days.^{n16.2} The second states that use by a nongovernmental person under an arrangement (other than one resulting in ownership of financed property by a nongovernmental person) that is not available for use on the same basis by natural persons not engaged in a trade or business is not private business use if the use under the arrangement, including renewal options, is not longer than 100 days.ⁿ¹⁷ The third applies to an arrangement (other than an arrangement resulting in the use of financed property by a nongovernmental person) that is a negotiated arm's length arrangement and provides for compensation at fair market value.ⁿ¹⁸ The term of use in the last case cannot be longer than 50 days.^{n18.1}

IRC Section 141(d) treats a bond issue as a private activity bond issue if the amount of the proceeds of the issue used by a governmental unit to acquire nongovernmental use property exceeds the lesser of 5 percent of the proceeds or \$5 million. A nongovernmental output facility is defined as property that, after October 13, 1987 and before its acquisition by a governmental unit, was used or held for use by a person other than a state or local government in connection with

an output facility within the meaning of *IRC Section 141(b)(4)* (other than a facility for the furnishing of water).

Two exceptions are provided. Nongovernmental output property does not include any property to be used in connection with an output facility 95 percent or more of the output of which will be consumed in a qualified service area of the acquiring governmental unit or in a qualified annexed area of such unit. An acquisition meets the qualified service area exception if it consists of the acquisition of nongovernmental property by a state or local governmental unit to meet existing or increased demands within a service area throughout which the acquiring entity has provided the same type of service for at least ten years immediately preceding the date of acquisition. The exception does not apply where the increase in demand arises from sales outside the existing service area through direct arrangements or through wheeling arrangements with another provider.

The qualified annexed area exception permits the acquisition of existing nongovernmental output property where a governmental unit served by an existing governmental output authority annexes contiguous property in a general governmental purpose annexation and seeks to expand its electric, gas, or other output service to the annexed territory as part of the annexation. An annexation is for general governmental purposes if it involves the transfer of voter registration and property tax rolls as well as responsibility for extension of general governmental services (e.g., police and fire protection) on the same basis as those services are provided to other residents of the governmental unit.

The second exception applies only if (1) the annexed area is no greater than 10 percent of the geographic area of the governmental unit, or (2) the output capacity of the governmental unit increases by not more than 10 percent as a result of the acquisition of output property to service the annexed area. Both determinations are made as of the last day of the calendar year immediately before the year in which the annexation occurs. Once an area is annexed, it becomes a general service area for purposes of applying the exception to later general purpose annexations. Finally, the exception is available only where service in the annexed area is made available directly to all members of the general public by the acquiring governmental output authority.

The two exceptions generally apply only to governmental authorities that satisfy a ten-year minimum service requirement on actually providing service to their service areas. An existing service area does not include any area that was not actively served during at least a substantial part of the last year. If a joint action agency is the acquiring agency, the rules and exceptions of *IRC Section 141(d)* are applied at the governmental unit member level.

Bonds that are treated as private activity bonds solely because of *IRC Section 141(d)* are not subject to the restrictions on land and existing property contained in *IRC Sections 147(c)* and *(d)*, and can qualify as exempt facility bonds providing facilities furnishing of electric energy or gas even if the furnishing is not local as required by *IRC Section 142(a)(8)*.

The exemption of *IRC Section 103(a)* extends to private activity bonds that are "qualified bonds." Under *IRC Section 141(e)*, a bond is a qualified bond if it is either (a) an exempt facility bond, (b) a qualified mortgage bond, (c) a qualified veterans' mortgage bond, (d) a qualified small issue bond, (e) a qualified student loan bond, (f) a qualified redevelopment bond, or (g) a qualified 501(c)(3) bond, and meets the applicable volume cap requirements of *IRC Section 146* and other requirements of *IRC Section 147*, discussed below.

IRC Section 146 imposes a ceiling on the amount of private activity bonds (other than qualified veterans' mortgage bonds, qualified 501(c)(3) bonds, and exempt facility bonds issued to provide airports, docks, and wharves, environmental enhancements of hydroelectric generating facilities, and qualified public educational facilities; and 75 percent of any exempt facility bond used to provide high-speed intercity rail facilities)¹⁹ that each state can issue during a calendar year; interest on obligations issued in excess of the limitation is not tax exempt. The annual bond limitation for a state is equal to the greater of (1) an amount equal to \$90 for the year multiplied by the state population, or (2) \$273,775,000.²⁰ There is a cost-of-living adjustment for each calendar year after 2002.²¹ For purposes of the limitation, the District of Columbia is treated as a state. Any possession having a population less than that of the least

populous state receives an annual limitation equal to the product of (1) the fraction, the numerator of which is \$225,000,000, and the denominator of which is the population of the least populous state, and (2) the population of the possession for the calendar year.ⁿ²² For calendar year 2008 there is an increase in the annual bond volume cap but such increase can only be used for "qualified housing issues."ⁿ²³ The state ceiling is increased by an amount equal to \$11,000,000,000 multiplied by a fraction: (i) the numerator is the state ceiling for the state for calendar year 2008 (determined without regard to the increase in *IRC Section 146(d)(5)(A)*), and (ii) the denominator is the sum of the state ceilings determined under clause (i) for all states.ⁿ²⁴ A "qualified housing issue" is an issue for qualified residential rental projects under *IRC Section 142(a)(7)*, or a qualified mortgage issue (determined by substituting a 12-month origination period for the 42-month origination period under *IRC section 143(a)(2)(D)(i)*).ⁿ²⁵

Each state's annual ceiling is allocated equally between (i) state agencies authorized to issue private activity bonds and (ii) local jurisdictions having such authority.ⁿ²⁶ The volume cap for any single local jurisdiction is an amount that bears the same ratio to 50 percent of the state ceiling for the year that the population of the jurisdiction bears to the population of the entire state.ⁿ²⁷ If an area is within the jurisdiction of two or more governmental units, the area is treated as only within the jurisdiction of the unit having jurisdiction over the smallest geographic area unless such unit agrees to surrender all or part of that jurisdiction to the unit with overlapping jurisdiction that has the next smallest geographical area.ⁿ²⁸ The state legislature can adopt a different formula for allocating the ceiling among governmental units or other authorities empowered to issue tax-exempt private activity bonds.ⁿ²⁹

If an issuing authority's private activity bond limit for a calendar year exceeds the amount of private activity bonds issued during the year, the authority can carry forward any portion of the unused limit to each of the three following calendar years.ⁿ³⁰ The election, which is irrevocable, must specify the carryforward purpose for which the carryforward is elected and specify the portion of the carryforward to be allocated to each such purpose.ⁿ³¹ (A carryforward purpose is defined as the purpose for issuing exempt facility bonds, qualified mortgage bonds or mortgage credit certificates, qualified student loan bonds, or mortgage credit certificates).ⁿ³²

A special allocation of the volume cap is required if the nonqualified amount with respect to an issue (the lesser of the proceeds of the issue to be used for any private business use or the proceeds of the issue with respect to which there are payments meeting the private security or payment test)ⁿ³³ exceeds \$15 million, but does not exceed the amount that would cause a bond that is part of the issue to be treated as a private activity bond. Unless the issuer allocates a portion of its volume cap equal to the excess of the nonqualified amount over \$15 million, the bond will be treated as a private activity bond.ⁿ³⁴ If the proceeds of an issue are to be used with respect to more than one project (a "multi-project issue"), the rule is applied by treating the portion of the proceeds of the multi-project issue to be used with respect to each project as a single issue.ⁿ³⁵ However, if any bond issued as part of the multi-project issue is treated as a private activity bond, all bonds issued as part of the issue will be treated as private activity bonds.

Refunding issues are exempt from the volume limitations if they do not exceed the outstanding amount of the refunded bonds.ⁿ³⁶ For qualified student loan bonds, the refunding issue exception applies only if the maturity date of the refunding obligation is not later than the later of the average maturity date of the bonds to be refunded, or 17 years after the refunded obligation was issued.ⁿ³⁷ For qualified mortgage bonds, the maturity of the refunding bonds must not be later than the later of the average maturity date of the refunded bonds, or 32 years after the date the original obligation was issued.ⁿ³⁸

IRC Section 147 prevents private activity bonds from being treated as qualified bonds in the following instances:

- (1) The bond is held by a person who is a substantial user of the facilities or a related person.ⁿ³⁹ For this purpose a related person is defined as (a) two or more persons if the relationship would result in the disallowance of losses under *IRC Section 267* or *707(b)*, (b) two or more corporations that are members of the same controlled group of corporations,ⁿ⁴⁰ (c) a partnership and each of its partners (and their spouses and minor children), and an S corporation and each of its shareholders (and their spouses and

minor children).ⁿ⁴¹

(2) The average maturity of the obligations forming a part of the issue exceeds 120 percent of the average reasonably expected economic life of the facilities financed by the issue.ⁿ⁴²

(3) The proceeds are used to acquire farmland, other than where the principal user is a first-time farmerⁿ⁴³ and the financed acquisition cost does not exceed \$250,000. For land not used for farming, the restriction applies if 25 percent or more of the net proceeds of the issue are to be devoted to the acquisition, unless the land is acquired for certain environmental purposes.ⁿ⁴⁴

(4) The proceeds are used to acquire existing property. This restriction does not apply if the property is a building and expenditures to rehabilitate the building equal or exceed 15 percent of the portion of the cost of the building financed by the issue. For property other than buildings, the rehabilitation expenditures must equal the portion of the issue proceeds used to purchase the property.ⁿ⁴⁵

(5) The proceeds are used to provide an airplane, skybox or other private luxury box, health club facility, facility used primarily for gambling, or a store whose principal business is the sale of alcoholic beverages for off-premises consumption.ⁿ⁴⁶

(6) The bond fails to meet the approval requirement. To meet this requirement, the issue of which the bond is a part must have been approved by (a) the governmental unit that issued the bond or on whose behalf the bond was issued, and (b) each governmental unit having jurisdiction over the area in which any facility to be financed by the proceeds is located (except that if more than one governmental unit has jurisdiction over the entire area in which the facility is located, only one unit need approve the issue).ⁿ⁴⁷ An issue is deemed to have been approved if it is approved by the applicable elected representative of the governmental unit after a public hearing following reasonable public notice, or by voter referendum.ⁿ⁴⁸ No approval is required for refunding bonds unless the average maturity date of which the refunding issue is a part is later than the average maturity date of the bonds to be refunded by the issue.ⁿ⁴⁹ The determination of maturity date is made in accordance with the provisions of *IRC Section 147(b)(2)(A)*.

IRC Section 147(f)(4) contains special rules for public approval of qualified scholarship funding bonds and volunteer fire department bonds. In the case of the former, the requirement is satisfied by a government unit that requested organization of the qualified scholarship funding corporation, or requested it to exercise power. If the corporation was requested to act by more than one local government, the public approval requirement may be satisfied by the state in which the corporation operates. The unit that requested the volunteer fire department to furnish firefighting services is the governmental unit that must satisfy the requirement.

(7) The issuance costs financed by the issue of which the bond is a part exceed 2 percent of the proceeds of the issue (3.5 percent for an issue of qualified mortgage bonds or qualified veterans's mortgage bonds if the proceeds of the issue do not exceed \$20 million).ⁿ⁵⁰

The first four limitations do not apply to qualified mortgage bonds, qualified veterans' mortgage bonds, and qualified student loan bonds.ⁿ⁵¹ The substantial user, farmland acquisition, and used property acquisition limitations do not apply to qualified 501(c)(3) bonds.ⁿ⁵²

[b] Exempt Facility Bonds.

[i] In General. Under *IRC Section 142*, interest received on a private activity bond will be exempt from federal

income taxes if 95 percent or more of the net proceeds of the issue are used to provide: (1) projects for residential rental property if, at all times during the qualified project period,ⁿ⁵³ the project meets certain requirements relating to occupancy by individuals of low or moderate income;ⁿ⁵⁴ (2) airports, docks, wharves, mass commuting facilities, or storage or training facilities directly related to the foregoing;ⁿ⁵⁵ (3) sewage or solid waste disposal facilities;ⁿ⁵⁶ (4) facilities for the furnishing of electric energy or gas solely within an area consisting of a city and one contiguous county (or two contiguous counties); (5) facilities for the furnishing of water; (6) qualified hazardous waste facilities; (7) facilities for furnishing heating and cooling facilities to an area consisting of a city and one contiguous county; (8) high-speed intercity rail facilities;ⁿ⁵⁷ and (9) environmental enhancements of hydroelectric generating facilities; (10) qualified public educational facilities;ⁿ⁵⁸ (11) qualified green building and sustainable design projects;ⁿ⁵⁹ or (12) qualified highway or surface freight transfer facilities.ⁿ⁶⁰ For this purpose, the net proceeds of an issue are the proceeds of the issue reduced by amounts in a reasonably required reserve or replacement funds, but not by proceeds used to pay issuance costs.ⁿ⁶¹

No bond can be issued as part of an issue with respect to a facility for the local furnishing of electric energy or gas on or after August 20, 1996, unless (a) the facility will (i) be used by a person who is engaged in the local furnishing of that energy source on January 1, 1997, and (ii) be used to provide service within the area served by that person on January 1, 1997 (or within a county or city any portion of which is within that area), or (b) the facility will be used by a successor interest to that person for the same use and within the same service area.ⁿ⁶² In the case of a facility financed with bonds issued before August 20, 1996, that would cease to be tax-exempt by reason of the failure to meet the local furnishing requirement as a result of a service area expansion, the bonds will not cease to be tax-exempt bonds if the person engaged in the local furnishing by the facility makes an election in which the person (or its predecessor in interest) agrees that (1) the election is made with respect to all of the person's facilities for the local furnishing of electric energy or gas, (2) no tax-exempt bond can be issued on or after August 20, 1996, with respect to all of the person's facilities, (3) any expansion of the service area is not financed with the proceeds of any exempt facility bond issued for a facility for the furnishing of electric energy or gas and is not treated as a nonqualifying use under *IRC Section 142(f)(2)*, and (4) all of the outstanding bonds used to finance the facilities for the person are redeemed not later than six months after the earliest date on which the bonds can be redeemed or the date of the election, whichever is later.ⁿ⁶³

[ii] Enterprise Zone Facility Bonds. The Omnibus Budget Reconciliation Act of 1993 added a new category of exempt facility bond, namely any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide any enterprise zone facility.ⁿ⁶⁴ For this purpose, an enterprise zone facility is any qualified zone property the principal user of which is an enterprise zone business, and any land that is functionally related and subordinate to such property.ⁿ⁶⁵

Qualified zone property is defined as any property to which the cost recovery rules of *IRC Section 168* or *179* apply if:

- (1) the property was acquired by the taxpayer by purchase after the date on which the designation of the empowerment zone or enterprise zone took effect;
- (2) the original use of the property in an empowerment zone or enterprise zone commences with the taxpayer; and
- (3) substantially all (at least 85 percent) of the use of the property is in an empowerment zone or enterprise zone and is in the active conduct of a qualified business by the taxpayer in the zone.ⁿ⁶⁶

An enterprise zone business is either a qualified business entity or a qualified proprietorship.ⁿ⁶⁷ A corporation or partnership will be a qualified business entity for any taxable year in which (1) every trade or business of the entity is the active conduct of a qualified business within an empowerment zone or enterprise zone, (2) at least 50 percent (80 percent for taxable years beginning before August 5, 1997) of the total gross income of the entity is derived from the active conduct of the business, (3) a substantial portion of the use of the tangible property of the entity (whether owned

or leased) is within an empowerment zone or enterprise zone, (4) a substantial portion of the intangible property of the entity is used in, and exclusively related to, the active conduct of the business, (5) a substantial portion of the services performed by the entity's employees are performed in the empowerment zone or enterprise zone, (6) at least 35 percent of its employees are residents of an empowerment zone or enterprise zone, (7) less than 5 percent of the average of the aggregate unadjusted bases of the property of the entity consists of collectibles⁶⁸ (other than collectibles that are held primarily for sale in the ordinary course of the business), and (8) less than 5 percent of the average of the aggregate adjusted bases of the property of the entity is attributable to nonqualified financial property.⁶⁹ The requirements for a qualified proprietorship--a qualified business carried on by an individual--are the same, except that the individual is not limited to carrying on businesses solely within an empowerment zone or enterprise zone.⁷⁰

A qualified business is, generally, any trade or business, except that it cannot be a (a) trade or business consisting predominantly of the development or holding of intangibles for sale or license, (b) trade or business operating a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises, and (c) farming business if, at the close of the preceding taxable year, the sum of the aggregate unadjusted bases (or fair market value, if greater) of the assets owned by the taxpayer and the aggregate value of assets leased by the taxpayer, that are used in the business, exceed \$500,000.⁷¹ The rental to others of real property located in an empowerment zone or enterprise zone can be a qualified business if the property is not residential real property and at least 50 percent of the gross rental from the real property is from enterprise zone businesses.⁷² The rental to others of tangible personal property can also qualify, but only if at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone or enterprise zone.⁷³

IRC Section 1397C(f) provides a special rule for a business entity or proprietorship that uses real property located within an empowerment zone and real property located outside the empowerment zone. If the amount of real property located within the empowerment zone is substantial compared to the amount of real property located outside the zone, and the latter is contiguous to the property within the zone, then all of the services performed by employees, all business activities, all tangible property, and all intangible property of the business entity or proprietorship that occur or are located on either parcel of real property are treated as occurring or situated in the empowerment zone.

A business will not fail to be treated as an enterprise zone business during the "startup period" if (1) as of the beginning of the startup period, it is reasonably expected that the business will be an enterprise zone business at the end of the period, and (2) the business makes bona fide efforts to be an enterprise zone business.⁷⁴ In addition, a business will not fail to be treated as an enterprise zone business for any taxable year beginning after the "testing period" by reason of failing to meet any requirement imposed on a qualified business entity or qualified proprietorship if at least 35 percent of the employees of the business for the year are residents of an empowerment zone or enterprise community.⁷⁵ The startup period is, with respect to any property being provided for any business, the period before the first taxable year beginning more than two years after the later of (1) the date of issuance of the issue providing such property, or (2) the date such property is first placed in service after the date of issuance or three years from the date of issuance, whichever is earlier.⁷⁶ The testing period consists of the first three taxable years after the startup date.⁷⁷

For purposes of the requirement that 35 percent of the employees of an enterprise zone business be residents of the enterprise zone, the issuer and the principal user can rely on a certification signed by the employee under penalties of perjury, if the certification provides to the principal user the address of the employee's principal residence, the employee is required to notify the principal user of a change in the employee's principal residence, and neither the issuer nor the principal user has actual knowledge that the principal residence set forth in the certification is not the employee's principal residence.⁷⁸ If an issue fails to comply with the 35 percent requirement because an employee who initially lived in the zone moves out of the zone, that employee is deemed to reside in the zone if that employee was a bona fide resident of the zone at the time of the certification, that employee continues to perform services for the principal user in an enterprise zone business and substantially all of the services are performed in the zone, and a resident of the zone is hired by the principal user for the next available comparable (or lesser) position.⁷⁹

An issue that fails to meet one or more of the requirements set forth for enterprise zone facility bonds will be treated as meeting those requirements if the issuer and any principal user in good faith attempted to meet the requirements throughout the compliance period, and the failure is corrected within one year after being discovered.ⁿ⁸⁰

In the case of a pooled financing bond program or a loan recycling program, the compliance requirements for enterprise zone facility bonds apply on a loan-by-loan basis.ⁿ⁸¹ If a loan fails to meet those requirements, within six months of noncompliance, an amount equal to the outstanding loan principal must be prepaid and the issuer must (a) reloan the amount of the prepayment, or (b) use the prepayment to redeem an amount of outstanding enterprise zone facility bonds equal to the outstanding principal amount of the loan that no longer meets those requirements.ⁿ⁸²

A pooled financing bond program is a program in which the issuer of enterprise zone facility bonds, in order to provide loans to enterprise zone businesses, lends the proceeds of the enterprise zone facility bonds to a bank or similar intermediary (intermediary lender) which must then relend the proceeds to two or more enterprise zone businesses.ⁿ⁸³ A loan recycling program is a program in which (1) the issuer reasonably expects, as of the issue date of the enterprise zone facility bonds, that loan repayments from principal users will be used to make additional loans during the zone designation period, (2) repayments of principal on loans (including prepayments) received during the zone designation period are used within six months of the date of receipt either to make new loans to enterprise zone businesses or to redeem enterprise zone facility bonds that are part of the issue, and (3) repayments of principal on loans (including prepayments) received after the zone designation period are used to redeem enterprise zone facility bonds that are part of the issue within six months of the date of receipt.ⁿ⁸⁴

The tax exemption for enterprise zone facility bonds will not apply to any issue if the aggregate amount of outstanding enterprise zone facility bonds allocable to any person (taking into account the issue) exceeds \$3 million with respect to any one empowerment zone or enterprise community, or \$20 million with respect to all empowerment zones and enterprise communities.ⁿ⁸⁵ The aggregate amount of outstanding enterprise zone facility bonds allocable to any person is determined under rules similar to *IRC Section 144(a)(10)* (see § 17.03[3][d]), taking into account only enterprise zone facility bonds.ⁿ⁸⁶

Except as noted below, enterprise zone facility bonds are treated as exempt facility bonds and all regulations generally applicable to exempt facility bonds apply to enterprise zone facility bonds.ⁿ⁸⁷ For this purpose, enterprise zone businesses are treated as meeting the public use requirement. *IRC Sections 147(c)(1)(A)* (relating to limitations on financing the acquisition of land), *147(d)* (relating to financing the acquisition of existing property), and *142(b)(2)* (relating to limitations on financing office space) do not apply to enterprise zone facility bonds. An issue of enterprise zone facility bonds, the proceeds of which are to be used as part of a loan recycling program, satisfies the maturity limitation of *IRC Section 147(b)* if each loan satisfies the requirements of that section (determined by treating each loan as a separate issue), and the term of the issue does not exceed 30 years.ⁿ⁸⁸

Bonds issued after the zone designation period to refund enterprise zone facility bonds (other than an advance refunding) are treated as enterprise zone facility bonds if the refunding issue and the prior issue, treated as a single combined issue, would meet all of the requirements for enterprise zone facility bonds, except the limitation of the amount of bonds that can be issued.ⁿ⁸⁹ The maturity limitation of *IRC Section 147(b)* is applied to a refunding issue by taking into account the issuer's reasonable expectations about the economic life of the financed property as of the issue date of the prior issue and the actual weighted average maturity of the combined refunding issue and prior issue.ⁿ⁹⁰

No deduction is allowed for interest on any financing provided from an enterprise zone facility bond to the extent that the interest accrues during the period beginning on the first day of the calendar year that includes the date on which (1) substantially all of the facility with respect to which the financing was provided ceases to be used in an empowerment zone or enterprise community, or (2) the principal user of the facility ceases to be an enterprise zone business.ⁿ⁹¹ The foregoing rule does not apply solely by reason of the termination or revocation of a designation as an empowerment

zone or an enterprise community, or to any cessation resulting from bankruptcy.ⁿ⁹²

IRC Section 1391(g), added by the Taxpayer Relief Act of 1997, permits the Secretaries of Housing and Urban Development (HUD) and Agriculture to designate an additional 20 areas as empowerment zones before January 1, 1999. *IRC Section 1391(h)(1)*, added by the Community Renewal Tax Relief Act of 2000, permits the designation of an additional nine areas, of which not more than seven may be designated in urban areas and not more than two designated in rural areas.ⁿ⁹³ A bond for a new empowerment zone facility is not treated as a private activity bond for purposes of the *IRC Section 146* volume cap, nor is the limitation imposed by *IRC Section 1394(c)* on the aggregate amount of enterprise zone facility bonds allocable to any person applicable.ⁿ⁹⁴ Instead the aggregate face amount of bonds that may be designated as new empowerment zone facility bonds with respect to any new empowerment zone is limited to (a) \$60 million, if the zone is in a rural area; (b) \$130 million, if the zone is in an urban area and the zone has a population of less than 100,000; and (c) \$230 million, if the zone is in an urban area and the zone has a population of at least 100,000.ⁿ⁹⁵ Any refunding of a new empowerment zone facility bond is not taken into account in applying the limitations specified in the preceding sentence if the amount of the refunding bonds does not exceed the amount of the refunded bond, and the refunded bond is redeemed not more than 90 days after the issuance of the refunding bond.ⁿ⁹⁶

An empowerment zone facility bond is an exempt facility bond under the provisions of *IRC Section 1394(a)* if (1) in the case of an obligation issued before January 1, 2002, only empowerment zones designated under *IRC Section 1391(g)* were taken into account under *IRC Sections 1397C* and *1397D*, and (2) in the case of an obligation issued after December 31, 2001, all empowerment zones (other than the District of Columbia Enterprise Zone) were taken into account under those sections.ⁿ⁹⁷

ARRA of 2009 authorizes the creation of a new kind of economic zone, "recovery zones," and two new types of bonds to finance improvements in these zone. One is a new category of exempt facility bond, the Recovery Zone Facility Bond. The second, the Recovery Zone Economic Development Bond, pays interest that is fully taxable but features a direct reimbursement by the federal government of 45 percent of the issuer's interest costs. Both types of recovery zone bond are discussed in *Section 17.03[15]*.

[c] Mortgage Revenue Bonds. Prior to 1978, most state housing finance agency bonds were issued to provide multi-family housing. A significant increase in the use of tax-exempt bonds for housing, especially owner-occupied housing, created concern in Congress and led to the enactment of the Mortgage Subsidy Bond Act of 1980. The Tax Reform Act of 1986 changed the designation of the obligations to mortgage revenue bonds, and added *IRC Section 143* to govern the treatment of the two mortgage revenue bonds on which interest is tax-free--qualified mortgage bonds and qualified veterans' mortgage bonds.

A qualified mortgage bond is one issued as part of a qualified mortgage issue, if all of the proceeds of the issue (exclusive of issuance costs and a reasonably required reserve) are to be used to finance owner-occupied residences,ⁿ⁹⁸ the issue does not meet the private business tests of *IRC Section 141(b)*, and the issue meets the following requirements:ⁿ⁹⁹

(1) Every residence for which owner financing is provided under the issue must be a single-family residenceⁿ¹⁰⁰ which can reasonably be expected to become the principal residence of the mortgagor within a reasonable time after financing is provided and must be located within the jurisdiction of the issuing governmental unit (the residence requirement).ⁿ¹⁰¹

(2) At least 95 percent of the lendable proceeds are used to finance the residence of mortgagors who had no present ownership interest in their principal residences at any time during the three-year period ending on the date the mortgage is executed (the three-year requirement).ⁿ¹⁰² For purposes of this requirement, any proceeds of an issue used to provide financing for targeted area residences,ⁿ¹⁰³ for any qualified home improvement loan,ⁿ¹⁰⁴ for qualified rehabilitation loans, for financing land possessed

under a contract for deed by a mortgagor and the construction of any residence thereon and, in the case of bonds issued after December 20, 2006, and before January 1, 2008, financing of any residence for a veteran who has not previously qualified for and received such financing are taken into account.ⁿ¹⁰⁵

(3) All owner-financing provided under the issue is provided for mortgagors whose family income is not greater than 115 percent of the applicable median family income, i.e., the greater of the area median gross income for the area, or the statewide median gross income for the state, in which the residence is located.ⁿ¹⁰⁶ In the case of financing provided for targeted area residences, one third of the financing can be provided without the income limitation if the remainder of the financing is for mortgagors whose family income is not greater than 140 percent of the applicable median family income.ⁿ¹⁰⁷ If the residence for which financing is provided under the issue is in a high housing cost area (any statistical area in which the housing cost/income ratio is greater than 1.2), the income limitation can be increased to a percentage of area median gross income (not greater than 140 percent) equal to 115 percent of the amount by which the housing cost/income ratio for the area exceeds 0.2.ⁿ¹⁰⁸ The housing cost/income ratio for any area is determined by dividing the applicable housing price ratio for the area by the ratio that the area median gross income for the area bears to the median gross income for the United States.ⁿ¹⁰⁹

(4) The acquisition costⁿ¹¹⁰ of each residence financed from the bond proceeds cannot exceed 90 percent (110 percent in targeted areas)ⁿ¹¹¹ of the average purchase price of the same type of residence (one-family, two-family, three-family, four-family, unit in a condominium or share in a cooperative housing corporation) purchased in the statistical area (a standard metropolitan statistical area or a county not within a standard metropolitan statistical area)ⁿ¹¹² in which the residence is located. The average price is based on sales during the most recent twelve-month period for which sufficient information is available, and is computed separately for new and used residences (the purchase requirement).ⁿ¹¹³ The requirement does not apply to qualified home improvement loans.ⁿ¹¹⁴

If a residence is located in a high housing cost area, the interest of a governmental unit in the residence by reason of financing provided under a qualified program is not taken into account, and the acquisition cost of the residence is its actual cost reduced by the amount of such financing.ⁿ¹¹⁵ A qualified program is any governmental program, which provides mortgage loans (other than first mortgage loans) or grants, (i) that restricts (throughout the nine-year period beginning on the date the financing is provided) the resale of the residence to a purchaser qualifying under *IRC Section 143* and to a price determined by an index that reflects less than the full amount of any appreciation in the residence's value, or (ii) that provides for deferred or reduced interest payments on the financing and grants the governmental unit a share in the appreciation in the residence, but only if the financing is not provided directly or indirectly through the use of any tax-exempt private activity bond.ⁿ¹¹⁶

(5) If an issuing jurisdiction includes a targeted area, at least 20 percent of the lendable proceeds of the issue must be made available (with reasonable diligence) for financing of target area residences for at least one year after financing via the bond proceeds first becomes available (the targeted area portion requirement).ⁿ¹¹⁷ However, the amount made available need not exceed 40 percent of the average annual principal amount of mortgages executed during the immediately preceding three years for single-family owner occupied residences in targeted areas within the jurisdiction of the issuing authority.ⁿ¹¹⁸

(6) The effective rate of interest on the mortgages provided under the issue cannot exceed the yield to maturity on the issue by more than 1.125 percentage points.ⁿ¹¹⁹ Two special statutory rules are to be used in determining the effective rate on any mortgage. First, all fees, charges, and other amounts borne by the mortgagor attributable to the mortgage or to the bond issue are taken into account.ⁿ¹²⁰ Two items are specifically excepted, namely, any expected rebate of arbitrage profits, and any application fee,

survey fee, credit report fee, insurance charge, or similar amount (but not origination fees, points, or similar amounts) to the extent usual and reasonable in the area in cases where owner financing is not provided through the use of qualified mortgage bonds.ⁿ¹²¹ Second, it is to be assumed that the mortgage prepayment rate will be the rate set forth in the most recent mortgage maturity experience table published by the Federal Housing Administration for the state or local area in which the residences are located, and that prepayments of principal are received on the last day of the month in which the issuer reasonably expects to receive such prepayments.ⁿ¹²²

A second arbitrage restriction applicable to qualified veterans' mortgage bonds, limits the amount of original proceeds, investment proceeds and mortgage principal repayments that may be invested in higher yield nonpurpose investments. Although investment in nonpurpose investments is permitted, the sum of the excess of the net amount earned on all such investments over the amount that would have been earned if the investments had been at a rate equal to the yield on the issue plus any income attributable to the excess on the bonds must be paid or credited to the mortgagors "as rapidly as may be practicable."ⁿ¹²³

(7) The final requirement is, in fact, two requirements. No part of the proceeds can be used to acquire or replace existing mortgages,ⁿ¹²⁴ unless the replaced loan is a construction period loan or a bridge loan or similar temporary initial financing, the financing is for a qualified rehabilitation, or the financing is for land possessed under a contract for deed agreement.ⁿ¹²⁵ Furthermore, a mortgage made from proceeds of a qualified issue can be assumed only if the residence requirement, the three-year requirement, and the purchase requirement are met at the time of the assumption.ⁿ¹²⁶

(8) Repayments of principal on financing provided by the issue must be used not later than the first semiannual period beginning after the date the prepayment (or complete repayment) is received to redeem bonds that are part of the issue.ⁿ¹²⁷ The requirement does not apply to amounts received within ten years after the date of issuance of the issue (or, in the case of a refunding bond, the date of issuance of the original bond).

Two good faith tests are imposed with respect to the requirements. An issue meets the first three-mentioned requirements only if the issuer in good faith attempted to meet all such requirements before the mortgages were issued, 95 percent or more of the lendable proceeds have been invested in mortgages that meet the requirement, and any failure to meet the requirements is corrected within a reasonable time after the failure is first discovered.ⁿ¹²⁸ The issue is deemed to meet the remaining requirements (other than the new mortgage requirement) if the issuer in good faith attempted to meet them and any failure to do so is due to inadvertent error after taking reasonable steps to comply.ⁿ¹²⁹

A qualified veterans' mortgage bond is more easily defined. It is one, (a) issued as part of an issue 95 percent of the proceeds of which are used to provide residences for veterans, (b) the payment of the principal and interest on which is secured by the general obligation of a state, (c) meets the residence and arbitrage requirements, (d) the proceeds of which are not used to acquire or replace existing mortgages (other than construction period loan, bridge loan or similar temporary initial financing, or, in the case of a qualified rehabilitation, any existing mortgage), and (e) that is part of an issue that does not meet the private business tests of *IRC Section 141(b)*.ⁿ¹³⁰

The authority to issue qualified veterans' mortgage bonds is limited to programs that issued such bonds before June 22, 1984.ⁿ¹³¹ Loans made with the proceeds of qualified veterans' mortgage bonds issued after June 22, 1984 are limited to veterans who served on active duty before January 1, 1977, and who applied for the financing before the later of 30 years after the veteran left active service or January 1, 1985.ⁿ¹³²

The Code also imposes a volume limitation on the amount of qualified veterans' mortgage loans that a state can issue during any calendar years. This limit is based on a specially computed annual average of qualified veterans' mortgage

bonds issued by the state from January 1, 1979 until June 22, 1984.ⁿ¹³³ Bonds issued in excess of the limit are not tax-exempt.

A state has the ability to elect to trade in all or part of its authority to private activity bonds that it can otherwise issue during the calendar year under its volume cap.ⁿ¹³⁴ If the state does so, it generally can issue mortgage credit certificates in an amount equal to 25 percent of the amount of qualified mortgage bond authority that it trades in.ⁿ¹³⁵

A home purchaser receiving a mortgage credit certificate is entitled to a nonrefundable income tax credit equal to a specified percentage of the interest paid during the taxable year on the mortgage on the purchaser's principal residence.ⁿ¹³⁶ The specified percentage cannot be less than 10 percent or more than 50 percent, but if the rate exceeds 20 percent, the credit allowable in any taxable year is limited to \$2,000.ⁿ¹³⁷ The allowable credit reduces the interest deduction otherwise available under *IRC Section 163*. If the credit allowable exceeds the taxpayer's tax liability for the year, the excess can be carried over to the next three years.ⁿ¹³⁸

Eligibility for mortgage credit certificates is generally limited to the same individuals who are eligible for qualified mortgage bonds. Thus, the recipient of the credit certificate must usually be a first-time home buyer, the purchase price of the residence cannot exceed 90 percent (110 percent in targeted areas) of the average area purchase price, the residence must be the principal residence of the buyer, and the mortgage must be a new mortgage.ⁿ¹³⁹ In addition, at least 20 percent of mortgage credit certificates under each program must be made available for financing in targeted areas for at least one year. A state or locality may establish more stringent criteria for participation in a mortgage credit certificate program, but cannot restrict mortgage credit certificates to loans made by a particular lender or to residences in a particular development.ⁿ¹⁴⁰ At least 90 days before any certificate is to be issued, the issuing authority must give public notice of the eligibility requirements for the certificates and the methods of their issuance.ⁿ¹⁴¹

The issuer of a qualified mortgage certificate can reissue a certificate in place of an existing mortgage credit certificate to the holder of that certificate provided:ⁿ¹⁴²

- (1) The reissued certificate is issued with respect to the same property to which the existing certificate relates.
- (2) The reissued certificate entirely replaces the existing certificate (that is, the holder cannot retain the existing certificate with respect to any portion of the outstanding balance of the certified mortgage indebtedness specified on the existing certificate).
- (3) The certified mortgage indebtedness specified on the reissued certificate does not exceed the remaining outstanding balance of the certified mortgage indebtedness specified on the existing certificate.
- (4) The reissued certificate does not increase the certificate credit rate specified in the existing certificate.
- (5) The reissued certificate does not result in the tax credit that otherwise would have been allowable to the holder under the existing certificate for any taxable year. The holder of a reissued certificate determines the tax credit that otherwise would have been allowable by multiplying the interest that was scheduled to have been paid on the refinanced loan by the certificate rate of the existing certificate. In the case of a series of refinancings, the tax credit that otherwise would have been allowable is determined from the amount of interest that was scheduled to have been paid on the original loan and the certificate rate of the original certificate.

If the refinanced loan is a fixed interest rate loan, the interest that was scheduled to be paid on the refinanced loan is determined using the scheduled interest method. The scheduled interest method determines the amount of interest for

each taxable year that was scheduled to have been paid in the taxable year based on the terms of the refinanced loan including any changes in the interest rate that would have been required by the terms of the refinanced loan and any payments of principal that would have been required by the terms of the refinanced loan (other than repayments required as a result of any refinancing of the loan).

If the refinanced loan is a variable interest rate loan, the interest that was scheduled to be paid on the refinanced loan is determined using either the scheduled interest method or the hypothetical method. The hypothetical method determines the amount of interest treated as having been scheduled to be paid for a taxable year by constructing an amortization schedule for a hypothetical self-amortizing loan with level payments. The hypothetical loan must have a principal amount equal to the outstanding balance of the certified mortgage indebtedness specified on the existing certificate, a maturity equal to that of the refinanced loan, and interest equal to the annual percentage rate of the refinancing loan that is required to be calculated for the Federal Truth in Lending Act.

A holder must consistently apply the scheduled interest method or the hypothetical interest method for all taxable years beginning with the first taxable year the tax credit is claimed by the holder based upon the reissued certificate.

Any person who makes a loan covered by a mortgage credit certificate must file a report with the Service identifying the certificate's issuer and recipient and giving such other information that the regulations will require.ⁿ¹⁴³ A lender who fails to file the report is subject to a \$200 penalty unless the failure is due to reasonable cause. A \$1,000 penalty is imposed if the report contains negligent misstatements; the penalty is \$10,000 if there is fraud.ⁿ¹⁴⁴

IRC Section 143(k)(9) provides that limited equity cooperative housing is to be treated as residential housing and not as owner-occupied housing, if the cooperative corporation so elects at the time of issuance of bonds to finance the housing. This prevents the bonds from being classified as mortgage revenue bonds, but the bonds can still be treated as private activity bonds used to finance a qualified residential rental project if the limitations applicable to such bonds are met. To qualify for financing as a qualified residential real estate project, (1) the cost of any stock in the cooperative must not exceed the amount paid for the stock by the original shareholder (adjusted for cost-of-living increases), increased by amounts paid for improvements on the stockholder's dwelling and by payments attributable to the stockholder to amortize the principal of the corporation's acquisition or development indebtedness, and (2) the assets of the cooperative in excess of the combined transfer values of outstanding stock in the cooperative (reduced by any liabilities) must be used only for public or charitable purposes or directly to benefit the cooperative, and must not be used directly to benefit any stockholder.

The election to be eligible for financing as multifamily residential rental property is irrevocable and applies only if bonds are issued before January 1, 1990, and the cooperative continues to qualify as a limited equity cooperative throughout the period any tax-exempt bonds are outstanding.

A further consequence of the election affects tenant-shareholders directly. They are not entitled to a deduction for their ratable share of interest and taxes paid by the cooperative.

Special rules allow for the refinancing of qualified subprime loans with qualified mortgage bonds that are issued by December 31, 2010.ⁿ¹⁴⁵ *IRC Section 143(k)(12)(A)* provides an exception to the general requirement that no part of the qualified mortgage issue proceeds can be used to acquire or replace existing mortgages. Further, for qualified subprime loan refinancing the general 42-month loan origination period under *IRC Section 143(a)(2)(D)(i)* is shortened to 12 months; the rule under *IRC Section 143(d)* limiting borrowers to those who had no ownership interest in a home in the preceding three years is inapplicable; and the purchase price limitation under *IRC Section 143(e)* applies based on the market value of the residence at the time of refinancing in lieu of the acquisition cost.ⁿ¹⁴⁶ A qualified subprime loan is an adjustable rate single-family residential mortgage loan made after December 31, 2001, and before January 1, 2008, that the bond issuer determines would be reasonably likely to cause financial hardship to the borrower if not refinanced.ⁿ¹⁴⁷ Issuers can make decisions regarding financial hardship to the borrower based on reasonable estimates

made in good faith.ⁿ¹⁴⁸

For qualified subprime loan refinancings to be funded from qualified mortgage bonds that have received an allocation of General Volume Cap (as opposed to 2008 Housing Act Volume Cap), an issuer may make proceeds of such bonds available for use for qualified subprime loan refinancings during the permitted 12-month origination period for such loans, and then either redeem bonds from unused proceeds or make such proceeds available for regular qualified mortgage loans under section 143 for the balance of the permitted 42-month origination period for such loans under the general rules for qualified mortgage bonds under section 143(a)(2)(D) before redemption of bonds from unused proceeds. Qualified mortgage bonds that receive an allocation of 2008 Housing Act Volume Cap must apply all unused proceeds to the redemption of bonds after the 12-month period as provided in section 146(d)(5)(B)(ii)(II), as added by section 3021(a) of the 2008 Housing Act.ⁿ¹⁴⁹

IRC Section 143(m) imposes a recapture requirement if a taxpayer disposes of a residence that was financed by proceeds from a qualified mortgage bond issue, or on which a mortgage certificate credit was taken ("federally-subsidized indebtedness"), within nine years from the date of the loan or the date the taxpayer became liable (the "testing date"), whichever is earlier.ⁿ¹⁵⁰ Generally, any disposition--sale, exchange, or gift--triggers recapture.ⁿ¹⁵¹ Subject to three exceptions, recapture occurs without regard to exclusion provisions such as *IRC Section 121*.ⁿ¹⁵²

Under the first exception, the death of an assisted mortgagor terminates that mortgagor's liability for recapture; the liability of other surviving mortgagors is not affected.ⁿ¹⁵³ The second exception excludes from current recapture any involuntary conversion of a residence due to fire, storm, or other casualty, if the taxpayer repairs or rebuilds the residence; liability for recapture continues with respect to the repaired house. Under the third exception, no recapture is recognized on an inter vivos disposition of an interest in a house to a spouse or former spouse (including a transfer incident to a divorce) but the transferee steps into the shoes of the transferor with respect to liability for recapture and determination of the recapture period. There is also no recapture tax imposed on a refinancing or other prepayment of an assisted loan within the nine-year recapture period unless the mortgagor also disposes of the house. The mortgagor continues to be liable for recapture if the house is disposed of within the nine-year period.

The recapture amount with respect to any indebtedness is an amount equal to 6.25 percent of the highest principal amount of the indebtedness for which the taxpayer was liable ("maximum special subsidy amount") multiplied by a holding period percentage determined in accordance with the following table:

If, after the testing date, the disposition occurs during:	The holding period percentage is:
Year 1	20
Year 2	40
Year 3	60
Year 4	80
Year 5	100
Year 6	80
Year 7	60
Year 8	40
Year 9	20

and by an income percentage. The latter is the percentage (but not greater than 100 percent) that:

(1) the excess of:

(a) the modified adjusted gross income¹⁵⁴ of the taxpayer for the taxable year in which the disposition occurs, over

(b) the adjusted qualifying income¹⁵⁵ for the taxable year,

bears to

(2) \$5,000.¹⁵⁶

Finally, the increase in the taxpayer's tax for the year of disposition is limited to the lesser of the recapture amount or 50 percent of the gain realized on the disposition of the taxpayer's interest in the residence. For this purpose, gain realized is equal to the excess of the amount realized on the disposition over the taxpayer's adjusted basis in the house, determined without regard to *IRC Section 1033(b)* or *1034(e)* (as in effect on August 4, 1997). Adjusted basis reflects selling costs and the value of permanent improvements. The fair market value of the house is treated as the amount realized from dispositions other than at arm's length or pursuant to gift.

Example:

H and *W* purchase a house on June 15, 2001, receiving a \$50,000 qualified mortgage bond-financed loan. At the time of the purchase, the applicable income limit for *H* and *W* (who have no children) is \$20,000. On September 1, 2004, *H* and *W*, who still have no children, sell the house at a gain of \$15,000 and purchase a new house.

In the year of sale, *H* and *W*'s modified adjusted gross income is \$35,000. The maximum special subsidy amount is \$3,125 (6.25 percent of \$50,000). The holding period percentage is 60 percent; the income percentage is 100 percent.¹⁵⁷ Therefore, the recapture tax is \$1,875, since that amount is less than 50 percent of the gain realized on the sale.

Issuers of qualified mortgage bonds and mortgage credit certificates must provide a written statement at the settlement informing the mortgagor of the potential recapture and then, within 90 days thereafter, provide a written statement specifying the federally subsidized amount with respect to the indebtedness and the amount of adjusted qualifying income for each year in the recapture period.¹⁵⁸

[d] Qualified Small Issue Bonds. By virtue of a special exception for certain small issues provided by *IRC Section 144(a)*, the exclusion provided by *IRC Section 103(a)* continues with respect to interest received on any obligation forming a part of an issue of industrial development bonds where (1) the aggregate authorized face amount of the issue is \$1 million or less, and (2) 95 percent of the proceeds of the issue are to be used either for the acquisition, construction, reconstruction, or improvement of land or depreciable property, or to redeem part or all of a prior issue used for those purposes.¹⁵⁹ There is still another condition. The face amount of outstanding prior small issues must be taken into account in determining whether a subsequent issue of \$1 million or less (whether issued by the same issuer or a different issuer) qualifies for the special exception of *IRC Section 144* whenever (a) the proceeds of the prior issues and the subsequent issue will be used primarily in connection with facilities located in the same incorporated municipality or in unincorporated areas of the same county and (b) the principal user of the facilities will be the same person or two or more related persons.¹⁶⁰ However, the face amount of any outstanding obligation which is to be redeemed from the proceeds of the later issue need not be taken into account.¹⁶¹ To illustrate:

Example:

County *C* and Corporation *Y* enter into an arrangement under which the county will issue \$1 million of

bonds, and use the proceeds to purchase land in Village V and construct a factory to be leased by Y for twenty years. The interest on the bonds is tax-exempt because of the special exception of *IRC Section 144(a)*.

At a later date, Corporation Y proposes to Village V that the latter build a \$400,000 warehouse for use by the corporation under terms similar to the factory arrangement. On the issue date of the new bond issue, \$750,000 of the prior issue is still outstanding. Although, standing alone, the subsequent issue would qualify as a small issue, it cannot when the face amount of the outstanding prior issue is added to the face amount of the new bonds. This is required inasmuch as the factory and warehouse are both located in Village V, and Y is principal user of both facilities.

The \$1 million small issue exception is not available for any industrial development bonds issued as part of a single issue with any other tax-exempt obligations other than those issued under the small issue provisions.ⁿ¹⁶² Thus, if a convention or trade show facility costing \$16 million is to be financed by industrial development bonds, the interest on the obligations will be tax free only if issued pursuant to the exempt purpose exception. Any attempt to qualify a portion of the issue under the small issue exception will cause the interest on that portion to be taxable.

At the election of the issuing governmental unit, the dollar limitation on the small issue exception can be raised from \$1 million to \$10 million.ⁿ¹⁶³ But in testing whether the issue comes within the larger dollar limit, there must be taken into account not only the face amount of outstanding prior small issues which are taken into account in determining whether a \$1 million dollar issue qualifies under *IRC Section 144(a)*, but also certain capital expenditures made during the six-year period beginning three years before and ending three years after the issue date of the \$10 million dollar issue. The included capital expenditures are those financed otherwise than out of proceeds of outstanding prior small issues and made with respect to facilities (a) located (as of the date of issue) in the same municipality or in unincorporated areas in the same county as the facilities to be financed by the new issue, and (b) used principally by the person who will use the new facility or by related persons.ⁿ¹⁶⁴ Notwithstanding, certain capital expenditures are not to be taken into account in determining the \$10 million limit, to wit:

- (1) capital expenditures to replace property destroyed or damaged by fire, storm, or other casualty, but only to the extent that the expenditure does not exceed the fair market value of the property replaced;
- (2) capital expenditures required by a change in any federal, state, or local law of general application enacted after the date of issue, or by a change in any rules or regulations issued under such law;
- (3) in the case of an issue 95 percent of the proceeds of which are used to finance an urban development action grant facility, capital expenditures of \$10 million or less;ⁿ¹⁶⁵
- (4) subject to a limitation of \$1 million with respect to any issue, capital expenditures required by circumstances which could not be reasonably foreseen on the date of issue, or arising out of a mistake of law or fact (e.g., a mistake pursuant to which an item is treated as a repair and deducted rather than capitalized); and
- (5) expenditures for research wages or supplies which the taxpayer elects to deduct currently.ⁿ¹⁶⁶

Unlike a \$1 million issue whose status as a small issue is determined solely by facts which exist on the date of issue, the \$10 million issue can qualify as a small issue on such date and then become disqualified by reason of a subsequent capital expenditure. To prevent a retroactive loss of exemption, and, thus, retroactive taxation of interest income, *IRC Section 144(a)(4)(D)* provides that "no bond issued as part of such issue shall be treated as qualified small issue bond by reason of any [capital] expenditure for any period before the date on which such expenditure is paid or incurred." In

other words, the loss of tax exemption for the interest on the previously qualified obligation begins with the date on which the expenditure, which causes the issue to cease to qualify under the \$10 million limit, is made.

Small issues will not qualify as tax-exempt bonds if more than 25 percent of the proceeds of an issue are used to provide a facility used for retail food and beverage services, automobile sales or service, or recreation or entertainment, or if any part of the proceeds is used to provide a private or commercial golf course, country club, massage parlor, skating facility, racquet sports facility, hot tub facility, suntan facility, or racetrack.ⁿ¹⁶⁷

The Code places an aggregate limit on the face amount of industrial development bonds that can be allocated to any test-period beneficiary. Pursuant to *IRC Section 144(a)(10)*, the small issue exception will not apply to any issue if the aggregate face amount of industrial development bonds allocated to the test-period beneficiary exceeds \$40 million after the issue. A test-period beneficiary is defined as an owner or principal user of facilities being financed by the issue at any time during the three-year period beginning on the later of the date the facilities are placed in service or the date of the issue.

The Code also limits the purposes to which the proceeds of an issue can be applied. Interest on small issue bonds will not be tax exempt if any portion of the proceeds is used to acquire depreciable farm property with respect to which the principal user is or will be the same person or two or more related persons, and the acquisition cost exceeds \$250,000.ⁿ¹⁶⁸

If a bond is purported to be a qualified small issue bond when issued, but the capital expenditure limitations are later exceeded, no deduction will be allowed for interest that accrues on the financing during the period the bond is not a qualified small issue bond.ⁿ¹⁶⁹

Because of a sunset provision, the small issue exception now applies only when 95 percent all of the proceeds of the issue are to be used to provide a manufacturing facility or farmland.ⁿ¹⁷⁰

[e] Qualified Student Loan Bonds. Under *IRC Section 144(b)(1)*, a qualified student loan bond is (1) a bond issued by a qualified governmental unit or by a qualified scholarship funding corporation, if 90 percent of the proceeds of the issue of which the bond is a part are used to make loans in connection with GSL and PLUS programs of the United States Department of Education, or (2) an obligation that is part of an issue of which 95 percent of the proceeds are used to make or finance loans under certain state supplemental loan programs including any program of general application approved by a state if loans under the program are limited to the difference between the cost of attending and other forms of student assistance.ⁿ¹⁷¹ Loans financed by qualified student loan bonds must be made to students enrolled in institutions within the issuing state, or to students attending institutions elsewhere who are residents of the issuing state.

A bond is not treated as a qualified student loan bond if the issue of which the bond is a part meets the private business use and private security tests of *IRC Section 141(b)*. For this purpose, the "use" by a Section 501(c)(3) educational institution solely by reason of its administration of a student loan program does not affect the tax-exempt status of the issue, provided the use does not constitute an unrelated trade or business of the institution.

[f] Qualified Redevelopment Bonds. *IRC Section 144(c)* defines a qualified redevelopment bond as a bond that is part of an issue (1) 95 percent or more of the net proceeds of which are to be used for redevelopment purposes in a designated blighted area, (2) is issued pursuant to a state law that authorizes the issuance of such bonds for redevelopment purposes in blighted areas and a redevelopment plan that is adopted before the issuance of the bonds local general governmental unit having jurisdiction over the blighted area, (3) either the payment of the principal and interest on the issue is primarily secured by taxes of general applicability imposed by a general purpose governmental unit, or any increase in real property tax revenues (attributable to increases in assessed value) by reason of carrying out the redevelopment is reserved exclusively for debt service on the issue (and similar issues) to the extent the increase

does not exceed the debt service, (4) each interest in real property located in the blighted area that is acquired by a governmental unit with the proceeds of the issue and is transferred to a person other than a governmental unit is transferred for fair market value, and (5) no owner or user of property located in the financed area (the portion of the designated blighted area with respect to which the proceeds of the issue are to be used) is subject to a charge or fee that similarly situated owners or users of comparable property located outside the area are not subject, and the assessment method or rate of real property taxes with respect to property located in the financed area does not differ from the method or rate with respect to comparable property located outside the area.ⁿ¹⁷²

The term "redevelopment purposes" means (1) the acquisition (by a governmental unit having the power to exercise eminent domain) of real property located in the blighted area, (2) the clearing and preparation for redevelopment of the acquired land, (3) the rehabilitation of the real property, and (4) the relocation of occupants of the real property.ⁿ¹⁷³ Qualified redevelopment bonds cannot be used to construct new buildings or similar structures in a redevelopment area.ⁿ¹⁷⁴

The designation of blighted area is to be based on state statutory criteria that take into account all relevant factors, including the presence of excessive vacant land on which structures were previously located, abandoned or vacant buildings, substandard structures, vacancies, and delinquencies in the payment of real property taxes.ⁿ¹⁷⁵ The assessed value of real property in all of the blighted areas designated by a general purpose local government unit cannot exceed 20 percent of the assessed value of all real property located within the jurisdiction of the governmental unit; the percentage with respect to any area is determined at the time the area is designated.ⁿ¹⁷⁶ Previously designated areas cease to be taken into account, for purposes of the 20 percent test, if no qualified redevelopment bonds remain outstanding with respect to the area.

A designated blighted area must satisfy one of two minimum size requirements:

- (1) The area must be comprised of at least 100 compact and contiguous acres; or
- (2) The area is comprised of between 10 and 100 compact and contiguous acres, and no more than 25 percent of the bond-financed land in the area is to be provided to any one person or related persons.ⁿ¹⁷⁷ The 25-percent rule is not considered to be violated if more than 25 percent of financing is to be made available to one person (or related persons) on a short term interim basis for use in redevelopment activities and the redevelopment property is to be transferred with reasonable speed to persons satisfying the 25-percent requirement.ⁿ¹⁷⁸

A bond will not be a qualified redevelopment bond if (1) more than 25 percent of the net proceeds of the issue are used to provide any facility the primary purpose of which is retail food and beverage service, automobile sales or service, or the providing of recreation or entertainment, or (2) any of the proceeds of the issue are to be used to provide any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, or liquor store.ⁿ¹⁷⁹

[g] Qualified 501(c)(3) Bonds. A private activity bond is a qualified 501(c)(3) bond if (1) all of the property that is to be provided by the net proceeds of the issue is to be used as a tax-exempt organization described in *IRC Section 501(c)(3)*, and (2) not more than 5 percent of the net proceeds of the issue are to be used for any private business use, or secured by any property used for a private business use or payment with respect to such property.ⁿ¹⁸⁰ For bonds issued on or before August 5, 1997, the Code placed a \$150 million limit on the aggregate amount of qualified 501(c)(3) bonds, other than qualified hospital bonds,ⁿ¹⁸¹ that could be issued by a 501(c)(3) organization that was a principal user of the facilities being financed by the issue at any time during the three-year period beginning on the later of the date the facilities were placed into service, or the date of the issue; there is no limitation with respect to bonds issued after August 5, 1997, as part of an issue 95 percent or more of the net proceeds of which are used to finance capital expenditures incurred after that date.ⁿ¹⁸²

A bond will not be a qualified 501(c)(3) bond if any portion of the net proceeds of the issue of which the bond is a part is used directly or indirectly to provide residential rental property for family units.ⁿ¹⁸³ This rule does not apply if the portion of the issue is used to provide (a) residential rental property for family units if the first use of the property is pursuant to the issue, (b) qualified residential rental projects as defined in *IRC Section 142(d)*, or (c) property that is to be substantially rehabilitated in a rehabilitation beginning within the two year period ending one year after the date of the acquisition of the property.ⁿ¹⁸⁴

A bond will not be treated as a qualified 501(c)(3) bond if the issuer so elects, and the issue can be treated as an exempt-facility bond or qualified redevelopment bond. In such case, the financing will be subject to the private activity volume cap.ⁿ¹⁸⁵

[h] Qualified New York Liberty Bonds. *IRC Section 1400L(d)*, added by the Job Creation and Worker Assistance Act of 2002, authorizes the issuance of up to \$8 billion of a new exempt facility bond--the qualified New York Liberty Bond.ⁿ¹⁸⁶ A qualified New York Liberty Bond is a bond that is part of an issue if: (1) 95 percent or more of the net proceeds of the issue are to be used for qualified project costs; (2) the bond is issued by New York State or a political subdivision thereof; (3) the Governor of New York State or the Mayor of New York State designates the bond as a New York Liberty Bond; and (4) the bond is issued after March 9, 2002, and before January 1, 2005.ⁿ¹⁸⁷

Limitations are placed on the face amounts of bonds that can be issued for certain purposes.ⁿ¹⁸⁸ Bonds used for costs for property located outside the New York Liberty Zone cannot exceed \$2 billion.ⁿ¹⁸⁹ Bonds issued for residential rental property are limited to \$1.6 billion. No more than \$800 million can be issued for costs with respect to property used for retail sales of tangible property and functionally related and subordinate property. No bonds can be issued for costs relating to movable fixtures or equipment.ⁿ¹⁹⁰ The specified limitations are allocated proportionately between the bonds designated by the Governor and those designated by the Mayor in proportion to the respective amounts designated by each.

The qualified project costs for which the bonds can be issued are the costs of acquisition, construction, reconstruction, and renovation of (a) nonresidential real property and residential rental property (including fixed tenant improvements) located in the Liberty Zone; (b) public utility property (electric, water, sewage, gas and telecommunication lines) located in the Liberty Zone; and (c) nonresidential real property (including fixed tenant improvements) located in New York City outside the Liberty Zone, if the property is part of a project that consists of at least 100,000 square feet of usable office or other commercial space located in a single building or multiple adjacent buildings.ⁿ¹⁹¹

A number of special rules apply to qualified New York Liberty Bonds. First, the bonds are not subject to the annual volume cap on the amount of bonds that New York State can issue.ⁿ¹⁹² Second, if existing property is to be acquired with the proceeds of the bonds, rehabilitation expenses must equal or exceed 50 percent of the cost of acquiring the building.ⁿ¹⁹³ Third, the two-year exception to the arbitrage bond rebate requirements for proceeds that are used to finance construction that meets certain spending requirements applies.ⁿ¹⁹⁴ Finally, repayments of bond-financed loans may not be used to make additional loans, but must be used to retire outstanding bonds.ⁿ¹⁹⁵

Certain bonds for facilities located in New York City can be advance refunded one additional time after March 1, 2002, and before January 1, 2005.ⁿ¹⁹⁶ The bonds are those bonds for which all advance refunding authority was exhausted before September 12, 2001, and with respect to which the advance refunding bond is the only other outstanding bond with respect to the refunded bond.ⁿ¹⁹⁷ To be eligible for the additional advance refunding, at least 90 percent of the refunded bonds must have been used to finance facilities located in New York City, and the bonds must be: (1) a state or local bond that is a general obligation bond of New York City; (2) a state or local bond other than a private activity bond issued by the New York Municipal Water Finance Authority (NYCMWFA) or the Metropolitan Transportation Authority (MTA); or (3) a qualified *IRC Section 501(c)(3)* bond that is a qualified hospital bond issued by or on behalf of New York State or New York City.ⁿ¹⁹⁸

The maximum amount of advance refunding that may be issued under this special authority is \$9 billion, with the Governor and Mayor each able to designate \$4.5 million as advance refunding bonds.ⁿ¹⁹⁹ The advance refunding bonds must meet all of the requirements of *IRC Section 148* (arbitrage bonds) and *IRC Section 149(d)* (other than the number of advance refundings allowed under *IRC Section 149(d)*).ⁿ²⁰⁰

[i] Qualified Gulf Opportunity Zone Bonds. The existence of major disaster areas following devastating hurricanes in 2005 (Hurricanes Katrina, Rita, and Wilma) prompted Congress to pass legislation authorizing the issuance of tax-exempt Gulf Opportunity Zone Bonds.ⁿ²⁰¹ Depending on the purpose for which the bonds are issued, they can be treated either as exempt facility bonds or qualified mortgage bonds.ⁿ²⁰²

Gulf Opportunity Bonds are considered exempt facility bonds if (i) 95 percent or more of the net proceeds of the issue of which the bonds are a part are to be used for qualified project costs of projects located in the Gulf Opportunity Zone, (ii) the bond is issued by Alabama, Louisiana, or Mississippi, or a political subdivision thereof, (iii) the bond is issued to fund projects approved by the governor of the state (or the state bond commission where state law requires commission approval), (iv) the bond is issued after December 21, 2005, and before January 1, 2011, and (v) no part of the proceeds of the issue can be used to provide any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for off-premises consumption.ⁿ²⁰³

Qualified project costs include the cost of acquisition, construction, reconstruction, and renovation of nonresidential real property (including fixed improvements associated with the property) and public utility property, and the cost of any residential rental project.ⁿ²⁰⁴ Bond proceeds cannot be used to finance movable fixtures and equipment.ⁿ²⁰⁵

Gulf Opportunity Zone Bonds are treated as qualified mortgage bonds if the bonds of the issue meet the requirements of a qualified mortgage issue and the other requirements of a Gulf Opportunity Zone Bond specified above.ⁿ²⁰⁶ Under *IRC Section 1400N(a)(5)(B)*, the residences financed by the issue must be owner-occupied and be located in the Gulf Opportunity Zone. They are treated as targeted area residences, with certain modifications. The normal rule applicable to targeted area residences, allowing one-third of mortgages to be made without regard to any income limits does not apply, so that 100 percent of the mortgages must be made to mortgagors whose family income is 140 percent or less than the applicable family income. In addition, the amount of a qualified home improvement loan that can be financed with bond proceeds is increased from \$15,000 to \$150,000.ⁿ²⁰⁷

For purposes of the qualified mortgage bond provisions and the Gulf Opportunity Zone Bonds rules, any qualified Gulf Opportunity Zone repair or reconstruction is treated as a qualified rehabilitation.ⁿ²⁰⁸ A qualified Gulf Opportunity Zone repair or reconstruction involves the repair of any damage caused by Hurricane Katrina, Hurricane Rita or Hurricane Wilma to a building located in the Gulf Opportunity Zone, the Rita Gulf Opportunity Zone, or the Wilma Gulf Opportunity Zone (or reconstruction of any such building in the case of the destruction of the building) if the expenditures for the work are 25 percent or more of the mortgagor's adjusted basis in the residence determined as of the completion of the work, or, if later, the date on which the mortgagor acquires the residence.ⁿ²⁰⁹ The provision applies only to owner-financing provided before January 1, 2011.ⁿ²¹⁰

The issuance of Gulf Opportunity Zone Bonds is subject to the following additional rules:

1. Repayments of principal on financing provided by an issue of Gulf Opportunity Zone Bonds cannot be used to make additional loans, except as otherwise permitted for a qualified mortgage issue by *IRC Section 143*.
2. The issuance of such bonds is not subject to the volume cap for private activity bonds contained in *IRC Section 146*.

3. *IRC Section 147(d)(2)*, providing a restriction on the acquisition of existing property, is applied using a minimum requirement of 50 percent (instead of 15 percent) of the cost of acquiring the building being devoted to rehabilitation.

4. The exception from the arbitrage bond rebate rules for proceeds used to finance certain construction expenditures is applied to Gulf Opportunity Zone Bonds used to finance qualified project costs; the bonds are treated as a construction issue for purposes of *IRC § 148(f)(4)(C)*.

5. Interest on Gulf Opportunity Zone Bonds is not a preference item for purposes of the alternative minimum tax.ⁿ²¹¹

The maximum aggregate face amount of bonds that can be designated under *IRC § 1400N(a)* with respect to a state cannot exceed the product of \$2,500 multiplied by the portion of the state population that is in the Gulf Opportunity Zone (as determined on the basis of the most recent census estimate of resident population released by the Bureau of the Census before August 28, 2005).ⁿ²¹²

[3] Arbitrage Bonds.

By virtue of *IRC Section 103(b)(2)*, interest, which would have been excluded from gross income pursuant to the general rule of *IRC Section 103(a)*, will be subject to federal income taxation if the particular obligation is classified as an arbitrage bond.

State and local obligations are classified as arbitrage bonds if any portion of the proceeds therefrom are reasonably expected (at the time of issuance of the bond) to be used to acquire higher yielding investments (or to replace funds that were used to acquire such investments).ⁿ¹ Investments are higher yielding if the investment property is either a security,ⁿ² an obligation, an annuity contract, or investment-type property (but not a tax-exempt bond unless it is a specified private activity bond as defined for alternative minimum tax purposes by *IRC Section 57(a)(5)(C)*), or, in the case of a bond other than a private activity bond, any residential rental property for family units that is not located within the jurisdiction of the issuer and that is not acquired to implement a court ordered or approved housing desegregation plan, and the property produces a yield over the term of the issue that is materially higher than the yield on the issue.ⁿ³ Investment-type property includes any property, other than investment property described above, that is held principally as a passive vehicle for the production of income.ⁿ⁴ For this purpose, production of income includes any benefit based on the time value of money.ⁿ⁵ Investment-type property also includes the investment element of a contract that is a hedge and that contains a significant investment element because a payment by the issuer relates to an obligation by the hedge provider to make a payment at a later date.ⁿ⁶

The determination of the yield of an issue is made on the basis of the issue price, within the meaning of *IRC Sections 1273 and 1274* (see § 17.02A[1]).ⁿ⁷ A bond is not to be treated as an arbitrage bond solely because the proceeds may be invested temporarily in securities or other obligations until needed for the purposes for which the bond was issued.ⁿ⁸

The temporary period cannot exceed six months if the proceeds of the issue are to be used to make or finance loans (other than nonpurpose investments)ⁿ⁹ to two or more persons.ⁿ¹⁰ The period is extended to two years with respect to any portion of the issue used to make or finance loans for construction expenditures.ⁿ¹¹ The period is three months with respect to proceeds from the sale or repayment of any loan that are to be used to make or finance any loan.ⁿ¹² None of the temporary period rules applies to a qualified mortgage bond or qualified veterans' mortgage bond.ⁿ¹³

The regulations provide for additional temporary periods. A three-year period, beginning on the issue date, applies to the proceeds of an issue allocated to expenditures for capital projects if the issuer reasonably expects to meet three tests. The first, the expenditure test, is met if at least 85 percent of the net sale proceeds of the issue are allocated to

expenditures on the capital projects by the end of the three-year period. The second, the time test, is met if the issuer incurs within six months of the issue date a substantial binding obligation to a third party to expend at least five percent of the net sale proceeds of the issue on capital projects. (An obligation is not binding if it is subject to contingencies within the issuer's or a related party's control.) The final test, the due diligence test, is met if completion of the capital projects and the allocation of the net proceeds to expenditures proceed with due diligence.ⁿ¹⁴

Proceeds of a pooled financing issue reasonably expected to be used to finance purpose investments qualify for a temporary period of six months while held by the issuer before being loaned to a conduit borrower.ⁿ¹⁵ Any otherwise available temporary period for proceeds held by a conduit borrower is reduced by the period of time during which the issuer held the proceeds before the loan was made. If all or a portion of a pooled financing issue qualifies as a construction issue, the temporary period is two years.ⁿ¹⁶

The temporary period for proceeds from the sale or repayment of any loan that are reasonably expected to be used to make or finance new loans is three months.ⁿ¹⁷ Any temporary period for proceeds held by a conduit borrower under a new loan is determined by treating the date the new loan is made as the issue date and by reducing the temporary period by the period the amounts were held by the issuer following the last repayment.ⁿ¹⁸

Proceeds of an issue that are reasonably expected to be allocated to restricted working capital expenditures within 13 months after the issue date qualify for a temporary period of 13 months beginning on the issue date. If the issuer reasonably expects to use tax revenues arising from tax levies for a single fiscal year to redeem or retire an issue, and the issue matures by the earlier of two years after the issue date or 60 days after the last date for payment of those taxes without interest or penalty, the 13-month temporary period is extended until the maturity date of the issue.ⁿ¹⁹

Replacement proceeds qualify for a temporary period of 30 days beginning on the date the amounts are first treated as replacement proceeds.ⁿ²⁰ Amounts in a bona fide debt service fund for an issue qualify for a temporary period of 13 months.ⁿ²¹ Unless another temporary period is specified in the regulations, investment proceeds qualify for a temporary period of one year beginning on the date of receipt.ⁿ²²

A bond also will not be an arbitrage bond solely because the proceeds of the issue may be invested in higher yielding investments that are part of a reasonably required reserve or replacement fund, provided that the amount which can be so invested is limited to 10 percent of the total proceeds of the issue, unless the taxpayer can establish that a higher amount is necessary.ⁿ²³ A bond will be treated as an arbitrage bond if the amount of the proceeds placed in a reserve or replacement fund exceeds 10 percent of the issue (or the higher established amount).ⁿ²⁴

Lastly, a bond is not an arbitrage bond solely because a portion of the proceeds of the issue are invested in higher yielding investments, if the amount so invested does not exceed the lesser of 5 percent of the proceeds of the issue of \$100,000.ⁿ²⁵ This "minor portion" exception is in addition to the amount that can be placed in temporary investments, or in reserve or replacement funds.

Yield on an investment is computed under the economic accrual method, with the same compounding interval and financial conventions used to compute the yield on the issue.ⁿ²⁶ The yield on an investment allocated to an issue is the discount rate that produces an amount equal to the present value of all unconditionally payable payments for the investment.

For purposes of the yield restriction rules of *IRC Section 148(a)* and *Regulations Section 1.148-2*, yield is computed separately for each class of investments.ⁿ²⁷ The yield on each individual investment within the class is blended with the yield on other individual investments within the class by treating those investments as a single investment; the yields on investments that are not within the same class are not blended. Each of the following is a separate class of investments: (i) each category of yield restricted purpose investment and program investment that is subject to a different definition of materially higher yield under *Regulations Section 1.148-2(d)(2)*; (ii) yield-restricted nonpurpose

investments; and (iii) all other nonpurpose investments.ⁿ²⁸

In computing the yield on investments allocable to an issue that are to be held beyond the reasonably expected redemption date of the issue, the investments are treated as sold for an amount equal to their value on that date.ⁿ²⁹ In computing the yield on investments that are held beyond an applicable temporary period, the investments are treated as purchased for an amount equal to their fair market value at the end of the temporary period.ⁿ³⁰

The value of an investment (including a payment or receipt on the investment) on any date must be determined using one of the following valuation methods consistently for all purposes of *IRC Section 148* to that investment on that date: (a) for a plain par investment, the outstanding stated principal amount; (b) for a fixed rate investment, present value; or (c) for any other investment, fair market value.ⁿ³¹ Any yield-restricted investment must be valued at present value.ⁿ³² Generally, an investment must be valued at fair market value on the date that it is first allocated to an issue or first ceases to be allocated to an issue as a consequence of a deemed acquisition or deemed disposition.ⁿ³³

An allocation of gross proceeds of an issue to a payment or receipt on an investment generally is not adjusted to take into account administrative costs (costs or expenses paid, directly or indirectly, to purchase, carry, sell, or retire the investment).ⁿ³⁴ However, adjustment is made for a nonpurpose investment for costs that are qualified administrative costs--reasonable, direct administrative costs, other than carrying costs, such as separately stated brokerage or selling commissions, but not legal and accounting fees, recordkeeping, custody, or general overhead costs (eg, employee salaries and office expenses).ⁿ³⁵ Adjustment is also made in the case of purpose investments for costs directly or indirectly paid to purchase, carry, sell, or retire the investment, and costs of issuing, carrying, or repaying the issue, and underwriter's discounts.ⁿ³⁶

Amounts are replacement proceeds of an issue if the amounts have a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds were not used or to be used for that governmental purpose. *Treas Reg § 1.148-1(c)(1)*.

Regulations provide that bonds of an issue are arbitrage bonds if an abusive arbitrage device is used in connection with an issue.ⁿ³⁷ An action is an abusive arbitrage device if the action has the effect of (i) enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage, and (ii) overburdening the tax-exempt bond market.ⁿ³⁸ An action overburdens the tax-exempt bond market if it results in issuing more bonds, issuing bonds earlier, or allowing bonds to remain outstanding longer than is reasonably necessary to accomplish the governmental purposes of the bonds.ⁿ³⁹

The Code limits the amount of the proceeds of a private activity bond issue (other than qualified 501(c)(3) bonds) that can be invested in nonpurpose investments with a materially higher yield than the yield on the issue. Except for an initial temporary period until the proceeds of an issue are needed for the governmental purpose of the issue, and except for temporary investment periods related to debt service, the amount of proceeds of an issue that can be invested in higher yielding nonpurpose investments cannot exceed 150 percent of the annual debt service on the bonds and the aggregate amount invested in such investments must be appropriately reduced as the amount of outstanding bonds of the issue is reduced (or in the case of a qualified mortgage bond or qualified veterans' mortgage bond, as the mortgages are repaid).ⁿ⁴⁰

Arbitrage (the sum of the excess of the amount earned on nonpurpose investments over the amount that would have been earned if the nonpurpose investment had been invested at the same yield as the issue, plus any income attributable to such excess) earned on investments in nonpurpose obligations must be paid to the federal government every five years.ⁿ⁴¹ Each installment must consist of at least 90 percent of the amount earned to the payment date, with any remaining balance paid within 60 days after the bonds are retired.ⁿ⁴² At the election of the issuer, a series of issues redeemed during a six-month period (or such longer period as the Service may prescribe) can be treated as one issue for purposes of the due date of the last installment if no bond that is part of any issue in the series has a maturity of more

than 270 days or is a private activity bond. In the case of a tax and revenue anticipation bond, the last installment need not be made until eight months after the date of issuance of the issue of which the bond is a part. No rebate is required if the gross arbitrage earnings for a bond year are less than \$100,000, or if the proceeds of the issue are expended for governmental purposes within six months from the date of issue.ⁿ⁴³ However, in the latter case, the rebate requirements must be met after the six-month period with respect to earnings on amounts in any reasonably required reserve or replacement fund.

There are three additional statutory exceptions to the rebate requirement. First, an additional six months in which to spend the proceeds of an issue for governmental purposes is allowed in the case of governmental bonds and qualified 501(c)(3) bonds, if all but 5 percent of the proceeds of the issue are spent for governmental purposes within the initial six-month period.ⁿ⁴⁴ The period is extended to two years if (1) at least 75 percent of the net proceeds of the issue are to be used for construction expenditures with respect to property that is owned by a governmental unit or Section 501(c)(3) organization, and (2) the following percentages of the net proceeds are spent for the governmental purpose of the issue during the specified time periods from the date of issuance: at least 10 percent within six months, at least 45 percent within one year, at least 75 percent within 18 months, and at least 100 percent within two years.ⁿ⁴⁵

Second, no rebate is required on bonds used to finance activities of governmental units if the unit reasonably expects to issue no more than \$5 million in governmental bonds during the calendar year when the issuance occurs and at least 95 percent of the net proceeds of the issue are to be used for local governmental activities of the issuer (or of a governmental unit the jurisdiction of which is entirely within the jurisdiction of the issuer).ⁿ⁴⁶ In determining whether the \$5 million limit is reasonably expected to be exceeded, (1) an issuer and all entities issuing bonds on its behalf are treated as one issuer, (2) bonds issued by a governmental unit on behalf of other governmental units with general taxing powers not subordinate to the unit are treated as not issued by the unit, (3) all bonds issued by a subordinate entity are treated as issued by the entity to which it is subordinate, and (4) an entity formed or availed of to avoid the purposes of the \$5 million limit and all other entities benefiting thereby are treated as one issuer. (Private activity bonds issued by the governmental unit are neither counted nor eligible for the rebate requirement exception).

Governmental units with general taxing powers may, in advance of the issuance date, irrevocably elect to allocate to a subordinate entity part or all of the \$5 million amount of governmental bonds that they can issue in a calendar year. To qualify, the subordinate entity cannot issue bonds in excess of the amount that could be issued if the allocating entity had directly issued the bonds. In addition, the allocation must bear a reasonable relationship to the benefits received by the allocating unit. In the case of entities subordinate to more than one allocating governmental unit with general taxing powers, only the proportionate part of the bonds represented by the benefit received by each allocating unit may be treated as issued by the unit. Absent qualifying allocations, the entire amount of the bonds issued by the multi-jurisdictional issuers will be treated as issued by each governmental unit to which the issuer is subordinate.

Current refunding bonds are not considered in determining whether an issuer qualifies for the small-issuer rebate exception if the amount of the refunding issue does not exceed the outstanding (redeemed) principal amount of the refunded bond. Advance refunding bonds are taken into account in determining whether an issuer reasonably expects to issue \$5 million or more in bonds in the same manner as new money bonds.

Current and advance refunding bonds are themselves eligible for the \$5 million rebate exception only if (a) the refunded bonds qualified for, and were taken into account under, the \$5 million exception when issued, (b) the aggregate face amount of the issue of which the refunding bond is a part does not exceed \$5 million, (c) except in the case of refunded issues having a weighted average maturity of three years or less, the weighted average maturity of the refunded bonds, and (d) no bond that is a part of the refunding issue has a maturity in excess of 30 years (measured from the date of issuance of the original bonds).

The \$5 million amounts mentioned in *IRC Section 148(f)(4)(D)* are increased by the lesser of \$10 million or so much of the aggregate face amount of the bonds as are attributable to financing the construction of public school facilities.ⁿ⁴⁷

Third, the rebate requirement does not apply to qualified student loan bonds issued before January 1, 1989, in connection with the federal GSL and PLUS programs. In this case the rebate requirement does not apply to arbitrage profits earned during the initial 18-month temporary period permitted for such bonds, if the proceeds of the issue are used to make or finance qualified student loans before the end of the 18-month period, and the arbitrage profits are used to pay the reasonable administrative and issuance costs associated with the issue that were financed with the proceeds of the issue and for which the issuer was not reimbursed.ⁿ⁴⁸ Amounts paid by student loan borrowers as interest are not to be taken into account in determining whether an issuer is reimbursed for costs. In addition, amounts earned under the exception can be taken into account in determining yield on GSL and PLUS bonds.

Regulations provide that an issue meets the rebate requirement if all of the following requirements are met:ⁿ⁴⁹

- (1) the gross proceeds of the issue are allocated to expenditures for a governmental purpose in accordance with the following schedule measured from the issue date: at least 15 percent within six months; at least 60 percent within 12 months; and 100 percent within 18 months;ⁿ⁵⁰
- (2) the rebate requirement is met for all amounts not required to be spent in accordance with the 18-month expenditure schedule (other than earnings on a bona fide debt service fund); and
- (3) all of the gross proceeds of the issue qualify for the initial temporary period under *Regulations Section 1.148-2(e)(2)*.

The Code contains a special safe-harbor exception that treats the net proceeds of tax and revenue anticipation notes as having been spent for the exempt purpose of the borrowing within six months, if, during the period beginning on the date of issuance of the issue and ending on the earlier of the date six months after the date of issuance or the date of computation of cumulative cash flow deficit the cumulative cash-flow deficit of the governmental unit issuing the notes has exceeded 90 percent of the proceeds of the issue.ⁿ⁵¹ For this purpose, cumulative cash-flow deficit is defined as the excess of the amount the governmental unit spends during the relevant period over the sum of all amounts (other than the issue process) that are available for payment of the expenses during the period.ⁿ⁵²

The Treasury can waive the loss of tax-exemption on an issue (if no bond in the issue is a private activity bond other than a qualified 501(c)(3) bond) where an error in the amount rebated, or a late payment occurs, if the error is not due to willful neglect. In such case, a penalty of 50 percent of the amount not paid, plus interest at the underpayment rate specified in *IRC Section 6621* is imposed, unless the Treasury waives the penalty.ⁿ⁵³

[4] Qualified Scholarship Funding Bonds.

Pursuant to *IRC Section 150(d)(1)*, a qualified scholarship funding bond is treated as a tax-exempt state or local bond. An obligation qualifies as such if issued by a nonprofit corporation that is (1) established and operated exclusively for the purpose of acquiring student loan notes incurred under the Higher Education Act of 1966; (2) organized at the request of a state or political subdivision thereof, or requested to exercise such power by the state or political subdivision; and (3) required by its charter and bylaws or by state law either to devote its net income to the purchase of additional student loan notes or to pay over its income to the state or to a political subdivision thereof.ⁿ¹

Any qualified scholarship funding bond outstanding on the date of the issuer's election outlined below (and any bond or series of bonds issued to refund such a bond) will not fail to be a tax-exempt bond because the issuer ceases to meet the requirements of *IRC Section 150(d)(2)* if: (1) all of the student loan notes of the issuer and other assets pledged to secure the repayment of qualified scholarship funding bond indebtedness of the issuer are transferred to another corporation within a reasonable period after the election; (2) the transferee corporation assumes or otherwise provides for payment of all of the qualified scholarship funding bond indebtedness of the issuer within a reasonable time after the

election is made; (3) to the extent permitted by law, the transferee corporation assumes all of the responsibilities, and succeeds to all of the rights, of the issuer under the issuer's agreements with the Secretary of Education in respect of student loans; (4) immediately after the transfer, the issuer, together with any other issuer that has made an election in respect of the transferee, hold all of the senior stock in the transferee corporation; and (5) the transferee corporation is not a tax-exempt organization.ⁿ² In addition, within a reasonable time after the transfer, (1) the issuer must be a tax-exempt organization described in *IRC Section 501(c)(3)*, (2) the issuer must no longer meet the requirements of *IRC Section 150(d)(2)*, and (3) at least 80 percent of the members of the board of directors of the issuer must be independent members.ⁿ³

Senior stock is stock (a) that participates pro rata and fully in the equity value of the corporation with all other common stock of the corporation but which has the right to payment of liquidation proceeds prior to payment of liquidation proceeds in respect of other common stock of the corporation; (b) that has a fixed right upon liquidation and upon redemption, to an amount equal to the greater of (i) the fair market value of the stock on the date of liquidation or redemption, or (ii) the fair market value of all assets transferred in exchange for the senior stock and reduced by the amount of all liabilities of the electing transferor corporation assumed by the transferee corporation in the transfer; (c) the holder of the stock has the right to require the transferee corporation to redeem on the stock not later than 10 years after the date on which the election was made and pursuant to which the stock was issued; and (d) during the time the stock is outstanding, there is not outstanding any equity interest in the corporation having liquidation, redemption, or dividend rights in the corporation that are superior to the stock.ⁿ⁴ An independent member of the board of directors of the issuer is one who (except for services as a member of the board) receives no compensation directly or indirectly for services performed for the transferee corporation, or for services as a member of the board or directors or as an officer of the transferee corporation.ⁿ⁵

Once made, the election can be revoked only with the consent of the Commissioner.ⁿ⁶

[5] Advance Refundings.

Interest on a bond issued to advance refund a governmental bond or a qualified 501(c)(3) bond is tax-exempt; interest on bonds issued to refund a private activity bond (other than a qualified 501(c)(3) bond) is not.ⁿ¹ A bond is treated as issued to advance refund another bond if it is issued more than 90 days before the redemption of the refunded bond.ⁿ²

The Code imposes the following requirements on permitted advance refunding bonds:

(1) The refunding bond must be the first advance refunding of an original bond issued after 1985, or the first or second refunding of an original bond issued before 1986.

(2) In the case of refunded bonds issued before 1986, the refunded bond must be redeemed not later than the earliest date on which the bond may be redeemed at par or at a premium of 3 percent or less, but not earlier than the 90th day after the refunding bond is issued.

(3) In the case of refunded bonds issued after 1985, the refunded bond must be redeemed not later than the earliest date on which the bond may be redeemed, but not earlier than the 90th day after the refunding bond is issued.

(4) The initial temporary period during which proceeds of the issue can be invested without running afoul of the arbitrage rules must end (a) with respect to the refunding bond, not later than 30 days after it is issued, and (b) with respect to the refunded bond, on the date of issuance of the refunding bond.

(5) The portion of the proceeds of the refunded bond that can be invested in higher yielding nonpurpose investments without regard to the arbitrage yield restrictions cannot exceed (a) the amount so invested as part of a reasonably required reserve or replacement fund, or during an allowable temporary

period, and (b) the amount that is equal to the lesser of 5 percent of the proceeds of the issue of which the refunded bond is a part or \$100,000 (to the extent allocable to the refunded bond).ⁿ³

The second and third requirements apply only if the issuer may realize present value debt service savings (determined without regard to administrative expenses) in connection with the issue of which the refunding bond is a part.ⁿ⁴

A permitted advance refunding bond will not be treated as such if a device is employed in connection with the issuance of the bond to obtain a material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates.ⁿ⁵

A special rule, contained in *IRC Section 1400N(b)*, allows one additional advance refunding after December 21, 2005, and before January 1, 2011, for any bond issued by Alabama, Louisiana, or Mississippi, or a political subdivision thereof, if (i) the bond was outstanding on August 28, 2005, (ii) the governor of the state designates the advance refunding bond for purposes of the provision, (iii) no advance refundings of the bond otherwise would be allowed on or after August 28, 2005, (iv) the advance refunding bond is the only other outstanding bond with respect to the refunded bond, and (v) the arbitrage requirements of *IRC Section 148* are met with respect to all bonds issued under *IRC Section 1400N(b)*.ⁿ⁶ The maximum aggregate face amount of bonds that can be designated cannot exceed \$4.5 billion in the case of Louisiana, \$2.25 billion in the case of Mississippi, and \$1.125 billion in the case of Alabama.ⁿ⁷

[6] Volunteer Fire Department Bonds.

Pursuant to *IRC Section 150(e)(1)*, a bond of a volunteer fire department is treated as a bond of a political subdivision of a state if (a) the department is a qualified volunteer fire department with respect to an area within the jurisdiction of the political subdivision, and (b) 95 percent of the proceeds of the issue of which the bond is a part are to be used for the acquisition, construction, reconstruction, or improvement of a firehouse (including land that is functionally related and subordinate thereto) or fire truck used or to be used by the department. A qualified volunteer fire department is one that is organized and operated to provide fire fighting or emergency medical services for persons in an area (within the jurisdiction of the political subdivision) that is not provided with any other fire fighting services, and that is required by written agreement by the political subdivision to furnish fire fighting services in the area.ⁿ¹ Bonds that qualify are not treated as private activity bonds except for purposes of the public approval requirement of *IRC Section 147(f)* and the rules relating to advance refundings contained in *IRC Section 149(d)*.ⁿ²

[7] Pooled Financing Bonds.

IRC § 149(f) prescribes additional requirements for the exclusion from income of interest on any pooled financing bond--a bond issued as part of an issue if more than \$5 million of the proceeds of the issue are reasonably expected at the time of issuance to be used (or are intentionally used) directly or indirectly to make or finance loans to two or more ultimate borrowers.ⁿ¹ Pooled financing bonds do not include private activity or qualified veterans' mortgage bond issues subject to the state volume cap, or to refunding issues exempted from volume limits by *IRC Section 146(i)*. For this purpose, the term "loan" does not include a nonpurpose investment or the use of proceeds by an agency of the issuer unless the agency is a political subdivision or instrumentality of the issuer.ⁿ² If only a portion of the proceeds of an issue is reasonably expected to be used (or is intentionally used) as a pooled financing bond vehicle, the two portions of the issue are treated as separate issues in determining whether the pooled financing bond part meets the requirements of *IRC Section 149(f)*.

Interest on a pooled financing bond will continue to be exempt from tax if the issuer reasonably expects that as of the close of the one-year period beginning on the date of issuance of the issue, at least 30 percent of the proceeds of the issue will have been used directly or indirectly to make or finance loans to ultimate borrowers, and as of the close of the three-year period beginning on the date of issuance of the issue, at least 95 percent of the net proceeds of the issue will have been used to make or finance loans to ultimate borrowers, the payment of legal and underwriting costs associated

with the bonds is not contingent, and at least 95 percent of the reasonably expected legal and underwriting costs associated with the issuance of the issue are paid within 180 days after issuance.ⁿ³ Expectations as to changes in interest rates or in federal tax law cannot be taken into account in determining whether expectations are reasonable.

The requirement of *IRC Section 149(f)* is met with respect to an issue if the issuer receives prior to the issuance loan commitments identifying the ultimate potential borrowers of at least 30 percent of the net proceeds of the issue, except if the issuer is a state (or an integral part of a state) issuing pooled financing bonds to make or finance loans to subordinate governmental units of the state, or is a state-created entity providing financing for water-infrastructure projects through the federally-sponsored state revolving fund program.ⁿ⁴ The requirement of the provision is met if to the extent that less than the percentage of the proceeds required to be used under *IRC Section 149(f)(2)* is used by the close of the applicable period, the issuer uses an amount of proceeds equal to the excess of the amount required to be used, over the amount actually used by the close of the period, to redeem outstanding bonds within 90 days after the end of the period.ⁿ⁵

[8] Hedge Bonds.

Interest on any hedge bond will not be tax exempt unless, with respect to the issue of which the bond is a part, (1) the issuer reasonably expects that, beginning with the date the bonds are issued, the spendable proceeds of the issue will be spent for the governmental purposes of the issue as follows: 10 percent within one year, 30 percent within two years, 60 percent within three years, and 85 percent within five years, and (2) the payment of legal and underwriting costs associated with the issuance of the bonds is not contingent and at least 95 percent of such costs are paid not later than 180 days after the date of issuance.ⁿ¹ At the request of an issuer, the Service can treat the five-year spending schedule as met with respect to any portion of the proceeds that is to be used for a construction project having a construction period in excess of five years if it is reasonably expected that the proceeds will be spent over a reasonable construction schedule specified in the request.ⁿ²

A hedge bond is defined as any bond that is part of an issue unless the issuer reasonably expects that 85 percent of the spendable proceeds of the issue will be used to carry out the governmental purposes of the issue within the three-year period beginning on the date of issuance, not more than 50 percent of the proceeds of the issue are invested in nonpurpose investments having a substantially guaranteed yield for four years or more.ⁿ³ A hedge bond does not include any bond that is part of an issue of which 95 percent of the net proceeds is invested in tax-exempt state and local bonds that are not private activity bonds.ⁿ⁴

A refunding bond will be treated as a tax-exempt hedge bond only if the original bond was so treated.ⁿ⁵ However, if the original bond was issued before September 15, 1989, interest on a refunding bond will be tax exempt if (1) the average maturity date of the refunding bond issue is not later than the average maturity date of the refunded issue, and the amount of the refunding bond does not exceed the outstanding amount of the original bond, or (2) the issuer reasonably expected that 85 percent of the spendable proceeds of the original issue would be used to carry out the governmental purposes of the issue within the five-year period beginning on the date of original issuance but did not reasonably expect that 85 percent of the proceeds would be so spent within three years of that date, and at least 85 percent of the spendable proceeds of the original issue (and all prior original issues used to fund the governmental purpose of such issue) were spent before the issuance of the refunding bonds.

[9] Issuer Reporting Requirements.

Interest on a state or local bond will not be tax exempt unless the issuer submits a statement containing the following information to the Treasury not later than the 15th day of the second calendar month after the close of the calendar quarter in which the bond is issued:

- (1) the name and address of the issuer;

- (2) the date of issue, the amount of net proceeds of the issue, the stated interest rate, term, and face amount of each bond that is a part of the issue, the amount of issuance costs of the issue, and the amount of reserves of the issue;
- (3) where required, the name of the applicable elected representative who approved the issue, or a description of the voter referendum, by which the issue was approved;
- (4) the name, address, and employer identification number of (a) each initial principal user of any facility provided with the proceeds of the issue, (b) the common parent of any affiliated group of corporations (within the meaning of *IRC Section 1504(a)*) of which the initial principal user is a member, and (c) if the issue is treated as a separate issue under *IRC Section 144(a)(6)(A)*, any person treated as a principal user under *IRC Section 144(a)(6)(B)*;
- (5) a description of any property to be financed from the proceeds of the issue;
- (6) a certification by a state official designated by state law (or by the governor if there is no such official) that the bond meets the volume cap requirement for private activity bonds; and
- (7) such other information as the Treasury may require.ⁿ¹

The third and fourth items of information do not have to be furnished if the bond is not a private activity bond.

[10] Tax-Exempt Bonds Issued by Indian Tribal Governments.

IRC Section 7871(c)(1) provides that Indian tribal governments may issue tax-exempt bonds if substantially all of the proceeds of the issue are used in the exercise of essential governmental functions.ⁿ¹ As a general rule, they cannot issue tax-exempt private activity bonds.ⁿ² However, *IRC Section 7871(c)(3)*, applicable to obligations issued after October 13, 1987, provides a limited exception for certain private activity bonds.

For a bond to qualify under the exception, no person other than the issuing Indian tribal government may use the proceeds (or be responsible for debt service on the bonds) in a manner that violates the private business use and private payment tests that generally determine whether a bond is a private activity bond. Additionally, no person other than the issuing tribal government may be a principal user of the bond proceeds or bond-financed property in a manner that is violative of the restrictions on participation in qualified small-issue bonds by franchisors, etc. At least 95 percent of the bond proceeds must be used to finance acquisition, construction, or improvement of depreciable property that is part of a manufacturing facility and is located on Indian tribal land that has been held in trust by the United States for the issuing tribe for at least five years immediately preceding issuance of the bonds and at all times when the bonds are outstanding. Finally, an employment test must be satisfied.

The latter test is met if the aggregate face amount of bonds outstanding at the close of each calendar year that begins more than two years after the date of issuance is not be more than 20 times greater than the aggregate wages paid to enrolled members of the issuing tribe (and their spouses) for services rendered at the facility. If the employment requirement is not satisfied, the bonds become taxable on January 1 of the year following the year in which noncompliance is found, unless the issuer redeems bonds in an amount sufficient to meet the test within 90 days.

Bonds issued under the exception are treated as qualified small issue bonds. However, the bonds are not subject to the state volume cap normally imposed on private activity bonds.

[11] Amortization of Bond Premium on Tax-Exempt Bonds.

As a general rule, no deduction for amortization of bond premium is allowed when the interest on the bond is excludable from gross income.ⁿ¹ (However, the taxpayer is required to adjust, i.e., decrease his basis in the bond "to the extent of the amortization of bond premium disallowable as a deduction pursuant to section 171(a)(2).")ⁿ² The one exception comes when the holder of the municipal bond is a dealer in securities and the bond is held primarily for sale to customers in the ordinary course of business.ⁿ³

[12] Qualified Tax Credit Bonds.

[a] General Rules--*IRC Section 54A.*

Qualified tax credit bonds are special purpose bonds, generally issued by state or local governments, the interest on which is paid by the federal government through the mechanism of giving nonrefundable tax credits to holders of the bonds in lieu of interest.ⁿ¹ Unlike interest paid by state and local governments, however, the interest paid by the federal government through the tax credit mechanism is not exempt from federal income tax but must be included by the holders in their gross income as taxable interest.ⁿ²

An *IRC Section 54A* tax credit accrues quarterly, on March 15, June 15, September 15 and December 15 of each year.ⁿ³ The total credit allowed for the taxable year is the sum of the quarterly credits to which the taxpayer is entitled by reason of holding the qualified tax credit bond on one or more of these "credit allowance dates" during the year.ⁿ⁴ The Section 54A credit is nonrefundable,ⁿ⁵ but any unused credit may be carried forward by the taxpayer to succeeding taxable years.ⁿ⁶ Moreover, under regulations to be issued by the Treasury, the holder of any qualified tax credit bond may strip (separate) entitlement to the credit from the ownership of the bond, and the credit will be allowed to whoever holds the instrument evidencing entitlement to the credit and not to the holder of the bond.ⁿ⁷ This should enlarge the market for state and local bonds by making them more attractive to tax-exempt entities, like pension funds and foreign governments, which will be able to strip the tax credits and sell them to US taxpayers who can use them.

*Notice 2010-28*ⁿ⁸ provides interim guidance for holders of tax credit bonds on which taxpayers can rely pending the issuance of regulations under *IRC Section 54A*.ⁿ⁹ The holder's entitlement to a tax credit by reason of holding a tax credit bond on the credit allowance date is treated as a payment of interest on a debt obligation (considered qualified stated interest for original issue discount (OID) purposes) to the same extent that a payment of stated interest in cash to the holder in the same amount and on the same date would have been so treated.ⁿ¹⁰ The credit is recognized as interest income as of the credit allowance date, if the taxpayer is on a cash method of accounting, but accrued as earned if the taxpayer is on the accrual method.ⁿ¹¹

The amount of the annual credit on a qualified tax credit bond is determined by multiplying the face value of the bond by a rate determined by the Treasury immediately prior to issuance of the bond,ⁿ¹² that is estimated to permit issuance of the bond, given its specific maturity or redemption date, without discount and without interest cost to the issuer.ⁿ¹³

A "qualified tax credit bond," must satisfy six requirements. First, it must fit the definition of one of the five types of bonds in *IRC Section 54A(d)(1)*, each of which imposes its own separate requirements.ⁿ¹⁴ Second, the issuer must reasonably expect (a) that 100 percent of the "available project proceeds"ⁿ¹⁵ will be spent for one or more "qualified purposes"ⁿ¹⁶ within 3 years from the date the bonds are issued, and (b) that there will be a binding commitment with a third party to spend at least 10 percent of the proceeds within 6 months of issuance.ⁿ¹⁷ If the issuer does not spend 100% of the proceeds of the issue on qualified purposes within a 3-year "expenditure period,"ⁿ¹⁸ all nonqualified bonds must be redeemed by the issuer within 90 days. The amount of nonqualified bonds required to be redeemed is to be determined in the same manner as under *IRC Section 142*.ⁿ¹⁹

Third, the issuer must submit reports to the IRS similar to those required by *IRC Section 149(e)* for tax-exempt bonds.ⁿ²⁰

Fourth, the bond issue must satisfy the arbitrage requirements applicable to tax-exempt bonds generally as set forth in *IRC Section 148*,ⁿ²¹ applied in the light of the following special rules:

(A) A tax credit bond issue cannot be treated as having failed to meet the arbitrage requirements by reason of any investment of available project proceeds during the expenditure period; and

(B) A tax credit bond issue cannot be treated as having failed to meet the arbitrage requirements by reason of having a sinking fund that is funded (i) at a rate not more rapid than equal annual installments, (ii) in a manner reasonably expected to result in an amount that is not greater than what is necessary to repay the issue, provided that (iii) the yield on the fund is not greater than the discount rate used by the IRS in setting the maximum term for the issue.ⁿ²²

Fifth, the term of the bond may not exceed the maximum term for tax credit bonds as determined by the IRS during the month preceding the month in which the bonds were issued.ⁿ²³ The maximum term is the term estimated to result in the present value of the obligation to pay the principal on the bond being equal to 50 percent of the face amount of the bond, rounded to the next highest whole year.ⁿ²⁴

The sixth and final requirement of *IRC Section 54A* is that the issuer certify that State and local law requirements governing conflicts of interest, as well as any additional conflict of interest rules that may be prescribed by the Treasury Department, are satisfied with respect to the bond issue.ⁿ²⁵

[b] Qualified Forestry Conservation Bonds--*IRC Section 54B*.

Qualified forestry conservation bonds (QFCBs) must be part of a bond issue with respect to which (1) 100 percent of the available project proceeds are to be used for qualified forestry conservation purposes, (2) the bonds are issued by a qualified issuer,ⁿ²⁶ and (3) the bonds are designated by the issuer for purposes of *IRC Section 54B*.ⁿ²⁷

QFCBs are used to fund acquisitions of private forest land that will be donated to and conserved by federal or state forest conservation agencies. Thus, the only qualified purpose for which a QFCB can be issued is the acquisition by a state or local government, or a Section 501(c)(3) organization, from an unrelated person, of forest and forest land, provided the following four requirements are met.ⁿ²⁸

(1) Some portion of the acquired land is adjacent to United States Forest Service (USFS) land.ⁿ²⁹

(2) At least half of the land acquired will be transferred to the USFS at no net cost to the United States. Not more than half of the land acquired may either remain with, or be conveyed to, a State.ⁿ³⁰

(3) All of the land acquired must be subject to a native fish habitat conservation plan approved by the United States Fish and Wildlife Service.

(4) The amount of acreage acquired with the available project proceeds of the QFCB issue must total at least 40,000 acres.ⁿ³¹

There is a \$500 million national limitation on the amount of bonds that can be designated QFCBs.ⁿ³² The Secretary of the Treasury has discretion to determine an appropriate allocation of this national limitation among prospective qualified issuers, as long as the allocation proceeds in a manner that ensures that all of the national limitation is allocated within 24 months of the section's enactment (i.e., by June 18, 2010).ⁿ³³ The Internal Revenue Service solicited applications for allocations of the national limitation in *Notice 2008-70*.ⁿ³⁴ Section 9 (2) of that Notice provides that if the IRS receives applications for allocations in excess of the national limitation, or receives competing

applications not all of which can be fulfilled (because, for example, they relate in whole or in part to the same land), it will make allocations to qualified issuers "in a manner consistent with the recommendations of the USFS."ⁿ³⁵

An unusual provision in *IRC Section 54B* gives a qualified issuer who receives an allocation to issue QFCBs an election to take 50 percent of its allocation in cash in lieu of issuing QFCBs, provided it uses the cash to acquire forest land subject to the same requirements of *IRC Section 54B(e)* that apply to use of the available project proceeds of an issue of QFCBs.ⁿ³⁶ If the election is made, cash is provided by the federal government by treating the issuer as having made a payment (the "deemed payment") of tax under Chapter 1 of the Internal Revenue Code (whether or not the issuer is subject to tax under that Chapter) equal to 50 percent of the allocation made to the issuer, for the taxable year preceding the taxable year in which the allocation was received.ⁿ³⁷ In order to receive the payment, the qualified issuer must certify to the IRS that if it fails to use any portion of the deemed payment for a qualified purpose under *IRC Section 54B*, the issuer will be liable to the United States in an amount equal to such portion, plus interest at the overpayment rate under *IRC Section 6621*, for the period from the date such portion was refunded to the issuer to the date it is paid.ⁿ³⁸ If an issuer makes an election to take the deemed payment, it may issue no bonds pursuant to its allocation and the IRS may not reallocate its allocation for any other purpose.ⁿ³⁹

[c] New Clean Renewable Energy Bonds--*IRC Section 54C.*

New clean renewable energy bonds (New CREBs), as the name implies, are the successor to an earlier version, clean renewable energy bonds (CREBs), issued under *IRC Section 54*.ⁿ⁴⁰ The principal difference between New CREBs and CREBs is that the amount of the annual interest credit on a new CREB is reduced to 70 percent of the full "applicable credit rate."ⁿ⁴¹

The only qualified purpose for a New CREB is to provide funds to governmental bodies, public power providers,ⁿ⁴² or cooperative electric companies for capital expenditures to acquire one or more qualified renewable energy facilities.ⁿ⁴³ A "qualified renewable energy facility" is any qualified facility described in *IRC § 45(d)* (determined without regard to any placed in service date, and excluding certain coal production facilities):ⁿ⁴⁴ viz, a wind facility, a closed-loop biomass facility, a geothermal or solar energy facility, a small irrigation power facility, a landfill gas facility, a trash combustion facility, a qualified hydropower facility, or a marine and hydrokinetic renewable energy facility. Every New CREB must be part of an issue (1) in which 100 percent of available project proceeds are used for this qualified purpose, (2) that is issued by a "qualified issuer,"ⁿ⁴⁵ and (3) that is designated for purposes of *IRC Section 54C*.ⁿ⁴⁶

A total of \$2.4 billion of New CREBs may be issued under Section 54C.ⁿ⁴⁷ This allocation is to be divided in equal thirds between projects for public power providers, governmental bodies, and cooperative electric companies.ⁿ⁴⁸ So long as allocations conform to this division, the choice of qualified projects to be funded by New CREB allocations is left to the discretion of the Treasury Department.ⁿ⁴⁹

[d] Qualified Energy Conservation Bonds--*IRC Section 54D.*

Qualified Energy Conservation Bonds (QECBs) are intended to assist State and local governmentsⁿ⁵⁰ in developing programs to conserve energy, particularly in the fields of transportation and building construction. The following are the five types of "qualified energy conservation purposes" that may be funded by a QECB (as listed in *IRC Section 54D(f)(1)*):

- (A) Capital expenditures incurred for purposes of (i) reducing energy consumption in publicly-owned buildings by at least 20 percent, (ii) implementing green community programs (including the use of loans, grants, or other repayment mechanisms to implement such programs), (iii) rural development involving the production of electricity from renewable energy resources, or (iv) any qualified facility as determined under *IRC Section 45(d)* (overlapping, to this extent, the qualified purpose of a New CREB, but apparently without limitation in a QECB as to the type of entity that may acquire such a facility).

(B) Expenditures with respect to research facilities and research grants, to support research in (i) development of nonfossil fuels such as cellulosic ethanol, (ii) technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels, (iii) increasing the efficiency of existing technologies for producing nonfossil fuels, (iv) automobile battery technologies and technologies to reduce fossil fuel consumption in transportation, or (v) technologies to reduce energy use in buildings.

(C) Mass commuting facilities and related facilities that reduce consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting.

(D) Demonstration projects designed to promote the commercialization of (i) green building technology, (ii) conversion of agricultural waste for use in the production of fuel or otherwise, (iii) advanced battery manufacturing technologies, (iv) technologies to reduce peak use of electricity, or (v) technologies for the capture and sequestration of carbon dioxide emitted from combusting fossil fuels in order to produce electricity.

(E) Public education campaigns to promote energy efficiency.

A QCEB can be a "private activity bond,"ⁿ⁵¹ but no allocation to any State or large local government may be re-allocated to issuers in a manner that results in 30 percent or more of the allocation being used for private activity bonds.ⁿ⁵² Moreover, any QCEB that is a private activity bond may only be used to fund capital expenditures.ⁿ⁵³

In addition to using 100 percent of the available project proceeds for qualified conservation purposes as set forth above, a QCEB must be issued by a State or local government, which must designate the bond for purposes of *IRC* § 54D.ⁿ⁵⁴ A total of \$3.2 billion of bonds nationwide may be so designated (the "national limitation"),ⁿ⁵⁵ The national allocation is to be allocated to the States in proportion to population.ⁿ⁵⁶ If a State has within it a "large local government" (i.e., a municipality or county with a population of 100,000 or more), a portion of the State's allocation must be allocated to the large local government(s), unless the latter reallocates its portion back to the State.ⁿ⁵⁷

[e] Qualified Zone Academy Bonds--*IRC* Section 54E.

A "qualified zone academy" (hereafter, "academy") is a public school (or academic program within a public school) established by and operated under the supervision of an eligible local education agencyⁿ⁵⁸ to provide education or training below the college level, which: (1) is designed in cooperation with business to enhance the academic curriculum, increase graduation and employment rates, and better prepare students for college and the workforce; (2) is subject to the same academic standards and assessments as other schools administered by the eligible local education agency, (3) has a comprehensive education plan approved by the eligible local education agency, and (4) is either (a) located in an empowerment zone or enterprise community, or (b) at least 35 percent of the students attending the school are reasonably expected to be eligible for free reduced-cost lunches under the school lunch program established under the National School Lunch Act.ⁿ⁵⁹

Qualified Zone Academy Bonds (QZABs) were originally authorized as a means of financing academies meeting these requirements in Section 226 the Tax Relief Act of 1997,ⁿ⁶⁰ which added *IRC* Section 1397E to the Code. Authority to issue QZABs under *IRC* Section 1397E was terminated by Section 313 of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (the 2008 Act), which also added new *IRC* Section 54E providing for QZABs with revised program provisions in lieu of the provisions under *IRC* Section 1397E, effective for obligations issued after October 3, 2008.ⁿ⁶¹ The provisions of *IRC* § 54E are similar to those of *IRC* § 1397E, however, and, except as otherwise provided in *IRS Notice 2009-30*, or to the extent inconsistent with *IRC* Sections 54A and 54E, both final and temporary regulations issued under *IRC* Section 1397E (Treasury Regulation Section 1.1397-1 and Temporary Treasury

Regulation Section 1.1397-1T) will also apply to QZABs issued under *IRC Section 54E*.ⁿ⁶² Moreover, the two-year carryforward of unused limitation amounts provided in *IRC Section 1397E(e)(4)* will be recognized under the carryover provisions of *IRC Section 54E(c)(4)*.ⁿ⁶³

A QZAB for purposes of *IRC Section 54E* is defined as a bond issued as part of an issue if (1) 100 percent of the available project proceeds are used for a qualified purpose,ⁿ⁶⁴ (2) the bond is issued by the State or local government within the jurisdiction of which the qualified zone academy is located, and (3) the issuer (a) designates the bond for purposes of *IRC Section 54E*, (b) certifies that it has written assurances that the "private business contribution requirement" will be met with respect to the academy, and (c) certifies that it has the written approval of the eligible local education agency for such bond issuance.ⁿ⁶⁵ To meet the private business contribution requirement, private entities must make written commitments to make "qualified contributions" having a present value (as of the date of issuance of the issue) of not less than 10 percent of the proceeds of the issue.ⁿ⁶⁶ The qualified contributions must consist of:

- (A) Equipment for use in the qualified zone academy.
- (B) Technical assistance in developing curriculum or in training teachers in order to promote appropriate market driven technology in the classroom.
- (C) Services of employees as volunteer mentors.
- (D) Internships, field trips, or other educational opportunities outside the academy for students, or
- (E) Any other property or service specified by the eligible local education agency.ⁿ⁶⁷

The annual national limitation on QZABs is \$400 million for 2008, \$1.4 billion for each of calendar years 2009 and 2010, and (except for allocations carried over under *IRC Section 54E(c)(4)*), zero thereafter.ⁿ⁶⁸ The national allocation is to be allocated among the States by the Treasury Department on the basis of the States' respective populations of individuals below the poverty line (as defined by the Office of Management and Budget), and each State's allocation is to be reallocated to qualified zone academies by the State education agency within such State.ⁿ⁶⁹ If in any calendar year a State's share of the national limitation for the year exceeds the amount of QZABs issued with respect to academies within the State during that year, the limitation amount for the following calendar year is increased by the amount of such excess, and any amount remaining unused in that year can be carried forward to one more calendar year.ⁿ⁷⁰

[f] Qualified School Construction Bonds--*IRC Section 54(F)*.

By far the most important of the *IRC Section 54A* qualified tax credit bonds, in terms of the amount of bonds authorized, are qualified school construction bonds (QSCBs), which have a national limitation for 2009 and 2010 of \$11 billion in each year (but a zero allocation thereafter).ⁿ⁷¹ The requirements that a QSCB must fulfill (apart from those in *IRC § 54A*) are also the shortest and simplest.

- (1) 100 percent of the available project proceeds of an issue of QSCB bonds must be used for the construction, rehabilitation, or repair of a public school facility.ⁿ⁷²
- (2) The bond must be issued by a State or local government within the jurisdiction of which the school is located.
- (3) The issuer must designate the bond for purposes of *IRC Section 54(F)*.

The remainder of *IRC Section 54(F)* is devoted to allocation issues. The initial allocation, among the States, is made by the Treasury Department in proportion to the respective amounts each State is eligible to receive under Section 1124 of the Elementary and Secondary Education Act of 1965 in the most recent fiscal year ending before the calendar year for which the allocation is being made. However, the Treasury must then make a second allocation of the national limitation, allocating 40 percent of that limitation to "large local educational agencies,"ⁿ⁷³ using the respective amounts of federal aid each agency was eligible to receive under the Elementary and Secondary Education Act of 1965 in the preceding fiscal year as the basis of allocation among these agencies. The allocation made to each State in the first allocation must be reduced by the aggregate of allocations made to large local educational agencies within such State under the second allocation, unless an agency receiving an allocation reallocates that amount back to the State.ⁿ⁷⁴ Amounts allocated to a State (and not reallocated to large local educational agencies within the State) are to be allocated by the State education agency (or such other agency as is authorized under State law to make such allocation) to issuers within the State.ⁿ⁷⁵

As in the case of QZABs, provision is made for the carryover of any excess of the amount allocated to any State for a calendar year over the amount of QSCBs actually issued during that year pursuant to the State's allocation, and such excess increases whatever volume cap is allocated to the State in the following calendar year.ⁿ⁷⁶ Unlike QZABs, however, the carryover is only available in the next calendar year and not the next two years.ⁿ⁷⁷

[g] Direct Pay Tax Credit Bonds--*IRC Section 6431.*

In 2010, Congress amended *IRC Section 6431* to give issuers of most qualified tax credit bondsⁿ⁷⁸ the option, previously available only to issuers of Build America and certain recovery zone bonds,ⁿ⁷⁹ of having their interest costs paid directly by the federal government in lieu of allowing federal tax credits to bondholders.ⁿ⁸⁰ The option is exercised by the issuer's making an irrevocable election under *IRC Section 6431(f)(3)(B)* to receive reimbursement of interest payments on the bonds from the federal government, in which case no credit under *IRC Section 54A* will be allowed to holders of the bonds.ⁿ⁸¹

The amount of interest reimbursed, in the case of qualified zone academy bonds (QZABs) and qualified school construction bonds (QSCBs), is the lesser of the interest actually payable on the bonds and the interest that would have been payable if interest payments on the bonds were calculated at the "applicable credit rate."ⁿ⁸² The applicable credit rate is the rate, determined under *IRC Section 54A(b)(3)*, at which a federal tax credit would have been allowed to holders of the qualified tax credit bonds if the issuer had not elected the direct reimbursement option.ⁿ⁸³ In other words, the federal government's reimbursement will not exceed the tax credits it would have owed to holders of the bonds had the direct payment option not been exercised. In the case of new clean renewable energy bonds (New CREBs) issued under *IRC Section 54C* or qualified energy conservation bonds (QECBs) issued under *IRC Section 54D*, the maximum reimbursement is equal to 70 percent of the lesser of actual interest or the interest that would have been payable at the applicable credit rate.ⁿ⁸⁴

The direct payment option is available for qualified tax credit bonds issued after March 18, 2010.ⁿ⁸⁵ Unlike Build America and recovery zone bonds, the January 1, 2011 deadline for issuing bonds eligible to elect direct reimbursement of interest costs under *IRC Section 6431* does not apply to Direct Pay Tax Credit Bonds.ⁿ⁸⁶

[13] Build America Bonds--*IRC Section 54AA.*

Build America Bonds offer prospective issuers of tax-exempt obligations an option, available for a limited time, to issue taxable bonds on which 35 percent of the interest will be paid by the federal government in the form either of a tax credit to the holder or a credit directly to the issuer.ⁿ¹ In contrast to *IRC Section 54A* tax credit bonds, which must be issued for a specific purpose authorized by the statute, and subject to national, state and local limitations as to the amounts that may be issued, Build America Bonds may be issued for any governmental purpose for which a tax-exempt bond may be issued, and are not subject to dollar limitations or allocations.

The definition of a Build America Bond can be briefly stated: any obligation the interest on which would be excludable from gross income under *IRC Section 103* can be a Build America Bond provided the issuer makes an irrevocable election to have *IRC Section 54AA* apply to the bond and issues it before January 1, 2011.ⁿ² *IRC Section 54AA(d)(2)* then prescribes three "applicable rules" to be followed in applying this brief definition. One of the rules, the only additional requirement or restriction on the definition, provides that a bond will not be treated as a Build America Bond if it is issued with more than a de minimis amount of premium over its face value.ⁿ³ A second and more favorable rule provides that, for purposes of determining the bond's compliance with the requirements imposed on tax-exempt obligations by *IRC Section 149(b)*, which prevent a federally guaranteed bond from qualifying for tax-exempt interest under *IRC Section 103*, a Build America Bond shall not be treated as federally guaranteed by reason of the credit allowed to the holder (or the issuer) of the bond.ⁿ⁴ The third rule, also favorable, provides that for purposes of applying the arbitrage rules in *IRC Section 148*, the yield on Build America Bonds shall be determined without taking into account the interest credit allowed to the bondholder (or to the issuer) under *IRC Section 54AA(a)*.ⁿ⁵

Although Build America Bonds use a tax credit mechanism to pay interest, as *IRC Section 54A* tax credit bonds do, there are important distinctions between the two. Most significantly, the amount of the tax credit on a Build America Bond is not determined by applying a credit rate sufficient to allow the issuer to issue the bond without discount or interest expense; rather, the credit on a Build America Bond is a flat 35 percent of whatever interest is paid by the issuer.ⁿ⁶ Thus, the tax credit that a taxpayer may claim with respect to a Build America Bond is determined simply by multiplying the interest payment that the bondholder is entitled to receive from the issuer (i.e., the bond coupon interest payment) by 35 percent.ⁿ⁷ Also unlike a *IRC Section 54A* tax credit bond, the credit does not accrue on quarterly fixed dates,ⁿ⁸ but accrues on every "interest payment date"; i.e., any date on which the holder of record of the Build America Bond is entitled to a payment of interest on the bond.ⁿ⁹

In most other ways, the tax credit mechanism works in the same manner for both *IRC Section 54A* tax credit bonds and *IRC Section 54AA* Build America Bonds. In both cases, the taxpayer's annual credit is the sum of the credits accrued during the year through ownership of the bond on each "credit allowance date" (*Section 54A* bonds) or "interest payment date" (*Section 54AA* bonds) during the taxable year.ⁿ¹⁰ Credits on both kinds of bonds are nonrefundable and subject to a limitation equal to the holder's liability for regular income tax and alternative minimum tax for the year, less the sum of nonrefundable credits allowable for the year (except credits on other tax credit bonds).ⁿ¹¹ Any unused credit for a taxable year on either type of bond may be carried to the succeeding taxable year and added to any credit allowable for that taxable year, again subject to the tax liability limitation.ⁿ¹² Finally, the rules requiring *Section 54A* credits to be included in the gross income of the holder, as well as the special rules applicable to holders that are subchapter S corporations, partnerships, and real estate investment trusts, and the rule allowing credit stripping, are all incorporated by reference in *IRC Section 54AA*.ⁿ¹³

Finally, an issuer may, if it makes an irrevocable election to do so, issue a Build America Bond as a "qualified bond," which converts the bond into a fully taxable bond so far as the holder is concerned but entitles the issuer to receive a credit equal to 35 percent of its interest costs directly from the US Treasury.ⁿ¹⁴ The tax credit mechanism in this case is not *IRC Section 54AA* but *IRC Section 6431*, which allows the issuer a fully refundable credit, payable contemporaneously with each interest payment date under the bond, equal to 35 percent of the interest payable under the bond on such date.ⁿ¹⁵

The only additional restriction imposed on Build America Bonds that are "qualified bonds," apart from making the irrevocable election, is that 100 percent of the excess of the "available project proceeds" over any "amounts in a reasonably required reserve" may only be used to finance capital expenditures.ⁿ¹⁶ "Available project proceeds" has the same meaning it is given in *IRC Section 54A(e)(4)*: the sale proceeds of the issue less the amount (not more than 2 percent of such proceeds) used to pay issuance costs plus the amount of any investment proceeds earned on investments of the proceeds. Although a "reasonably required reserve" is defined in *IRC Section 54AA(g)(2)(A)(ii)* with reference to its meaning in *IRC Section 150(a)(3)* (where the term is used but not defined), the IRS has announced that "in

determining a reasonably required reserve fund for purposes of this provision, the rules under *IRC Section 148(d)(2)* apply."ⁿ¹⁷

[14] Recovery Zone Bonds--IRC Section 1400U.

Recovery zone bonds, like Build America Bonds, are authorized by ARRA of 2009.ⁿ¹ There are two types. The first, "Recovery Zone Economic Development Bonds" (RZEDBs), is actually a Build America Bond issued for "qualified economic development purposes."ⁿ² Unlike Build America Bonds issued under *IRC Section 54AA*, however, RZEDBs issued under *IRC Section 1400U* do not give the issuer the option of providing a tax credit to the holder of the bond. Rather, RZEDBs are treated as "Qualified Bonds"ⁿ³ for which a refundable credit is allowed to the issuer under *IRC Section 6431*, except that the amount of the credit is 45 percent of the interest on the bond rather than 35 percent as on Qualified Bonds issued under *IRC Section 54AA*.ⁿ⁴ A second difference between Build America Bonds generally and RZEDBs is that the latter (like tax credit bonds) may only be issued pursuant to an allocation, determined in this case by a national limitation of \$10 billion allocated to States and large municipalities in accordance with their rates of unemployment in a manner discussed below.ⁿ⁵

An RZEDB, as noted above, is any Build America Bond, issued before January 1, 2011, as part of an issue in which 100 percent of the excess of the available project proceeds (as defined in *IRC Section 54A*) over the amounts in a reasonably required reserve (within the meaning of *IRC Section 150(a)(3)*) are to be used for qualified economic development purposes.ⁿ⁶ A "qualified economic development purpose" means an expenditure for purposes of promoting development or other economic activity in a "recovery zone," including--

- (1) capital expenditures paid or incurred with respect to property located in such zone,
- (2) expenditures for public infrastructure and construction of public facilities, and
- (3) expenditures for job training and educational programs.ⁿ⁷

A "recovery zone" is any area

- (1) designated by the issuer as having significant poverty, unemployment, rate of home foreclosures, or general distress,
- (2) designated by the issuer as economically distressed by reason of the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990, or
- (3) for which a designation as an empowerment zone or renewal community is already in effect.ⁿ⁸

The issuer must also designate the bond as an RZEDB for purposes of *IRC Section 1400U-2*, but not in excess of the limitation allocated to the issuer under *IRC Section 1400U-1*.ⁿ⁹

The second type of recovery zone bond, known as a "Recovery Zone Facility Bond" (RZFB), is a new category of exempt facility bond--a type of private activity bond that qualifies for an exception to the general rule that private activity bonds do not qualify as tax-exempt obligations under *IRC Section 103*.ⁿ¹⁰ An RZFB is defined in *IRC Section 1400U-3(b)* as any bond issued as part of an issue if (a) 95 percent of the net proceeds (as defined in *IRC Section 150(a)(3)*) of such issue are to be used for "recovery zone property;" (b) the bond is issued before January 1, 2011, and (c) the issuer designates the bond as an RZFB for purposes of *IRC Section 1400U-3*.ⁿ¹¹

The term "recovery zone property" means any property subject to depreciation to which IRC Section 168 applies (or would apply but for *IRC Section 179*) if (1) such property was constructed, reconstructed, renovated, or acquired by purchase by the taxpayer after the date on which the designation of the recovery zone took effect; (2) the original use of such property in the recovery zone commences with the taxpayer; and (3) substantially all of the use of such property is in the recovery zone and is in the active conduct of a qualified business by the taxpayer in such zone.ⁿ¹² The term "qualified business" means any trade or business except that the rental to others of real property located in a recovery zone is treated as a qualified business only if the property is not residential rental property (as defined in *IRC Section 168(e)(2)*) and does not include any trade or business consisting of the operation of any facility described in *IRC Section 144(c)(6)(B)* (i.e., any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal purpose of which is the sale of alcoholic beverages for consumption off premises).ⁿ¹³

RZFBs are subject to the general rules applicable to issuance of private activity bonds the interest on which is exempt from tax under *IRC Section 103* (e.g., in *IRC Section 147*) with the following exceptions: (1) RZFBs are not subject to the aggregate annual State private activity bond volume limits in *IRC Section 146*, but rather are subject to the limits imposed by *IRC Section 1400U-1*; and (2) the general requirement in *IRC Section 147(d)* that any use of the proceeds of an issue to acquire property be restricted to property the first use of which commences with such acquisition does not apply.ⁿ¹⁴

The national limitations on RZEDBs (\$10 billion) and RZFBs (\$15 billion) are allocated separately but in the same manner. The national limitation is first allocated among the States in the proportion that each State's 2008 State employment decline bears to the aggregate of the 2008 State employment declines for all the States.ⁿ¹⁵ Each State's 2008 State employment decline is the excess of the number of individuals employed in the State in December, 2007 over the number employed in the State in December, 2008.ⁿ¹⁶ The Treasury Department is then to adjust each State's allocation to the extent necessary to ensure that no State receives less than 0.9 percent of the RZEDB national limitation (or less than 0.9 percent of the RZFB national limitation).ⁿ¹⁷ After the State allocations are determined, each State reallocates its allocation among the counties and large municipalities in the Stateⁿ¹⁸ in the proportion that each county or large municipality's "2008 employment decline" bears to the aggregate of the 2008 employment declines for all the counties and municipalities in the State.ⁿ¹⁹ The employment decline in any large municipality or county is the difference between the number of employed individuals in such municipality or county on December, 2007 compared to December, 2008, just as in the case of the States, except that employed individuals in a large municipality which is located within a county are to be counted in both months by the municipality and not by the county.ⁿ²⁰ A large municipality or county may waive any portion of an allocation made to it by a State.ⁿ²¹

[15] Reacquisition and Reissuance by State and Local Governments of Their Own Bonds.

In general, the acquisition of a tax-exempt bond by or on behalf of its issuer followed by a later reissuance of the same bond is treated as a retirement of the old bond and issuance of a new bond.ⁿ¹ Similarly, a "significant modification" of the terms of an outstanding tax-exempt bond, within the meaning of *Treasury Regulation Section 1.1001-3*, will result in a deemed exchange of the pre-modification "old bond" for a "new bond."ⁿ² In either case, the new bond will not be tax-exempt unless it meets, as of its re-issue date, the various program requirements for a new issue of tax-exempt bonds.ⁿ³

The Internal Revenue Service re-examined these rules in light of the 2008 crisis in the financial markets which made it necessary in some cases for state and local government issuers temporarily to acquire their own bonds to facilitate liquidity and stability in the markets for those bonds, or to modify the terms of the bonds to preserve their marketability. *Notice 2008-41*ⁿ⁴ was released to provide guidance to issuers of tax exempt bonds on reacquisition/reissuance issues pending final resolution of those issues in regulations to be issued under *IRC Section 150*, and to provide temporary administrative relief in certain cases.

The Service had previously considered reacquisition/reissuance issues in *Notice 88-130*ⁿ⁵ in the context of tax-exempt "tender option bonds" with short-term interest features tied to current market rates necessary to remarket the bonds at par.

"Tender option bonds have ongoing tender options or put options associated with the interest rate-setting mechanism which allow bondholders to tender their bonds for purchase at par at specified intervals, typically every seven days. Tender option bonds generally have creditworthy third party liquidity facilities from banks or other liquidity providers to support the tender options and may have credit enhancement from bond insurers or other providers. Tender option bonds also may have interest mode conversion options which grant to the issuer or a conduit borrower an option to change the interest rate mode on the bonds from a tender option mode to another short-term interest rate modeⁿ⁶ or to a fixed interest rate to maturity. At the time of a conversion to another interest rate mode, tender option bonds typically are subject to a mandatory tender for purchase but a bondholder may be allowed to elect to retain the bonds. Upon the exercise of ongoing tender options associated with the short-term interest rate-setting mechanism for tender option bonds and upon any mandatory or optional tender upon conversion of the interest rate on the bonds to another interest rate mode, a remarketing agent or a liquidity provider typically will acquire the bonds subject to the tender at par and resell the bonds either to the same bondholders or to others willing to purchase such bonds."ⁿ⁷

Notice 88-130, later supplanted by *Notice 2008-27* and then *Notice 2008-41*, created a safe harbor allowing issuers to acquire and remarket tender option bonds, and modify them by switching to other short-term interest rate modes if authorized to do so by the original bond documents, without triggering the "negative consequences" of a deemed retirement followed by a "new" issue of the bond.ⁿ⁸ The safe harbors apply only to a "qualified tender bond," which as redefined in *Notice 2008-41*ⁿ⁹ is a tax exempt bond with all of the following features:

- (1) For each interest rate mode preauthorized under the terms of the bond considered separately, the bond bears interest during the allowable term of that interest rate mode at either a fixed interest rate, a variable interest rate that constitutes a "qualified floating rate"ⁿ¹⁰ (including, without limitation, interest rates determined by reference to eligible interest rate indexes, tender option-based interest rate measures, or a Dutch auction process), or a variable interest rate that constitutes an "eligible objective rate" for a variable rate debt instrument that is a tax-exempt bond.ⁿ¹¹
- (2) Interest on the bond is unconditionally payable at periodic intervals at least annually.
- (3) The final maturity date on the bond is no longer than the lesser of (a) 40 years after the issue date of the bond, or (b) the latest date that is reasonably expected as of the issue date of the issue of which the bond is a part to be necessary to carry out the governmental purpose of the issue of which the bond is a part.ⁿ¹²
- (4) The bond is subject to an optional tender right or mandatory tender requirement which allows or requires a bondholder to tender the bond for purchase in one or more prescribed circumstances under the terms of the bond.

A qualified tender bond will not be treated as reissued or retired solely as a result of a change in its interest rate mode, provided the change is a "qualified interest rate mode change" as defined in *Notice 2008-41*.ⁿ¹³ To so qualify, the change (1) must be authorized under the terms of the bond as it was originally issued, and (2) must require that the bond be purchased and resold at a price equal to par upon conversion to a new interest rate mode, except that if the conversion is to an interest rate mode that is a fixed interest rate for the remaining term of the bond to maturity, the bond may be resold at a market premium or a market discount from the stated principal amount of the bond.ⁿ¹⁴

A tender right in a qualified tender bond, whether optional or mandatory, must similarly meet the requirements of a "qualified tender right," as defined in *Notice 2008-41*,ⁿ¹⁵ to qualify for the safe harbor. To do so, it (1) must be authorized under the terms of the bond upon its original issuance; (2) must allow (optional tender) or require (mandatory tender) the bondholder to tender the bond for purchase on at least one tender date before the final maturity date; (3) must entitle a tendering bondholder to receive a purchase price equal to par (which may include any accrued interest); and (4) the terms of the tender right must require the issuer or its remarketing agent to use at least best efforts to remarket the bond purchased pursuant to the tender right.

Notice 2008-41 describes the safe harbor as follows:

(1) A qualified tender bond will not be treated as reissued or retired solely as a result of a qualified interest rate mode change or existence or exercise of any qualified tender right.

(2) In applying *Treasury Regulation Section 1.1001-3* to modifications of tax exempt bonds, any interest rate variance directly resulting from a qualified interest rate mode change will not be treated as a modification under *Treasury Regulation Section 1.1001-3*, and thus such interest rate variances need not be tested under the change in yield rule for determining significant modifications under *Treasury Regulation Section 1.1001-3(e)(2)*.ⁿ¹⁶

However, a governmental issuer which reacquires a qualified tender bond is allowed to hold the bonds for only a temporary period.ⁿ¹⁷ Under its terms, the safe harbor allows qualified tender bonds acquired by their governmental issuerⁿ¹⁸ pursuant to a qualified tender right to be held for a maximum period of 90 days (180 days if the bond was acquired on or before December 31, 2010ⁿ¹⁹) from their purchase.ⁿ²⁰ A sale by the governmental issuer to a third-party guarantor, third party liquidity facility provider or conduit borrower (other than a conduit borrower that is a governmental issuer) terminates the issuer's holding period for purposes of the safe harbor; moreover, such third party guarantors, liquidity facility providers, and conduit borrowers are not considered purchasers by or on behalf of the governmental issuer for this purpose. Thus, for example, a governmental issuer may hold a bond purchased on or before December 31, 2010 pursuant to the exercise of a qualified tender right for 179 days while using best efforts as required by the terms of the bond documents to resell the bond and, if unsuccessful, resell the bond to a third party guarantor, third-party liquidity facility, or other independent third party before the expiration of the 180-day period, which may later resell it at a subsequent date without triggering a deemed reissuance of the bond.ⁿ²¹ An issuer that holds a reacquired qualified tender bond beyond the safe harbor period is treated as though it retired the bond immediately after the end of such period and, in accordance with the general rule, the bond's status as a tax-exempt bond upon resale will depend on its meeting the requirements applicable to the issuance of a new tax-exempt bond at that time.

The safe harbor for governmental issuer purchases of qualified tender bonds was extended by *Notice 2008-88* to cover, in addition, "tax-exempt commercial paper," defined as commercial paper which may be treated as part of a single issue under *Treasury Regulation 1.150-1(c)(4)(ii)*. Under that regulation, all commercial paper (short-term bonds having a maturity of 270 days or less) issued under a commercial paper program to finance the same governmental purpose pursuant to a single master legal document may be treated as part of a single issue, provided such commercial paper is issued within 18 months of the program's deemed issue date, the first date on which the aggregate amount of commercial paper issued under the program exceeds the lesser of \$50,000 or 5 percent of the aggregate issue price of the commercial paper in the program. Commercial paper issued after the 18 month period may also be treated as part of a commercial paper program if it is issued to refund commercial paper that is part of the program, provided (1) there is no increase in the principal amount outstanding under the program and (2) the program does not have a term in excess of either 30 years or the period reasonably necessary for the governmental purposes of the program.ⁿ²²

Notice 2008-41 states that issuers of tax-exempt bonds may rely on its provisions "for any actions taken with respect to tax-exempt bonds on or after November 1, 2007 and before the effective date of any future regulation under [IRC]

Section 150 that implement [sic] the guidance with respect to any particular applicable provision in this notice or other public guidance that withdraws or supersedes any particular applicable provision in this notice."²³ In addition, "issuers may also continue to rely on *Notice 88-130* until the effective date of such future regulations." However, *Notice 2008-88*, which extended the safe harbor for qualified tender bonds in *Notice 2008-41* to include tax-exempt commercial paper, and extended the deadline for reacquisitions eligible for the 180-day safe harbor holding period, appears to have set a deadline of December 31, 2009 (subsequently extended by Section 3.2 of *Notice 2010-7* to December 31, 2010) on the amnesty for reacquisitions of both qualified tender bonds and tax-exempt commercial paper. "Solely for purposes of [IRC] § 103 and [IRC] §§ 141 through 150, the Treasury Department and the IRS will treat a tax-exempt "qualified tender bond" ... or "tax-exempt commercial paper" ... that is purchased by its "governmental issuer" ... on a temporary basis as continuing in effect without resulting in a reissuance or retirement of the purchased tax-exempt bond if, irrespective of when the governmental issuer purchases the bond ... , the governmental issuer holds the bond until not later than December 31, 2009 [extended to December 31, 2010 by *Notice 2010-7*]. Subsequent to the end of this period, a governmental issuer generally may not hold its own bond without causing a reissuance or retirement of such bond under the general rules in § 3.1 of *Notice 2008-41* and other applicable law."²⁴

After December 31, 2010, it would appear that governmental issuers that reacquire their own tax-exempt bonds will have to rely upon the provisions of Treasury Regulation Section 1001-3 to avoid the negative consequences of a reacquisition or modification of their tax-exempt bonds, as demonstrated in the following examples from *Notice 2008-41* .²⁵

Example 1:

On July 1, 2007, a municipality (the "Issuer") issued \$1 million in tax exempt bonds bearing interest at an auction interest rate and maturing in 40 years (the "Bonds"). The Bonds are recourse obligations that are secured by the issuer's underlying primary A-rated investment grade credit. The Bonds are secured further by credit enhancement under a bond insurance policy provided by a AAA-rated bond insurer. Pursuant to the terms of the Bonds, the auction interest rate on the Bonds resets every 7 days. The terms of the Bonds grant the issuer the option to convert the interest rate mode on the Bonds from an auction rate mode to either a 7-day tender option rate mode or to a long-term fixed interest rate to maturity, subject to a mandatory tender of the Bonds upon such a conversion. The Bonds are qualified tender bonds as defined in Section 3.2 of *Notice 2008-41* .

On January 3, 2008, the auction interest rate on the Bonds is set at 10 percent as a consequence of a downgrade in the bond insurer's credit rating from a AAA rating to a AA rating and associated market disruption. On January 10, 2008, the issuer amended the terms of the Bonds to replace the now AA-rated bond insurance with a AAA-rated bank letter of credit as credit enhancement, but otherwise made no other changes to the terms of the Bonds. On January 10, 2008, the auction rate on the Bonds floated down to 3% primarily as a result of the change in credit enhancement on the Bonds.

The amendment to the terms of the Bonds to change the credit enhancement is a modification to a recourse debt instrument that must be tested for significance under the change in security or credit enhancement rule in *Treasury Regulation Section 1.1001-3(e)(4)(iv)*. Because the change in security or credit enhancement did not cause a change in payment expectations on the Bonds (i.e., the Bonds had an investment grade payment expectation before and after the change in credit enhancement), this change in credit enhancement is not a significant modification of the Bonds under Treasury Regulation Section 1001-3, and thus does not cause a reissuance of the Bonds under *IRC Section 103* and *IRC Sections 141 through 150*. Further, the fact that the market impact of the change in credit enhancement caused the floating interest rate on the Bonds to float down from 10% to 3% is not required to be tested under the 25-basis point change in yield rule for significant modifications under *Treasury Regulation Section 1.1001-3(e)(2)* because the Issuer made no change to the interest rate-setting mechanism under the terms of the Bonds.

Example 2:

Assume the same facts as in Example 1 above, except that, instead of amending the terms of the existing Bonds (the "Old Bonds") to change the credit enhancement, on January 10, 2008 the Issuer issued new bonds with new CUSIP numbers (the "New Bonds") and did an actual exchange of the New Bonds for the Old Bonds. The New Bonds are not backed by any bond insurance or other credit enhancement. The New Bonds without the bond insurance have an A credit rating. There are no other differences between the New Bonds and the Old Bonds. The result would be the same as in Example 1 and no reissuance of the Bonds would occur. Treasury Regulation Section 1001-3 applies the same significant modification standard to amendments to the terms of an existing debt instrument and to actual exchanges of an existing debt instruments for a different debt instrument.

[16] United States Series EE Savings Bonds.

Interest derived from obligations issued by the United States is generally subject to federal income tax.ⁿ¹ This state of affairs did not always exist. Interest on obligations issued before September 1, 1917 was wholly exempt from tax; interest on Treasury bonds issued after that date and before March 1, 1941 was partially exempt. However, all United States obligations issued prior to March 1, 1941 have either matured or been called.ⁿ²

Series EE United States Savings Bonds are a limited exception to the rule. Under *IRC Section 135(a)*, such "qualified United States savings bonds" may be redeemed tax-free if, during the taxable year, an amount equal to the redemption proceeds is devoted to the payment of "qualified higher education expenses," namely, tuition and fees for the taxpayer, the taxpayer's spouse, or dependents of the taxpayer at an eligible educational institution.ⁿ³

The exclusion is available only for "qualified bonds"--Series EE and Series I savings bonds purchased after December 31, 1989, by an individual who was at least 24 years old at the time of purchase and owns the bonds either individually or jointly with a spouse. No exclusion is permitted for "gift bonds"--bonds purchased by one person and placed in the name of another.ⁿ⁴ There is also no exclusion allowed if the taxpayer is a married individual and files a separate return.ⁿ⁵

If the redemption proceeds exceed the tuition and fees paid by the taxpayer, the amount excludable from gross income is determined by multiplying the interest portion of the proceeds by the fraction:

$$\frac{\text{Qualified education expenses paid during year}}{\text{Total amount of qualified bonds redeemed during year}}.$$
ⁿ⁶

The exclusion granted by *IRC Section 135* is reduced above certain income levels, as indexed.ⁿ⁷ For MAGI between these amounts, the interest exclusion is reduced in the same ratio as the excess MAGI over the threshold amount bears to \$30,000 (in the case of a joint return) or \$15,000 (for other returns).ⁿ⁸

The operation of *IRC Section 135* can be illustrated by the following examples:

Example 1:

A husband and wife, who file a joint return in 2009 and have \$45,000 in MAGI, receive \$4,000 in principal and \$4,000 in interest. In the same year, they pay \$9,000 in tuition and fees for a child attending college. Since the amount of qualified higher education expenses exceeds the proceeds of the redemption, the entire \$4,000 in interest is excludable from gross income.

Example 2:

Assume the same facts as in Example 1, except that the amount of tuition and fees is only \$6,000. In this case, the exclusion is limited to \$3,000 (\$4,000 interest multiplied by the fraction: \$6,000 qualified expenses/\$8,000 redemption proceeds).

Example 3:

Assume the same facts as in Example 1 except that MAGI is \$119,900. Here, the interest exclusion is limited to \$2,000. The otherwise excludable amount (\$4,000) is cut in half by applying the fraction: \$15,000 excess MAGI/\$30,000.

FOOTNOTES:

(n72)Footnote 1. *IRC § 103(c)(1), (2)*.

(n73)Footnote 2. Interest on bonds issued by the governments of Guam and Puerto Rico are also exempt from federal income tax. *Rev Rul 71-402, 1971-2 CB 91 ; Rev Rul 70-219, 1970-1 CB 23* .

An industrial development board or an energy cooperative can issue tax-exempt bonds under *IRC § 103*. See *Rev Rul 57-187, 1957-1 CB 65* and *PLR 200836005* .

Interest on municipal housing authority bonds that are exempt from federal income tax under the Federal Housing Act is excludable from gross income without regard to the provisions of *IRC § 103*. *Rev Rul 82-56, 1982-1 CB 17* .

Notice 98-58, 1998-2 CB 704 , provides guidance on procedures for issuers to follow when requesting an administrative appeal of a determination that interest on their debt obligations is not exempt from tax under *IRC § 103*.

The Service will not ordinarily rule whether the interest on State or local bonds will be tax-exempt, if the proceeds of issues of bonds (other than advance refunding issues) are placed in escrow or otherwise not expended for a governmental purpose for an extended period of time even though the proceeds are invested at a yield that will not exceed the yield on the State or local bonds prior to their expenditure for governmental purposes. *Rev Proc 2010-3, 2010-1 IRB 110, 115 (§ 4.01(5))*.

(n74)Footnote 3. *Treas Reg § 1.103-1; Rev Rul 73-563, 1973-2 CB 24* . The delegation must not be insubstantial. *Philadelphia Natl Bank v US, 666 F2d 834 (3d Cir 1981) cert denied 457 US 1105 ; Rev Rul 77-165, 1977-1 CB 21* (state university not a political subdivision); *Rev Rul 77-164, 1977-1 CB 20* (community development authority not political subdivision; ability to charge user fees not power to tax).

Rev Proc 82-26, 1982-1 CB 476 , sets forth the circumstances under which the Service will ordinarily rule that obligations issued by a corporation formed under the general nonprofit corporation law of a state will be treated as obligations of a political subdivision.

(n75)Footnote 4. *Treas Reg § 1.103-1*; see, eg, *Rev Rul 59-373, 1959-2 CB 37* (soil conservation district).

(n76)Footnote 5. Eg, *Commr v White's Est, 144 F2d 1019 (2d Cir 1944)* , *cert denied, 323 US 792* (Triborough Bridge Authority); *Commr v Shamburg's Est, 144 F2d 998 (2d Cir 1944)* , *cert denied, 323 US 792* (Port of New York Authority); *Rev Rul 55-75, 1955-1 CB 238* (Mackinac Bridge Authority).

(n77)Footnote 6. *Rev Rul 61-145, 1961-2 CB 21* (Kentucky Highways Department); *Rev Rul 56-33, 1956-1 CB 62* (Indiana Toll Road Commission).

(n78)Footnote 7. *Rev Rul 61-181, 1961-2 CB 21 ; Rev Rul 54-296, 1954-2 CB 59 .*

(n79)Footnote 8. An independent insurance company's guarantee of payment of principal and interest on bonds issued by a political subdivision of a state did not affect the tax-exempt status of the interest. Payment by the insurance company gave it the right to enforce the political subdivision's continuing obligation under the bonds. *Rev Rul 72-134, 1972-1 CB 29 , as amplified by Rev Rul 72-575, 1972-2 CB 74 . Rev Rul 72-134* was further amplified by *Rev Rul 76-78, 1976-1 CB 25 ,* and held applicable to proceeds of insurance purchased by individual investors or municipal bond funds, representing interest on state and local obligations. The cited rulings were distinguished and clarified, and interest held not to be excludable, in *Rev Rul 94-42, 1994-2 CB 15 .* In *Rev Rul 94-42 ,* the holder of bonds issued by a political subdivision contracted with a third party for that third party to pay amounts equal to any shortfall in the debt service on the bonds if the issuer defaulted; the agreement was not incidental to and was, in substance, a separate debt instrument.

A district court found a discount offered by a municipality for prepayment of property taxes to be interest on an obligation of the municipality and, thus, exempt from tax under *IRC § 103(a)*. *Consolidated Edison Co v US*. The original opinion can be found at 778 *F Supp* 766 (SDNY 1992) . That opinion was withdrawn. A proposed amended opinion found at 1992 *US Dist Lexis* 5034 was filed on Apr 15, 1992. A memorandum opinion and order, filed Nov 2, 1992, can be found at 1992 *US Dist Lexis* 16777 . The Second Circuit reversed the lower court on this issue. The appellate court's opinion is reported at 10 *F3d* 68 (1993) .

(n80)Footnote 9. *Cf Helvering v Stockholms Enskilda Bank, 293 US 85 (1934) .* The final opinion in the matter is reported at 71 *AFTR2d* 93-712 .

(n81)Footnote 10. *US Trust Co v Anderson, 65 F2d 575 (2d Cir 1933) , cert denied 290 US 683 ; Stewart v Commr, TC Memo 1982-209 ; Iske v Commr, TC Memo 1980-61 .*

(n82)Footnote 11. *IRC § 103(f)*. The guarantee is effective only with respect to obligations issued to employee pension funds or agencies of New York City or New York State, and terminates when the obligation is sold by the fund or agency. Nonexempt status attaches to the obligation only during the period that the guarantee is effective.

(n83)Footnote 12. *Norfolk Natl Bank of Commerce & Trust Co v Commr, 66 F2d 48 (4th Cir 1933) .*

(n84)Footnote 13. The procedures governing requests for both a ruling that a prospective issuer wants to be subject to the declaratory judgment provisions of *IRC 7478* and a ruling that the prospective issuer does not desire to be reviewable are contained in *Rev Proc 96-16, 1996-1 CB 630 .*

(n85)Footnote 14. A number of cases have dealt with interest collected by banks under arrangements cast in the form of a purchase of bonds by the bank with a right in the bank to require their repurchase by the seller. The transaction (known as a repurchase agreement or "repo") is likely to be viewed as a secured loan with the bonds pledged as collateral, causing the interest to be treated as interest paid by the borrower and, therefore, as taxable income. *American Natl Bank v US, 467 F2d 1098 (6th Cir 1972) ; Union Planters Natl Bank v US, 426 F2d 115 (6th Cir 1970) , cert denied 400 US 827 ; American Natl Bank v US, 421 F2d 442 (5th Cir 1970) , cert denied 400 US 819 ; Third Natl Bank v US, 27 AFTR2d 71-818 (MD Tenn 1971) , affd on other grounds 454 F2d 689 (6th Cir 1972) ; Rev Rul 74-27, 1974-1 CB 24 .*

Union Planters Natl Bank and *Rev Rul 74-27* were distinguished in *Rev Rul 82-144, 1982-2 CB 34 ,* in which a municipal bond fund purchased "puts" covering tax-exempt securities at a price independent of the amount that the fund had paid for the securities. The purpose of the options was to increase the liquidity of the obligations in order to provide cash to meet the demand of the fund's shareholders who could withdraw their investments at any time. The mutual fund was considered the owner of the tax-exempt obligations even though it shifted the risk of loss with respect to the bonds by the purchase of the options.

(n86)Footnote 15. *Rev Rul 72-587, 1972-2 CB 74* ; *Clyde C Pierce Corp v Commr, 120 F2d 206 (5th Cir 1941)* ; *R O Holton & Co v Commr, 44 BTA 202 (1941)* .

(n87)Footnote 16. *IRC § 103(b)(3); IRC § 149(a)(1)*.

The requirement that tax-exempt bonds be in registered form is constitutional. *S Carolina v Baker, 485 US 505 (1988)* .

(n88)Footnote 17. *IRC § 149(a)(2)*. Bonds issued prior to March 19, 2012 will not be treated as registration-required bonds if they are foreign targeted obligations described in *IRC § 163(f)(2)(B)*, viz: (1) there are arrangements reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person; (2) interest is payable only outside the United States and its possessions, and (3) the face of the obligation contains a statement that any United States person who holds the obligation will be subject to limitations under the United States income tax laws. *IRC § 149(a)(3)*. The exception of such foreign targeted obligations from registration requirements is repealed, for purposes of both the denial of tax exemption for interest on registration-required bonds not in registered form (*IRC § 149(a)*), and the denial of a deduction for interest on registration-required obligations not in registered form (*IRC § 163(f)*), for bonds issued after March 18, 2012. See Sections 502(a) and 502(f) of the Hiring Incentives to Restore Employment Act of 2010, Pub L No 111-147, *124 Stat 71 (2010)* (the HIRE Act of 2010").

(n89)Footnote 18. *Treas Reg § 5f.103-1(c)*.

(n90)Footnote 19. The IRS has announced that obligations transferable under a "dematerialized book entry system," in which bonds are not represented by physical certificates and transfers are made only by book entries, qualify as "in registered form" even though holders can obtain physical certificates in bearer form in the "extraordinary event" that the clearing organization responsible for the book entries goes out of business without a successor to continue to operate the book entry system. See Notice 2006-99, *2006-2 CB 907* . The IRS policy has been codified in *IRC § 163(f)(3)*. See Section 502(c) of the HIRE Act of 2010 (effective after March 18, 2012).

(n91)Footnote 20. *Treas Reg § 5f.103-1(e)(1)*..

(n92)Footnote 21. *IRC § 103(m)* (applicable to obligations issued before Aug 16, 1986), *IRC § 149(c)(1)* (applicable to obligations issued after Aug 15, 1986). A number of non-Code obligations are excepted from the limitation. *IRC § 103(m)(3)* (applicable to obligations issued before Aug 16, 1986), *IRC § 149(c)(2)* (applicable to obligations issued after Aug 15, 1986).

(n93)Footnote 22. See, eg, *Rev Rul 82-56, 1982-1 CB 17* , holding that interest on bonds that are exempt from federal income tax under the Federal Housing Act is excludable from gross income without regard to *IRC § 103*.

(n94)Footnote 23. *IRC § 149(b)(3)*.

(n95)Footnote 24. *IRC § 103(h)(1)* (applicable to obligations issued before Aug 16, 1986), *IRC § 149(b)(1)* (applicable to obligations issued after Aug 15, 1986).

(n96)Footnote 25. *IRC § 103(h)(2)* (applicable to obligations issued before Aug 16, 1986), *IRC § 149(b)(2)* (applicable to obligations issued after Aug 15, 1986).

Payments of principal and interest on state and local bonds will not be considered federally guaranteed solely by reason of the fact that the debt service reserve fund for the bonds (or principal and interest on the bonds) may be funded with capitalization grants under the EPA State Water Pollution Control Revolving Fund Program. IRS Notice 88-54, *1988-1 CB 539* . The same holds true for bonds insured, reinsured, or guaranteed by Connie Lee Insurance Company, a wholly owned subsidiary of the College Construction Loan Insurance Association. IRS Notice 88-114, *1988-2 CB 449* .

Treasury's 2008 temporary program which, provides funds from its Exchange Stabilization Fund to money market funds to enable the money market funds to maintain stable \$1 per share net asset values, will not cause any violation of the restrictions against federal guarantees of tax-exempt bonds under *IRC § 149(b)* for any tax-exempt bonds held by tax-exempt money market funds participating in the program. *Notice 2008-81, 2008-2 CB 852* .

(n97)Footnote 1. The provisions of *IRC § 141* apply to obligations issued after Aug 15, 1986; private activity obligations issued before that date are governed by *IRC § 103(b)*, as it read prior to the Tax Reform Act of 1986.

(n98)Footnote 1.1. A governmental unit includes an instrumentality of a state or local government. *Treas Reg § 1.141-1(b)*. *Rev Rul 57-128, 1957-1 CB 311* , sets forth the following factors to be considered in determining whether an entity is an instrumentality of a governmental unit: (1) whether the organization is used for a governmental purpose and performs a governmental function; (2) whether performance of its function is on behalf of one or more states or political subdivisions; (3) whether there are any private interests involved, or whether the state or political subdivisions involved, have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in a public authority or authorities; (5) whether express or implied statutory authority or other authority is necessary for the creation or use of the instrumentality, and whether this authority exists; and (6) the degree of financial autonomy of the entity and the source of its operating expenses.

(n99)Footnote 2. *Rev Proc 93-19, 1993-1 CB 526* , sets forth the circumstances under which the Service will issue advance rulings that facilities operated by a nonexempt person are not used in the trade or business of that person.

Rev Proc 93-17, 1993-1 CB 507 , provides a safe harbor under which a change of use of proceeds of an issue of state and local bonds from a qualified use to a nonqualified use will not be treated as causing the interest on the bonds to be includable in gross income. To satisfy the safe harbor, the following requirements must be met:

- (1) As of the date of the issue, the issuer and all conduit borrowers reasonably expected to use the proceeds of the issue for a qualified use for the entire term of the issue.
- (2) The proceeds of the issue were used for a qualified use for at least five years after the later of the date of the issue or the date on which the facility with respect to which the change of use occurred was placed in service.
- (3) Any agreements between the new user and the original user are bona fide and arm's length, and the new user pays consideration equal to the fair market value for the facility.
- (4) No circumstances are present that indicate an attempt to avoid directly or indirectly the requirements of *IRC §§ 103 and 141* or the conditions of *Rev Proc 93-17* .
- (5) The issuer must take one of the remedial actions described in *Rev Proc 93-17* , including redemption of the nonqualified bonds, alternative qualified use of disposition proceeds of a facility in an amount at least equal to the proceeds allocable to the nonqualified bonds, or alternative qualified use of the facilities.

For a situation in which the change from qualified use to nonqualified use did not cause interest to be taxable even though the safe harbor was not met, see *Ltr Rul 9535037* .

Rev Proc 97-15, 1997-1 CB 635 , provides a program under which an issuer of state or local bonds may request a closing agreement with respect to outstanding bonds (1) to prevent the interest on those bonds from being includable in the gross income of bondholders, or (2) to prevent the interest on those bonds from being treated as an item of tax

preference for purposes of the alternative minimum tax, in each case as a result of an action subsequent to the issue date that causes the bonds to fail to meet the requirements of a tax-exempt bond relating to the use of the proceeds of the issue.

(n100)Footnote 3. *IRC § 141(a), (b)(1), (2), (6)*. If 5% more of the proceeds of the issue are to be used to finance an output facility (other than a water furnishing facility), the maximum amount of bond financing that can be used for a private business use is \$15 million. *IRC § 141(b)(4)*. The \$15 million amount is reduced by the aggregate nonqualified amounts of all prior tax-exempt issues 5% or more of the proceeds of which are or will be used with respect to the facility (or any other facility that is a part of the same project). In applying the \$15 million output limitation to an issue, a tax-exempt bond of an earlier issue is taken into account if (i) the earlier bond is outstanding on the issue date of the later issue, (ii) the earlier bond will not be redeemed within 90 days of the issue date of the later issue in connection with the refunding of the earlier bond by the later issue, and (iii) 5% or more of the sale proceeds of the earlier issue financed an output facility that is part of the same project as the output facility that is financed by 5% or more of the proceeds of the later issue. *Treas Reg § 1.141-8(a)(2)(ii)*.

Any activity carried on by a person other than a natural person is treated as a trade or business. *Treas Reg § 1.141-3(a)(1)*.

Rev Proc 97-13, 1997-1 CB 632, sets forth the conditions under which a management contract does not result in private business use. *Rev Proc 97-14, 1997-1 CB 634*, sets forth the conditions under which a research agreement does not result in private business use.

(n101)Footnote 4. In general, the amount of private business use of property is determined according to the average percentage of private business use of the property during the period that begins on the later of the issue date of the obligations or the date the property is placed in service, and ends on the earlier of the last date of the reasonably expected life of the property or the latest maturity date of any bond of the issue financing the property (determined without regard to any optional redemption dates). *Treas Reg § 1.141-3(g)(1), (2)(i)*.

Generally, the amount of private business use of a refunding issue is determined under *Treas Reg § 1.141-3(g)*, based on the measurement period for that issue (for example, without regard to any private business use that occurred prior to the issue date of the refunding issue). *Treas Reg § 1.141-13(b)(2)(i)*. However, in applying the private business use test to a refunding issue that refunds a prior issue of government bonds, the amount of business use of the refunding issue is the amount of private business use (a) during the combined measurement period; or (b) at the option of the issuer, during the measurement period for the refunding issue, but only if, without regard to the reasonable expectations test of *Treas Reg § 1.141-2(d)* (discussed below), the prior issue does not satisfy the private business use test, based on a measurement period that begins on the first day of the combined measurement period and ends on the issue date of the refunding issue. *Treas Reg § 1.141-13(b)(2)(ii)(A), (B)*. The combined measurement period is the period that begins on the first day of the measurement period as defined in *Treas Reg § 1.141-3(g)* for the prior issue (or, in the case of a series of refundings of government bonds, the first issue of government bonds in the series) and ends on the last day of the measurement period for the refunding issue. *Treas Reg § 1.141-13(b)(2)(iii)*.

(n102)Footnote 5. The private payment portion of the test takes into account the payment of the debt service on the issue that is directly or indirectly to be derived from payments (whether or not to the issuer or any related party) in respect of property, or borrowed money, used or to be used for a private business use. The private security portion of the test takes into account the payment of debt service on the issue that is directly or indirectly secured by any interest in property used or to be used for a private business use or payments in respect of property used or to be used for a private business use. *Treas Reg § 1.141-4(a)(1)*. Payments taken into account as private payments and payments or property taken into account as private security are aggregated, but the same payments are not taken into account as both private security and private payments. *Treas Reg § 1.141-4(a)(2)*.

(n103)Footnote 6. *IRC § 141(c)(1)*. The private loan financing test does not apply to a loan that enables the

borrower to finance any governmental tax or assessment of general application for a specific essential governmental function, or if the loan is a nonpurpose investment, ie, investment property acquired with the proceeds of an issue, but not in order to carry out the governmental purpose of the issue. *IRC §§ 141(c)(2), 148 (f)(6)(A)*.

In determining whether the private loan financing test is met, the amount actually loaned to a nongovernmental person is not discounted to reflect the present value of the loan repayments. *Treas Reg § 1.141-5(b)*.

The Tax Court has held that a municipality cannot use time value of money principles in determining the amount of bond proceeds used to make or finance loans to private persons. *City of New York v Commr, 103 TC 481 (1994)*, *aff'd 70 F3d 143 (DC Cir 1995)*. The Regulations also provide that, in determining whether the private loan financing test is met, the amount actually loaned to a private person is not discounted to reflect the present value of the loan repayments. *Treas Reg § 1.141-5(b)*.

(n104)Footnote 7. *Treas Reg § 1.141-2(d)(1)*.

(n105)Footnote 8. *Treas Reg § 1.141-2(d)(2)(i)*.

(n106)Footnote 9. *Treas Reg § 1.141-2(d)(2)(ii)*. Remedial actions include the redemption or defeasance of nonqualified bonds, alternative use of disposition proceeds, or alternative use of the financed facility. *Treas Reg § 1.141-12(d), (e), (f)*.

(n107)Footnote 10. *Treas Reg § 1.141-2(d)(1)*.

(n108)Footnote 10.1. *Treas Reg § 1.141-2(d)(3)(i), (e)*.

(n109)Footnote 10.2. *Treas Reg § 1.141-2(d)(3)(ii)*.

(n110)Footnote 10.3. *Treas Reg § 1.141-2(f)*.

(n111)Footnote 11. *Treas Reg § 1.141-4(b)(2)(i)*. Debt service does not include any amount paid or to be paid from sale proceeds or investment proceeds. *Treas Reg § 1.141-4(b)(2)(ii)(A)*. Moreover, debt service is adjusted to take into account payments and receipts that adjust the yield on an issue for purposes of *IRC § 148* (relating to arbitrage bonds). *Treas Reg § 1.141-4(b)(2)(ii)(B)*.

If the amount of private business use of a refunding issue is determined based on the measurement period for that issue in accordance with *Treas Reg § 1.141-13(b)(2)(i)* or *Treas Reg § 1.141-13(b)(2)(ii)(B)* (discussed above), then the amount of private security and private payments allocable to the refunding issue is determined under *Treas Reg § 1.141-4* by treating the refunding issue as a separate issue. *Treas Reg § 1.141-13(c)(1)*. If the amount of business use of a refunding issue is based on the combined measurement period in accordance with *Treas Reg § 1.141-13(b)(2)(A)*, then the amount of private security and private payments is determined under *Treas Reg § 1.141-4* by treating the refunding issue and all earlier issues taken into account in determining the combined measurement period as a combined issue. *Treas Reg § 1.141-13(c)(2)*.

(n112)Footnote 11.1. *Treas Reg § 1.141-4(b)(3)(iii)(A)*.

(n113)Footnote 11.2. *Treas Reg § 1.141-4(b)(3)(iii)(B)*.

(n114)Footnote 11.3. *Treas Reg § 1.141-4(b)(3)(iii)(C)*.

(n115)Footnote 11.4. *Treas Reg § 1.141-4(c)(2)(i)(A)*.

(n116)Footnote 11.5. *Treas Reg § 1.141-4(c)(2)(i)(B)*.

(n117)Footnote 11.6. *Treas Reg § 1.141-4(c)(2)(i)(C)*.

(n118)Footnote 11.7. *Treas Reg § 1.141-4(c)(2)(ii)*.

(n119)Footnote 11.8. *Treas Reg § 1.141-4(c)(3)(i)*. For this purpose, different sources of funding may include different tax-exempt issues, taxable issues, and amounts that are not derived from a borrowing, such as revenues of an issuer (equity).

If a payment is made for the use of property financed with two or more sources of funding (e.g., equity and a tax-exempt issue), that payment must be allocated to those sources of funding in a manner that reasonably corresponds to the relative amounts of those sources of funding that are expended on that property. *Treas Reg § 1.141-4(c)(3)(iii)*.

A private payment for the use of property made under an arrangement that is entered into in connection with the issuance of the bonds that finance the property generally is allocated to that issue. *Treas Reg § 1.141-4(c)(3)(iv)*.

(n120)Footnote 11.9. *Treas Reg § 1.141-4(c)(3)(ii)*.

(n121)Footnote 11.10. *Treas Reg § 1.141-4(d)(2)*. Special rules govern the pledge or unexpended proceeds, property or payments securing the payment of debt service, and payments in respect of property used, or to be used, for a private business. *Treas Reg § 1.141-4(d)(3), (4), (5)*.

(n122)Footnote 11.11. *Treas Reg § 1.141-4(d)(6)*.

(n123)Footnote 11.12. *Treas Reg § 1.141-4(e)(1)*.

(n124)Footnote 11.13. *Treas Reg § 1.141-4(e)(2)*.

(n125)Footnote 11.14. A tax does not have a generally applicable manner of determination and collection to the extent that one or more taxpayers make any impermissible agreement relating to the payment of those taxes. *Treas Reg § 1.141-4(e)(4)(i)*. Examples of impermissible agreements and permissible agreements can be found in *Treas Reg §§ 1.141-4(e)(4)(ii)* and *1.141-4(e)(4)(iii)*, respectively.

(n126)Footnote 11.15. *Treas Reg § 1.141-4(e)(3)*.

(n127)Footnote 11.16. *Treas Reg § 1.141-5(c)(1)*. A loan that is a nonpurpose investment (e.g., a temporary investment of proceeds in U.S. obligations) generally is not treated as a loan under the private loan financing test. *Treas Reg § 1.141-5(c)(2)(i)*.

(n128)Footnote 12. *Treas Reg § 1.141-5(c)(2)(ii)*.

(n129)Footnote 13. *IRC § 141(b)(3)(A)*. The determination of whether a private use is related to a governmental use also being financed with the proceeds is to be made on a case-by-case basis. HR Rep No 841, 99th Cong, 2d Sess II-691 (1986). The determination of whether a private use is disproportionate to the governmental use to which the private use relates is determined by comparing the amount of bond proceeds used for the two uses; the private use is disproportionate to the related governmental use to the extent it exceeds such use in amount. *IRC § 141(b)(3)(B)*.

(n130)Footnote 14. *IRC § 141(b)(9)*.

(n131)Footnote 15. *Treas Reg § 1.141-3(d)(5)*.

(n132)Footnote 16. *Treas Reg § 1.141-3(d)(6)*.

(n133)Footnote 16.1. *Treas Reg § 1.141-3(c)(1)*. Generally, use under an arrangement that provides priority rights

of other preferential benefits is not use on the same basis as the general public. *Treas Reg § 1.141-3(c)(2)*.

(n134)Footnote 16.2. *Treas Reg § 1.141-3(c)(2)*. The 200-day period applies to any bond sold on or after Nov 20, 2001, and may be applied to any bond outstanding on Nov 20, 2001, to which *Treas Reg § 141-3* applies.

(n135)Footnote 17. *Treas Reg § 1.141-3(d)(3)(i)*. The arrangement must be one that would be treated as general public use, except that it is not available for use on the same basis by natural persons not engaged in a trade or business because generally applicable and uniformly applied rates are not reasonably available to such persons. In addition, the property cannot be financed for a principal purpose of providing that property for use by the nongovernmental person.

The 100-day period applies to any bond sold on or after Nov 20, 2001, and may apply to any bond outstanding on Nov 21, 2001, to which *Treas Reg § 1.141-3* applies.

(n136)Footnote 18. *Treas Reg § 1.141-3(d)(3)(ii)*. The property cannot be financed for a principal purpose of providing that property for use by the nongovernmental person.

(n137)Footnote 18.1. The 50-day period applies to any bond sold on or after Nov 20, 2001, and may apply to any bond outstanding on Nov 21, 2001, to which *Treas Reg § 1.141-3* applies.

(n138)Footnote 19. *IRC § 146(g), (h)*.

(n139)Footnote 20. *IRC § 146(d)(1); Rev Proc 2009-50, 2009 IRB LEXIS 652, *13-14*. The proper population figures to be used for calculating the volume cap under *IRC § 146* for calendar year 2010 can be found in *Notice 2010-21, 2010-12 IRB 451*.

(n140)Footnote 21. *IRC § 146(d)(2)*. The adjustment is made by multiplying the dollar amounts by the cost-of-living adjustment determined under *IRC § 1(f)(3)* for the calendar year, using calendar year 2001 as the base year.

(n141)Footnote 22. *IRC § 146(d)(4)*.

(n142)Footnote 23. *IRC § 146(d)(5)*.

(n143)Footnote 24. *IRC § 146(d)(5)(A)*. See Notice 2008-79 for a list of the allocations of the additional 2008 volume cap to the states, the District of Columbia, and possessions of the United States.

(n144)Footnote 25. *IRC § 146(d)(5)(B)*.

(n145)Footnote 26. If more than one state agency is authorized to issue tax-exempt private activity bonds, all such agencies are treated as a single agency. *IRC § 146(b)(2)*.

(n146)Footnote 27. *IRC § 146(c)(1)*.

(n147)Footnote 28. *IRC § 146(c)(2)*.

(n148)Footnote 29. *IRC § 146(e)(1)*. The deadline for allocating any portion of the state ceiling is the earlier of (1) Feb 15 of the calendar year following the year in which the state ceiling arises, or (2) the date of issue of the bonds issued pursuant to an allocation of the portion of the state ceiling. *Notice 2003-41, 2003-2 CB 49*.

(n149)Footnote 30. *IRC § 146(f)(1), (3)*. The carryforward election must be filed with the Service by the earlier of (1) Feb 15 of the calendar year following the year in which the state ceiling represented by the volume cap arises, or (2) the date of issuance of the bonds issued pursuant to the assignment of a portion of the volume cap. *Notice 2003-42, 2003-2 CB 49*. An issuing authority that fails to make a timely carryforward election is granted an automatic extension

of six months from the due date of the election if the authority meets the requirements set forth in *Rev Proc 2005-30, 2005-1 CB 1148*.

The amount of volume cap an issuing authority uses during the year, and therefore the amount remaining for carryforward should be determined by reference to the issue price of the bonds. *Rev Rul 83-154, 1983-2 CB 33*; *Ltr Rul 9431007*.

(n150)Footnote 31. *IRC § 146(f)(2), (4)*.

(n151)Footnote 32. *IRC § 146(f)(5)*. Issuing enterprise zone facility bonds is a carryforward purpose. *Treas Reg § 1.1394-1(m)(3)*.

(n152)Footnote 33. *IRC § 141(b)(8)*.

(n153)Footnote 34. *IRC § 141(b)(5)*.

(n154)Footnote 35. *Notice 87-69, 1987-2 CB 378*.

(n155)Footnote 36. *IRC § 146(i)(1)*.

(n156)Footnote 37. *IRC § 146(i)(2)*.

(n157)Footnote 38. *IRC § 146(i)(3)*.

(n158)Footnote 39. *IRC § 147(a)(1)*.

(n159)Footnote 40. The *IRC § 1563(a)* definition of controlled group applies, except that only 50 percent stock ownership is required for control.

(n160)Footnote 41. *IRC § 147(a)(2)*.

(n161)Footnote 42. *IRC § 147(b)(1)*.

(n162)Footnote 43. A first-time farmer is an individual who has not at any time had any direct or indirect ownership interest in substantial farmland in the operation of which the individual materially participated, and has not received financing in excess of \$250,000. *IRC § 147(c)(2)(C)*. Substantial farmland means any parcel of land unless such parcel is smaller than 30 percent of the median size of a farm in the county in which the parcel is located and the fair market value of the land does not at any time held by the individual exceed \$125,000. *IRC § 147(c)(2)(E)*.

(n163)Footnote 44. *IRC § 147(c)*. In no event can the amount of financing provided to a first-time farmer for used depreciable personal property exceed \$62,500.

The acquisition by a first-time farmer of land or personal property from a related person (as defined in *IRC § 144(a)(3)*) is not treated as an acquisition from a related party if (i) the acquisition price is for the fair market value of the land or property, and (ii) subsequent to the acquisition, the related party does not have a financial interest in the farming operation with respect to which the bond proceeds are to be used. *IRC § 147(c)(2)(G)*.

(n164)Footnote 45. *IRC § 147(d)*.

(n165)Footnote 46. *IRC § 147(e)*. The proceeds of a qualified 501(c)(3) bond can be used to provide a health club facility. *IRC § 147(h)(2)*.

A helicopter is not an airplane within the meaning of *IRC § 147(e)*. *Rev Rul 2003-116, 2003-2 CB 1083*.

(n166)Footnote 47. *IRC § 147(f)(1), (2)(A)*. If the issue is to finance facilities at an airport or high-speed intercity rail facilities that is operated by the governmental unit issuing the bonds, such governmental unit is the only one deemed to have jurisdiction over the airport or high-speed intercity rail facilities. *IRC § 147(f)(3)*.

If there has been public approval for a plan for financing a facility, it continues to be effective for any bonds that are issued pursuant to the plan within three years after the date of the first issue pursuant to the approval, if substantially all of the proceeds of the later issue are to be used to finance the facility or to refund previous financing under the plan. *IRC § 147(f)(2)(C)*.

A political subdivision of a state issued bonds without obtaining public approval, as required by the state constitution. The state supreme court held that the bonds were not valid obligations because of the lack of voter approval. This led the Service to rule that interest on the bonds was not tax-exempt. *Rev Rul 87-116, 1987-2 CB 44*. See *Prop Treas Reg § 1.147(f)-1* for guidance on the public approval requirement.

(n167)Footnote 48. *IRC § 147(f)(2)(B)*. The term "applicable elected representative" means (a) an elected legislative body of a governmental unit, or (b) the chief elected executive officer, the chief elected state legal officer of the executive branch, or any other elected official designated by the chief elected executive officer or by state law as the approving official. If the office of any elected official described in (b) is vacated and an individual is appointed by the chief elected executive officer of the governmental unit and confirmed by the elected legislative body of the unit (if any) to serve the remaining term of the elected official, the individual is treated as the elected official for the remainder of the term. If a governmental unit has no applicable elected official, the applicable elected representative of the next higher governmental unit from which the lower unit derives its authority will serve as such for the unit without an official. *IRC § 147(F)(2)(E)*.

(n168)Footnote 49. *IRC § 147(f)(2)(D)*.

(n169)Footnote 50. *IRC § 147(g)*.

(n170)Footnote 51. *IRC § 147(h)(1)*.

(n171)Footnote 52. *IRC § 147(h)(2)*.

(n172)Footnote 53. The "qualified project period" begins on the first day that 10 percent of the units in the project are occupied and ends on the later of (1) the date which is 15 years after the date on which 50 percent of the units are occupied, (2) the first day on which no tax-exempt private activity bond issued with respect to the project is outstanding, or (3) the date on which any assistance provided with respect to the project under Section 8 of the US Housing Act of 1937 terminates. *IRC § 142(d)(2)*.

(n173)Footnote 54. A project is a qualified residential rental project if the requirements of one of two alternative tests are met. The issuer must choose one of the tests at the time of issuance of the bonds for the project. The 20-50 test is met if 20 percent or more of the residential units in the project are occupied by individuals whose income is 50 percent or less of area median gross income. The 40-60 test is met if 40 percent (25 percent in New York City) of the residential units in the project are occupied by individuals whose income is 60 percent or less of area gross income. *IRC § 142(d)(1), (6)*. *Rev Proc 2004-39, 2004-2 CB 49*, sets forth procedures for determining whether a residential rental project is in compliance with the applicable set-aside requirements contained in *IRC § 142(d)* during the qualified project period.

A facility will not be residential real property if it makes available continual or frequent nursing, medical, or psychological services to its residents. *Rev Rul 98-47, 1998-2 CB 399*.

The determination of a person's income and area median gross income is made pursuant to standards set by the

Secretary of the Treasury in a manner consistent with Section 8 of the US Housing Act of 1937. If an occupant satisfies the test when he or she first occupies the premises, the occupant will be treated as a qualifying individual as long as he or she continues to reside in the project, even though the occupant later has income that exceeds the applicable income limit. The last-stated rule will cease to apply to any resident whose income exceeds 140 percent (170 percent in a deep rent skewed project) of the applicable income limit if, after the annual determination of a resident's income, but before the next annual determination, any residential unit of comparable or smaller size in the project (any low-income unit in a deep skewed rent project) is occupied by a new resident whose income exceeds the applicable limit (40 percent in a deep skewed rent project). *IRC § 142(d)(3)(B), (4)(A)*. If the owner of the project elects, and the project meets the following tests, a project will be a deep skewed rent project: (a) at least 15 percent of the low-income units (units that must be occupied by persons who meet the applicable income limit) are occupied by persons whose income is 40 percent or less of area median gross income, (b) the gross rent for each low-income unit does not exceed 30 percent of the applicable income limit that applies to occupants of the unit, and (c) the gross rent for each low-income unit does not exceed one third of the average gross rent of units of comparable size not occupied by low-income individuals. *IRC § 142(d)(4)(B)*.

(n174)Footnote 55. All of the described property financed by the issue must be owned by a governmental unit. Property leased by a governmental unit will be treated as owned by it if the lessee makes an irrevocable election not to claim depreciation with respect to the property, the lease term is not more than 80 percent of the reasonably expected economic life of the property, and the lessee has no option to purchase the property other than at fair market value (as of the time the option is exercised). *IRC § 142(b)*.

The described property or a high-speed intercity rail facility will not be treated as an exempt facility if it is to be used for a private business use and is (a) a lodging facility, (b) a retail facility (including a food and beverage facility) in excess of a size necessary to serve passengers and employees at the exempt facility, (c) any retail facility (other than parking) for passengers or the general public located outside the exempt facility terminal, (d) any office building for individuals who are not employees of a governmental unit or of the operating authority for the exempt facility, or (e) an industrial part or manufacturing facility. *IRC § 142(c)(2)*.

(n175)Footnote 56. See *Treas Reg § 1.142(a)(5)-1(b)(1)* for the definition of sewage facility.

(n176)Footnote 57. A high-speed rail intercity facility that is not owned by a governmental unit will be treated as an exempt facility only if the owner irrevocably elects not to claim any depreciation deduction or credit with respect to the property financed by the issue. *IRC § 142(i)(2)*.

A bond that is part of an issue to finance a high-speed intercity rail facility will not be considered an exempt facility bond unless any proceeds not used within a three-year period of the date of issuance are used, not later than six months after the close of the period, to redeem bonds that are part of the issue. *IRC § 142(i)(3)*.

(n177)Footnote 58. A qualified public educational facility is a school facility that is part of a public elementary or secondary school, and is owned by a private, for-profit corporation pursuant to a public-private partnership agreement with a state or local educational agency. *IRC § 142(k)(1)*.

An issue is not treated as one used to provide qualified educational facilities if the aggregate face amount of bonds issued by the state pursuant thereto (when added to the aggregate face amount of bonds previously issued during the calendar year) exceeds an amount equal to the greater of (i) \$10 multiplied by the state population, or (ii) \$5 million. *IRC § 142(k)(5)*. The proper population figures to be used for calculating the 2000 calendar year limitation under *IRC § 142(k)(5)* are contained in *Notice 2002-56, 2002-2 CB 319*.

(n178)Footnote 59. A qualified green building and sustainable design project is any project that is designated by the Secretary of the Treasury, after consultation with the Administrator of the Environmental Protection Agency, as a qualified green building and sustainable design project and that meets certain other requirements. *IRC § 142(l)*.

A bond is an exempt facility bond for this purpose if it is issued after Dec 31, 2004, and before Oct 1, 2009.

(n179)Footnote 60. A qualified highway or surface freight transfer facility is one that receives federal assistance under Title 23, United States Code, and is either (1) a surface transportation project, (2) a project for an international bridge or tunnel for which an international entity authorized under federal or state law, or (3) a facility for the transfer of freight from truck to rail or rail to truck. *IRC § 142(m)(1)*. There is a \$15 billion aggregate limit on tax-exempt financing for facilities. *IRC § 142(m)(2)*.

(n180)Footnote 61. *IRC § 150(a)(3); Rev Rul 90-51, 1990-1 CB 22*.

The Service will not ordinarily rule whether an issue of private activity bonds meets the requirements of *IRC § 142* if (1) the portion of the proceeds used to finance a facility in which an owner or lessee (or a related person) is a user of the facility both after the bonds are issued and at any time before they were issued, and (2) the portion used to pay issuance costs and nonqualified costs amounts to more than 5 percent of the net proceeds. *Rev Proc 2010-3, 2010-1 IRB 110, 115-116 (§ 4.01(8))*.

(n181)Footnote 62. *IRC § 142(f)(3)*.

(n182)Footnote 63. *IRC § 142(f)(4)*.

(n183)Footnote 64. *IRC § 1394(a)*. See, generally, Ballard & Schakel, "EZ Bonds Will Not Be Easy," 62 *Tax Notes* 1321 (1994).

(n184)Footnote 65. *IRC § 1394(a), (b)(1)*.

(n185)Footnote 66. *IRC §§ 1394(b)(2), 1397D(a); Treas Reg § 1.1394-1(l)*. Any reference in *IRC § 1397C* to empowerment zones is treated as including references to enterprise communities. *IRC § 1394(b)(3)(B)(i)*.

(n186)Footnote 67. *IRC §§ 1394(b)(3), 1397C(a)*. A portion of a trade or business can be an enterprise zone business if it would qualify as such were it separately incorporated. *IRC § 1394(b)(3)(D)*.

(n187)Footnote 68. A collectible is any work of art, rug or antique, metal or gem, stamp or coin, alcoholic beverage, or other tangible property specified by the Service for purposes of *IRC § 408(m)(2)*.

(n188)Footnote 69. *IRC § 1397C(b)*. Nonqualified financial property is defined as debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property specified in regulations, but does not include (i) reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less, or (ii) accounts or notes receivable acquired in the ordinary course of business for services rendered or from the sale of inventory or property held for sale to customers. *IRC § 1397C(e)*.

(n189)Footnote 70. *IRC § 1397C(c)*. The proprietor is considered an employee for this purpose.

(n190)Footnote 71. *IRC § 1397C(d)(1), (4), (5)*. See Ltr Rul 200006016 for an example of a corporation whose business activities consist predominantly of the development or holding of intangibles for sale or license.

(n191)Footnote 72. *IRC § 1397C(d)(2)*. The lessor of property may rely on a lessee's certification that the lessee is an enterprise zone business.

(n192)Footnote 73. *IRC § 1397C(d)(3)*.

(n193)Footnote 74. *IRC § 1394(b)(3) (B)(ii)*.

(n194)Footnote 75. *IRC § 1394(b)(3)(B)(iii)*. The rule does not apply to any business that is not a qualified business by reason of *IRC § 1397C(d)(1), (4), or (5)*. See the text accompanying N 50.8.

In the case of a District of Columbia Enterprise Zone, *IRC § 1394(b) (3)(b)(iii)* is applied without regard to the employee residency requirement.

(n195)Footnote 76. *IRC § 1394(b)(3)(C)(i)*.

(n196)Footnote 77. *IRC § 1394(b)(3)(C)(ii)*.

(n197)Footnote 78. *Treas Reg § 1.1394-1(e)(1)*.

(n198)Footnote 79. *Treas Reg § 1.1394-1(e)(2)*.

(n199)Footnote 80. *IRC § 1394(e)(1); Treas Reg § 1.1394-1(b)(3)(i)(B)*. In order to satisfy the good faith requirement, the principal user must at least annually demonstrate to the issuer the principal user's monitoring of compliance with *IRC § 1394(a) and (b)*. *Treas Reg § 1.1394-1(b)(3)(iii)*.

The good faith exception does not apply to the requirement that a qualified business cannot be a trade or business operating a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. *Treas Reg § 1.1394-1(b)(3)(ii)*.

(n200)Footnote 81. *Treas Reg §§ 1.1394-1(f), 1.1394-1(n)(3)*.

(n201)Footnote 82. *Treas Reg § 1.1394-1(m)(4)*.

(n202)Footnote 83. *Treas Reg § 1.1394-1(g)(2)(ii)*.

(n203)Footnote 84. *Treas Reg § 1.1394-1(m)(2)(ii)*.

(n204)Footnote 85. *IRC § 1394(c)(1)*. Whether an issue satisfies the aggregate amount limitations is determined as of the issue date of the issue, based on the issue price of the issue and the adjusted issue price of outstanding enterprise zone facility bonds. *Treas Reg § 1.1394-1(g)(1)*.

The aggregate amount limitations for an issue for a pooled financing bond program are determined with regard to the amount of the actual loans to enterprise zone businesses rather than the amount lent to intermediary lenders. *Treas Reg § 1.1394-1(g)(2)(i)*. This applies only to the extent the proceeds of those enterprise zone facility bonds are loaned to one or more enterprise zone businesses within 42 months of the issue date of the enterprise zone facility bonds or are used to redeem enterprise zone facility bonds of the issue within that 42-month period.

The limitation on the amount of bonds issued by the District of Columbia Enterprise Zone from Jan 1, 1998 through Dec 31, 2007 is increased from \$3 million to \$15 million. *IRC § 1400A*.

(n205)Footnote 86. *IRC § 1394(c)(2)*.

(n206)Footnote 87. *Treas Reg § 1.1394-1(m)(1)*.

(n207)Footnote 88. *Treas Reg § 1.1394-1(m)(2)(i)*.

(n208)Footnote 89. *Treas Reg § 1.1394-1(o)(1)*.

(n209)Footnote 90. *Treas Reg § 1.1394-1(o)(2)*.

(n210)Footnote 91. *IRC § 1394(e)(2)*. *IRC § 1394(e)(2)* does not apply during any period in which the issue is deemed to comply with the requirements of *IRC § 1394* under the deemed compliance provisions of *Treas Reg § 1.1394-1(b)(3)*. *Treas Reg § 1.1394-1(n)(2)*.

(n211)Footnote 92. *IRC § 1394(e)(3), (4)*.

(n212)Footnote 93. The designation may be made before Jan 1, 2002. It will remain in effect during the period beginning Jan 1, 2002, and ending on Dec 31, 2009. *IRC § 1391(h)(2)*.

(n213)Footnote 94. *IRC § 1394(f)(1)*. The bond must be designated as a new empowerment zone facility bond by the local government that nominated the area to which the bond relates. *IRC § 1394(f)(2)(A)*. Bonds to which *IRC § 1394(f)(1)* applies are not taken into account in applying the aggregate amount limitation of *IRC § 1394(c)*. *IRC § 1394(f)(2)(C)(i)*.

(n214)Footnote 95. *IRC § 1394(f)(2)(B)*.

(n215)Footnote 96. *IRC § 1394(f)(2)(C)(ii)*.

(n216)Footnote 97. *IRC § 1394(f)(3)*.

(n217)Footnote 98. The issue will not qualify as a qualified mortgage issue unless all proceeds of the issue required to be used to finance owner-occupied residences are so used within the 42-month period beginning on the date of issuance of the issue (or, in the case of a refunding bond, within the 42-month period beginning on the date of issuance of the original bond) or, to the extent not so used within the period, are used within the period to redeem bonds that are part of the issue, and no portion of the proceeds of the issue are used to make or finance any loan (other than one that is a nonpurpose investment within the meaning of *IRC § 146(f)(6)(A)*) after the close of the period. *IRC § 143(a)(2)(D)(i)*. Amounts less than \$250,000 need not be used to redeem bonds. *IRC § 143(a)(2)(D)(ii)*.

(n218)Footnote 99. *IRC § 143(a)(1), (2)(A)*.

(n219)Footnote 100. A single-family residence includes any structure containing no more than four family residences, one unit of which is occupied by the owner of the units, and which were first occupied at least five years before the mortgage is executed, an individual unit in a condominium, or a share in a cooperative housing corporation. *IRC § 143(k)(7), (8)*.

The residence can be a new two-family residence if the residence is a targeted area residence and the family income of the mortgagor is not greater than 140 percent of the applicable median family income. *IRC § 143(f)(3)(B)*. The "applicable median family income" is the greater of the median gross income for the area in which the residence is located or the median gross income for the state in which the residence is located. *IRC § 143(f)(4)*.

(n220)Footnote 101. *IRC § 143(c)*.

(n221)Footnote 102. *IRC § 143(d)(1)*. The three-year requirement does not apply to any financing provided with respect to a residence located in an area determined by the President to warrant assistance from the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act if the financing is provided within two years after the date of the disaster declaration. The foregoing applies to bonds issued after December 31, 1996 and before January 1, 1999. *IRC § 143(k)(11)*.

(n222)Footnote 103. A targeted area residence is one located in a census tract in which 70 percent or more of the families have income which is 80 percent or less of the statewide median family income or in an area of chronic economic distress (an area designated as such by the state and approved as such by the Secretary of the Treasury and the Secretary of Housing and Urban Development). *IRC § 143(j)*.

(n223)Footnote 104. A qualified home improvement loan cannot exceed \$15,000 and must be used for alterations, repairs and improvements on an existing residence by the owner thereof, but only if the work substantially protects or improves the basic livability or energy efficiency of the property. *IRC § 143(k)(4)*.

(n224)Footnote 105. *IRC § 143(d)(2)*. A qualified rehabilitation loan is defined as any owner financing provided in connection with a qualified rehabilitation or the acquisition of a residence with respect to which there has been a qualified rehabilitation, provided the mortgagor is the first resident of the structure after completion of the rehabilitation. A rehabilitation of a building is qualified if:

- there is a period of at least 20 years between the date on which the building was first used and the date rehabilitation work begins;
- 50 percent or more of the existing external walls of the building are retained as external walls, 75 percent or more of the existing external walls are retained as internal or external walls, and 75 percent or more of the existing internal structural framework is retained; and
- the expenditures for the rehabilitation amount to at least 25 percent of the mortgagor's adjusted basis determined as of the completion of the rehabilitation or, if later, the date on which the mortgagor acquires the residence. *IRC § 143(k)(5)*.

(n225)Footnote 106. *IRC § 143(f)(1), (4)*.

(n226)Footnote 107. *IRC § 143(f)(3)*. The income requirement will be determined under the targeted area rule in the case of financing obtained within two years after a disaster declaration.

(n227)Footnote 108. *IRC § 143(f)(5)(A), (B), (C)*. The multiplier will be 100 percent and the overall limitation will be 120 percent for a mortgagor having a family of fewer than three individuals. *IRC § 143(f)(6)*. Nationwide average purchase prices for new and existing residences located in the US are set forth in *Rev Proc 2009-18, 2009-1 CB 670*.

(n228)Footnote 109. *IRC § 143(a)(5)(D)*. The applicable housing price ratio for any area is the new housing price ratio or the existing housing price ratio, whichever results in the housing cost/income ratio being closer to 1. The housing cost ratio in each case is the ratio that the average purchase price for residences in the area bears to the average purchase price for residences in the United States.

Rev Proc 2007-31, 2007-1 CB 1225, provides guidance concerning the US and area median gross income figures that are to be used by issuers of qualified mortgage bonds and issuers of mortgage credit certificates in computing the housing cost/income ratio. Issuers can continue to rely on the U.S. and area median gross income figures specified in *Rev Proc 2006-20, 2006-1 CB 841*, with respect to bonds originally sold and nonissued bond amounts elected not later than May 17, 2007 if commitments to provide financing or purchases, if the purchase precedes the financing commitment, are made not later than Jul 18, 2007. Otherwise, *Rev Proc 2006-20* is obsolete.

(n229)Footnote 110. The term "acquisition cost" means the cost of acquiring the residence as a completed residential unit, but does not include usual and reasonable settlement or financing costs, the value of services performed by the mortgagor or members of his family in completing the structure, or the cost of land (other than land acquired under a contract for deed) owned by the mortgagor for at least two years before the date on which construction begins. *IRC § 143(k)(3)*.

(n230)Footnote 111. The acquisition cost requirement will be determined under the targeted area rule for financing acquired within two years after a disaster declaration. The three-year requirement does not apply to any financing provided with respect to a residence located in an area determined by the President to warrant assistance from the

federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act if the financing is provided within two years after the date of the disaster declaration. The foregoing applies to bonds issued after December 31, 1996 and before January 1, 1999. *IRC § 143(k)(11)*.

(n231)Footnote 112. *IRC § 143(k)(2)*.

(n232)Footnote 113. *IRC § 143(d)(2), (3)*.

(n233)Footnote 114. *IRC § 143(d)(6)*.

(n234)Footnote 115. *IRC § 143(k)(10)(A)*.

(n235)Footnote 116. *IRC § 143(k)(10)(B)*.

(n236)Footnote 117. *IRC § 143(h)(1)*.

(n237)Footnote 118. *IRC § 143(h)(2)*.

(n238)Footnote 119. *IRC § 143(g)(1), (2)(A)*. The issue price is the initial offering price to the public or a private party (excluding bond houses and brokers) at which a substantial amount of bonds were sold. *IRC §§ 143(g)(2)(C)(i), 1273(b)(1)*.

(n239)Footnote 120. *IRC § 143(g)(2)(B)(i)*. Points or similar charges paid by the seller of the property are treated as borne by the mortgagor as are amounts paid by any person in excess of the usual and reasonable acquisition costs incurred where financing is not provided through qualified mortgage bonds. *IRC § 143(g)(2)(B)(ii)*.

(n240)Footnote 121. *IRC § 143(g)(2)(B)(iii)*. Amounts paid for Federal Housing Administration, Veterans' Administration, or similar private mortgage insurance on an individual's mortgage, or amounts paid for pool mortgage insurance on a pool of mortgages, are not taken into account so long as the amounts do not exceed the amounts charged in the area with respect to a similar mortgage, or pool of mortgages, that is not financed with mortgage revenue bonds. *Treas Reg § 1.148(g)-1(b)(2)(iii)(B)*.

(n241)Footnote 122. *IRC § 143(g)(2)(B)(iv)*.

(n242)Footnote 123. *IRC § 143(g)(3)(A)*. In determining the amount earned on nonmortgage investments, any gain or loss on the disposition of such investments must be taken into account. *IRC § 143(g)(3)(B)*. If the excess of the effective rate on the mortgages over the yield on the issue is less than 1.125 percent, the refund to the mortgagors is reduced by the amount which would result by treating the excess as being equal to 1.125 percent. *IRC § 143(g)(3)(C)*.

In lieu of refunding arbitrage and investment gains to mortgagors, the issuer can elect before issuing the obligations to pay the gains to the US. *IRC § 143(g)(3)(D)*.

(n243)Footnote 124. *IRC § 143(i)(1)(A)*. There is an exception for refinancing of qualified subprime loans with qualified mortgage bonds issued by December 31, 2010.

(n244)Footnote 125. *IRC § 143(i)(1)(B)*. The contract for deed exception applies to land possessed under a contract for deed by a mortgagor (1) whose principal residence is located on the land, and (2) whose family income is not more than 50 percent of applicable median family income as defined in *IRC § 143(f)(4)*. A contract for deed is a seller-financed contract for the conveyance of land under which legal title does not pass to the purchaser until the purchase price is fully paid to the seller, and the seller's remedy for nonpayment is forfeiture rather than foreclosure. *IRC § 143(i)(1)(C)*.

(n245)Footnote 126. *IRC § 143(i)(2)*.

(n246)Footnote 127. *IRC § 143(a)(2)(A)(iv)*. The rule does not require amounts less than \$250,000 to be used to redeem bonds. *IRC § 143(a)(2)(D)(ii)*.

(n247)Footnote 128. *IRC § 143(a)(2)(B)*.

(n248)Footnote 129. *IRC § 143(a)(2)(C)*. Good faith is met here if the issuer takes all reasonable steps to insure that the issue complies with the requirements.

(n249)Footnote 130. *IRC § 143(b)*.

(n250)Footnote 131. *IRC § 143(l)(2)*.

(n251)Footnote 132. *IRC § 143(l)(4)*. In the case of Alaska, Oregon, and Wisconsin, a qualified veteran must apply for financing before the date that is 25 years after the last date on which the veteran served on active duty.

(n252)Footnote 133. The average is determined by taking the aggregate amount of bonds issued in the lowest year, and dividing the sum by the number of years (not exceeding five) after 1979 that the state issued qualified veterans' mortgage bonds. *IRC § 143(l)(3)(B)*. The state veterans limit for Alaska, Oregon, and Wisconsin is \$5 million for calendar year 2006, \$10 million for 2007, \$15 million for 2008, \$20 million for 2009, and \$25 million thereafter.

(n253)Footnote 134. *IRC § 146(n)*.

(n254)Footnote 135. *IRC § 25(d)(2)*.

(n255)Footnote 136. *IRC § 25(a)(1)*. No credit is allowed if the interest is paid to a related person within the meaning of *IRC § 144(a)(3)(A)*. *IRC § 25(e)(6)*. The certificate remains in effect until it is revoked by the issuing authority or the residence is sold. A certificate is invalid if the financing is not obtained prior to the close of the second taxable year after the year in which the issuing authority elected to issue mortgage credit certificates. *IRC § 25(e)(3)*.

(n256)Footnote 137. *IRC § 25(a)(2)*.

(n257)Footnote 138. *IRC § 25(e)(1)*.

(n258)Footnote 139. *IRC § 25(c)*. The loan can also be a qualified home improvement loan or a qualified rehabilitation loan. *IRC § 25(b)(2)*.

(n259)Footnote 140. The regulations can specify the extent to which the particular lender prohibition can be waived. The issuing authority can allocate a block of certificates to a particular development if the developer supplies to the buyer and the issuing authority that the price is no higher than it would have been without the use of a mortgage credit certificate. *IRC § 25(c)(2)(A)(v), (vii)*.

(n260)Footnote 141. *IRC § 25(e)(5)*.

(n261)Footnote 142. *Treas Reg § 1.25-3(p)(1),(3)*.

(n262)Footnote 143. *IRC § 25(g)*.

(n263)Footnote 144. *IRC § 6709*.

(n264)Footnote 145. *IRC § 143(k)(12)*.

(n265)Footnote 146. *IRC § 143(k)(12)(B)*. See also *Notice 2008-79*.

(n266)Footnote 147. *IRC § 143(k)(12)(C)*.

(n267)Footnote 148. *Notice 2008-79* .

(n268)Footnote 149. *Notice 2008-79* .

(n269)Footnote 150. Federally subsidized indebtedness excludes qualified home improvement loans.

The recapture rules apply generally to financing provided, and mortgage credit certificates issued, after Dec 31, 1990. The recapture provisions apply to the assumption of a loan, or relending of proceeds derived from repayment of any prior loan, originally made from proceeds of qualified mortgage bonds issued under *IRC § 143* after Aug 15, 1986. *Rev Rul 91-3, 1991-1 CB 31* .

Issuers of qualified mortgage bonds used to finance the purchase of a residence after Dec 31, 1990, must report the name, residence address and social security number of the purchaser. The reporting requirement is designed as a means of effectively enforcing *IRC § 143(m)*. *IRS Notice 90-70, 1990-2 CB 351* .

(n270)Footnote 151. H Rep No 100-795, 100th Cong, 2d Sess 441 (1988). A disposition that is accompanied by a mortgage assumption or mortgage credit certificate transfer is a recapture event. H Rep No 100-795, 100th Cong, 2d Sess 442 (1988).

(n271)Footnote 152. H Rep No 100-795, 100th Cong, 2d Sess 441 (1988).

(n272)Footnote 153. If two or more persons hold interests in a residence and are jointly liable for the federally subsidized indebtedness, the recapture amount is determined separately with respect to their separate interests in the residence.

(n273)Footnote 154. Modified adjusted gross income is adjusted gross income for the taxable year in which disposition occurs increased by any tax-exempt income received by the taxpayer in that year. It does not include gain realized on the disposition.

(n274)Footnote 155. Adjusted qualifying income is the product of (1) the highest family income that (as of the date the financing was provided) would have met the income requirements with respect to the residents, and (2) 1.05 percent to the nth power, where "n" equals the number of full years during the period beginning on the date the financing was provided and ending on the date of disposition.

(n275)Footnote 156. The percentage is rounded to the nearest whole percentage point.

(n276)Footnote 157. The property was held for three full years making 1.05 to the nth power 1.05^[3] and adjusted qualifying income \$23,153 (\$20,000 x 1.157625). Since modified adjusted gross income exceeds adjusted qualifying income by more than \$5,000, the income percentage must be 100 percent.

(n277)Footnote 158. *IRC § 143(m)(7)*. *Rev Proc 91-8, 1991-1 CB 417* , provides issuers of qualified mortgage bonds safe harbor guidelines for complying with the *IRC § 143(m)(7)* reporting requirements.

(n278)Footnote 159. The small issue exemption does not apply to any obligation which is issued as a part of an issue if 5 percent of the proceeds of which are to be used directly or indirectly to provide residential real property for family units. *IRC § 144(a)(5)*.

All industrial development bonds issued to finance a single project are treated as a single issue and any person who is a principal user with respect to any of the issues is treated as a principal user with respect to the aggregated issue. *IRC § 144(a)(9)*.

(n279)Footnote 160. Under *IRC § 144(a)(3)*, one person is related to another if:

"the relationship between such persons would result in the disallowance of losses under section 267 or 707(b), or

"such persons are members of the same controlled group of corporations (as defined in section 1563(a), except that 'more than 50 percent' shall be substituted for 'at least 80 percent' each place it appears therein)."

(n280)Footnote 161. *IRC § 144(a)(2)*.

(n281)Footnote 162. *IRC § 144(a)(7)*.

(n282)Footnote 163. *IRC § 144(a)(4)(A)*.

If the issue involved is a refinancing issue, the election can be made only if all of the prior issues being redeemed are issues which qualified as small issues under *IRC § 144(a)(1)*. *IRC § 144(a)(4)(E)*.

(n283)Footnote 164. *IRC §§ 144(a)(4)(A)(ii), (B)*.

If the issue involved is a refinancing issue, capital expenditures are taken into account only for the purpose of determining whether those prior issues that were made under an *IRC § 144(a)(4)(A)* election qualified, and would have continued to qualify under *IRC § 144(a)(1)* but for the redemption. *IRC § 144(a)(4)(E)*.

(n284)Footnote 165. *IRC § 144(a)(4)(F)*. The provision does not apply to bonds issued after Sept 30, 2006.

(n285)Footnote 166. *IRC § 144(a)(4)(C)*. In addition, with respect to bonds issued after Sept 30, 2006, capital expenditures not exceeding \$10 million are not taken into account in applying *IRC § 144(a)(4)(A)(ii)*. *IRC § 144(a)(4)(G)*.

(n286)Footnote 167. *IRC § 144(a)(8)*.

(n287)Footnote 168. *IRC § 144(a)(11)*.

(n288)Footnote 169. *IRC § 150(b)(6)*.

(n289)Footnote 170. *IRC § 144(a)(12)*. The sunset rule does not apply to any bond or series of bonds issued to refund a bond issued before Dec 31, 1986, if (1) the average maturity date (determined in accordance with *IRC § 147(b)(2)(A)*) of the issue of which the refunding bond is a part is not later than the average maturity date of the bonds to be refunded by the issue, (2) the amount of the refunding bond does not exceed the outstanding amount of the refunded bond, and (3) the net proceeds of the refunding bond are used to redeem the refunded bond not later than 90 days after the issuance of the refunding bond.

The maturity date requirement for refunding bonds issued before July 1, 1987, is satisfied if the bond has a maturity date not later than the maturity date of the refunded bond.

(n290)Footnote 171. For purposes of determining other forms of student assistance, loans made pursuant to § 428B(a)(1) of the Higher Education Act of 1965 (relating to parent loans), and loans made pursuant to subpart C.I of Title VII of the Public Health Service Act (relating to certain student assistance) are not taken into account.

(n291)Footnote 172. *IRC § 144(c)(1), (2), (5)*.

(n292)Footnote 173. *IRC § 144(c)(3)*.

(n293)Footnote 174. S Rep No 99-813, 99th Cong, 2d Sess 837 (1986).

(n294)Footnote 175. *IRC § 144(c)(4)(B)*.

(n295)Footnote 176. *IRC § 144(c)(4)(C)*.

(n296)Footnote 177. *IRC § 144(c)(4)(D)*.

(n297)Footnote 178. HR Rep No 99-841, 99th Cong, 2d Sess II-722 (1986). Congress intends that the designation of blighted areas will be made in contemplation of the redevelopment of the entire area, and that areas will not be artificially designated in order to allow bond financing for one or more specific facilities that happen to be located in the area.

(n298)Footnote 179. *IRC § 144(c)(6)*.

(n299)Footnote 180. *IRC § 145(a)*. A determination that an organization's *IRC § 501(c)(3)* status was revoked was made retroactive to the year in which the organization issued bonds. This caused the interest on the bonds to be includable in the bondholder's income from the date of issuance of the bonds. *TAM 200006049*.

The use of gross proceeds of an issue of qualified *IRC § 501(c)(3)* bonds to acquire investments in such a manner as to comply with *IRC § 148* will not constitute an unrelated trade or business for purposes of *IRC § 145(a)(2)* and will not result in income from debt-financed property under *IRC § 514*. *Notice 2002-10, 2002-1 CB 490*.

Industrial development bonds issued to provide funds for a pervasively sectarian university (an *IRC Section 501(c)(3)* organization) for the purpose of constructing and renovating facilities were held not to violate the *First Amendment* in *Steele v Industrial Dev Board, 301 F3d 401 (6th Cir 2002)*; the loan agreement specifically prohibited the university from using any bond-financed facilities for religious purposes.

(n300)Footnote 181. A bond is a qualified hospital bond if 95 percent or more of the proceeds of the issue are to be used with respect to a hospital. *IRC § 145(c)*.

(n301)Footnote 182. *IRC § 145(b)(1), (5)*.

(n302)Footnote 183. *IRC § 145(d)(1)*. A facility will not be residential real property if it makes available continual or frequent nursing, medical, or psychological services to its residents. *Rev Rul 98-47, 1998-2 CB 399*.

(n303)Footnote 184. *IRC § 145(d)(2)*. Rules similar to those of *IRC § 48(g)(1)(C)* apply in determining whether property is substantially rehabilitated.

(n304)Footnote 185. *IRC § 145(e)*.

(n305)Footnote 186. *IRC § 1400L(d)(1), (3)(A)*. Interest earned on qualified New York Liberty Zone bonds is not an item of tax preference for purposes of the alternative minimum tax. *IRC § 1400L(d)(5)(E)*.

The issuer can elect to forgo qualified New York Liberty Bond treatment for a portion of an issue which, if issued as a separate issue, would be treated as a qualified bond or as a bond that is not a private activity bond. *IRC § 1400L(d)(6)*.

Notice 2003-40, 2003-2 CB 10, Q & A 4, Q & A 5.

(n306)Footnote 187. *IRC § 1400L(d)(2)*. The Governor and Mayor each can designate a maximum of \$4 billion of bonds. *IRC § 1400L(d)(3)(A)*. The Governor and Mayor are not required to utilize the limitation amounts at the same time and can utilize the limitation amounts in any order relative to their designations of bonds for other qualified project costs. *Notice 2002-42, 2002-2 CB 36, Q & A-20.*

The net proceeds of an issue are the proceeds of the issue reduced by amounts in a reasonably required reserve or replacement fund. *IRC § 150(a)(3)*.

(n307)Footnote 188. *IRC § 1400L(d)(3)(B)*.

(n308)Footnote 189. The New York Liberty Zone is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan, New York City. *IRC § 1400L(h)*.

(n309)Footnote 190. *IRC § 1400L(d)(3)(C)*.

(n310)Footnote 191. *IRC § 1400L(d)(4)*.

(n311)Footnote 192. *IRC § 1400L(d)(5)(A)*.

(n312)Footnote 193. *IRC §§ 147(d), 1400L(d)(5)(B)*.

(n313)Footnote 194. *IRC §§ 148(f)(4)(C), 1400L(d)(5)(C)*.

(n314)Footnote 195. *IRC § 1400L(d)(5)(D)*. The first retirement must occur not later than 10 years after issuance.

(n315)Footnote 196. *IRC § 1400L(e)*. An advance refunding occurs when the refunded debt is not redeemed within 90 days after the refunding bonds are issued.

(n316)Footnote 197. *IRC § 1400L(e)(4)(A), (B)*.

(n317)Footnote 198. *IRC § 1400L(e)(1), (2)*. Included in the permissible property is any property that is functionally related and subordinated to facilities in New York City for the furnishing of water.

Solely for purposes of *IRC § 1400L(e)(2)(B)*, a state or local bond that is not actually issued by the NYCMWFA or MTA is treated as issued by it to the extent that the Authority is the obligor of the bond within the meaning of *Treas Reg § 1.150-1(d)(2)(ii)(B)*, namely, that the obligor of the portion of an issue properly allocable to an investment in a purpose investment is the conduit borrower under the purpose investment. *Notice 2002-73, 2002-2 CB 844*.

Bonds issued by the New York City Transit Authority and the Triborough Bridge and Tunnel Authority are eligible for the advance refunding provisions of *IRC § 1400L(e)(1)*. *Notice 2002-42, 2002-2 CB 36*, Q & A-22. Legislation will be introduced to provide the same for bonds issued by the Municipal Assistance Corporation for The City of New York. *Notice 2002-42, Q & A-23*.

Notice 2003-40, 2003-2 CB 10, Q & A 6.

(n318)Footnote 199. *IRC § 1400L(e)(3)*.

(n319)Footnote 200. *IRC § 1400L(e)(4)(C)*.

(n320)Footnote 201. There are three Gulf Opportunity Zones, as defined in *IRC § 1400M*, all of which were declared to be major disaster areas by President Bush. These have been named the Gulf Opportunity Zone (the Hurricane Katrina disaster area), the Rita GO zone (the Hurricane Rita disaster area), and the Wilma GO Zone (the Hurricane Wilma disaster area).

The special provisions for tax-exempt bond financing in the Gulf Opportunity Zone under *IRC § 1400N(a)* were extended, with certain modifications, to include tax-exempt bond financing of qualified project costs in the Midwestern and Hurricane Ike Disaster Areas under the Heartland Disaster Tax Relief Act of 2008, Subtitle A of Title VII of the

Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (Division C of Public Law 110-343, 122 Stat 3765, enacted on Oct 3, 2008) (the "Act"). The Internal Revenue Service provided guidance on the application of Sections 702 and 704 of the Act, providing for tax-exempt bond financing referred to as "Qualified Midwestern Disaster Area Bonds" and "Qualified Hurricane Ike Disaster Area Bonds," in *Notice 2008-109*, 2008-50 IRB 1282 and *Notice 2010-10*, 2010-3 IRB 299 .

(n321)Footnote 202. *IRC § 1400N(a)(1)*.

(n322)Footnote 203. *IRC § 1400N(a)(2)*. The list of unacceptable uses is found in *IRC § 144(c)(6)(B)*.

(n323)Footnote 204. *IRC § 1400N(a)(4)*. A project is a qualified residential rental project for this purpose if 20% or more of the residential units in the project are occupied by individuals whose income is 60% or less than the area median gross income or if 40% or more of residential units in the project are occupied by individuals whose income is 70% or less than the area median gross income. *IRC §§ 142(d)(1), 1400N(a)(5)(A)*.

(n324)Footnote 205. *IRC § 1400N(a)(3)(B)*.

(n325)Footnote 206. *IRC § 1400N(a)(2)*. See § 17.03[3][c] for a discussion of qualified mortgage bonds.

(n326)Footnote 207. *IRC §§ 1400N(a)(5)(B), 1400T*.

(n327)Footnote 208. *IRC § 1400N(a)(7)(A)*.

(n328)Footnote 209. *IRC § 1400N(a)(7)(B)*.

(n329)Footnote 210. *IRC § 1400N(a)(7)(C)*.

(n330)Footnote 211. *IRC § 1400N(a)(5)(C)-(G)*. The provisions of *IRC § 1400N(a)(5)* will not apply to the portion of an issue which (if issued as a separate issue) would be treated as a qualified bond or as a bond that is not a private activity bond, if the issuer elects to so treat that portion. *IRC § 1400N(a)(6)*.

(n331)Footnote 212. *IRC § 1400N(a)(3)(A)*. *Notice 2006-21*, 2006-1 CB 643 , sets forth the population figures to be used by each state in determining the maximum aggregate face amount of bonds that can be issued.

(n332)Footnote 1. *IRC § 148(a)*. A bond is treated as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue to acquire higher yielding investments or to replace bonds that were used to acquire such investments.

IRC § 148 was enacted to minimize the arbitrage benefits from investing gross proceeds of tax-exempt bonds in higher yielding investments and to remove the arbitrage incentives to issue more bonds, to issue bonds earlier, or to leave bonds outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes for which the bonds were issued. *Treas Reg § 1.148-0(a)*.

Generally, a yield produced by an investment acquired to carry out the governmental purpose of an issue (purpose investment) is materially higher than the yield on the issue if the yield on the purpose investment is more than one eighth of one percentage point higher than the yield on the issue. *Treas Reg § 1.148-2(d)(2)(i)*. The yield produced by purpose investments that are acquired program obligations (obligations that carry out the purpose of a governmental loan program that meets certain requirements) is materially higher than the yield on the issue if the yield on the former is more than one and one-half percentage points higher than the yield on the latter. *Treas Reg § 1.148-2(d)(2)(ii)*. The permitted arbitrage spread on guaranteed student loans that are acquired program obligations is increased to two percentage points. *Treas Reg § 1.148-2(d)(2)(iv)*. No yield limitation applies for investments that are tax-exempt bonds that are not alternative minimum tax bonds treated as investment property under *IRC § 148(b)(3)*. *Treas Reg §*

1.148-2(d)(2)(v).

Under a reverse purchase agreement, a city transferred US Treasury Notes for cash to a securities dealer who retransferred the notes to the city at the end of a specified period of time for the same amount of cash involved in the original transfer and retained the interest that accrued on the notes during the period. The city invested the cash that it received for the notes in a local government investing pool that paid a higher rate of interest than the notes. Held, the city did not comply with the arbitrage yield restrictions, and the interest retained by the dealer was not excludable from gross income. *Rev Rul 79-108, 1979-1 CB 75*.

(n333)Footnote 2. The *IRC § 165(g)* definition of security applies. Thus, (a) stock or the right to subscribe or receive stock, and (b) bonds, debentures, notes, certificates, other evidences of indebtedness issued by corporation, or by a government, with interest coupons or in registered form, are securities for this purpose.

(n334)Footnote 3. *IRC § 148(b)*. The Service plans to issue regulations providing that certain types of investments other than tax-exempt bonds will not be treated as investment property. It is anticipated that the regulations will provide that the term "investment property" does not include (a) any tax-exempt bond, (b) any obligation issued by the United States pursuant to the Demand Deposit State and Local Government program (demand deposit SLGS), and (c) certain temporary investments relating to demand deposit SLGS and tax-exempt bonds. In addition, stock of a regulated investment company will be treated as a tax-exempt bond, if it (a) has one class of stock authorized and outstanding, (b) to the extent practicable, invests all of its assets in tax-exempt bonds, and (c) at least 98 percent (i) of its gross income is derived from interest on or gains from the disposition of tax-exempt bonds, or (ii) of the weighted average value of its assets is represented by investments in tax-exempt bonds. *Notice 87-22, 1987-1 CB 466*. The rules contained in the notice can be relied upon until the regulations are issued.

A prepayment for property can be investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. *Treas Reg § 1.148-1(b)*. See *City of Columbus, Ohio v Commr*, 106 TC 325 (1996), where, in a declaratory judgment action, the Tax Court held that the yield resulting from a prepayment was materially higher than the yield on bonds that the municipality proposed to issue to fund the prepayment. The Sixth Circuit remanded the case for the Tax Court to address the issue of whether the taxpayer's satisfaction of a debt to the State of Ohio could be deemed a prepayment for property. The appellate court's opinion is at 112 F3d 1201 (DC Cir 1997). On remand, the Tax Court held that the bonds were not arbitrage bonds because they were not used to acquire "investment type property." The opinion on remand is reported as *TC Memo 1998-135*.

Rev Proc 95-47, 1995-2 CB 417, sets forth the conditions under which an issuer of state or local bonds may make payments to the US to reduce the yield on investments purchased with the proceeds of advanced refunding bonds on a date when the issuer is unable to purchase SLGS because the Department of the Treasury has suspended sales of SLGS.

(n335)Footnote 4. *Treas Reg § 1.148-1(e)(1)*.

(n336)Footnote 5. A prepayment for property and services, including a prepayment for property and services that is made after the date that the contract to by the property or services is entered into, also gives rise to investment-type property if a principal purpose for repaying is to receive an investment return from the time the payment is made until the time the payment otherwise would be made.

A prepayment does not give rise to investment-type property if (i) prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing (customary payment); (ii) the prepayment is made within 90 days of the reasonably expected date of delivery to the issuer of all of the property for which the payment is made; or (iii) the prepayment is made to acquire a supply of natural gas or electricity. The determination of whether a payment is a customary payment generally is based on all the facts and circumstances. A prepayment will be considered a customary payment if made for certain

maintenance, repair, or extended warranty purposes. *Treas Reg § 1.148-1(e)(2)*.

(n337)Footnote 6. *Treas Reg § 1.148-1(e)(3)*.

(n338)Footnote 7. *IRC § 148(h)*. A safe harbor for establishing the fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow can be found in *Treas Reg § 1.148-5(d)(6)(iii)*. The essence of the safe harbor is a bid solicitation procedure.

(n339)Footnote 8. *IRC § 148(c)(1)*.

(n340)Footnote 9. A nonpurpose investment is defined as investment property that is acquired with the gross proceeds of an issue, and is not acquired in order to carry out the governmental purpose of the issue. *IRC § 148(f)(6)*. The taxpayer in *Harbor Bancorp & Subs v Commr*, 105 TC 260 (1995), urged the Tax Court to construe the term "nonpurpose investment" to exclude any unauthorized investment. The court refused to do so on the ground that the statute does not provide such an exclusion. The Ninth Circuit affirmed the decision of the Tax Court. 115 F3d 722 (9th Cir 1997), *cert denied*, 118 S Ct 1035.

(n341)Footnote 10. *IRC § 148(c)(2)(A)*.

(n342)Footnote 11. *IRC § 148(c)(2)(C)*.

(n343)Footnote 12. *IRC § 148(c)(2)(B)*. For this purpose, a nonpurpose investment is not treated as a loan.

(n344)Footnote 13. *IRC § 148(c)(2)(D)*.

(n345)Footnote 14. *Treas Reg § 1.148-2(e)(2)*. The three-year temporary period is also applicable to the proceeds of qualified mortgage bonds and qualified veterans' mortgage bonds, by substituting qualified mortgage loans for each place that the original regulation refers to capital projects.

The three-year period is extended to five years if the proceeds are expected to be allocated to a capital project involving a substantial amount of construction proceeds, the issuer satisfies the expenditure test by substituting five years in each place that three years appears, and both the issuer and a licensed architect or engineer certify that the longer period is necessary to complete the project.

(n346)Footnote 15. *Treas Reg § 1.148-2(e)(4)(i)*.

(n347)Footnote 16. *Treas Reg § 1.148-2(e)(4)(iii)*.

(n348)Footnote 17. *Treas Reg § 1.148-2(e)(4)(ii)(A)*.

(n349)Footnote 18. *Treas Reg § 1.148-2(e)(4)(ii)(B)*.

(n350)Footnote 19. *Treas Reg § 1.148-2(e)(3)*.

(n351)Footnote 20. *Treas Reg § 1.148-2(e)(5)(i)*. A 30-day temporary period also applies to the gross proceeds of an issue not otherwise eligible for a temporary period. *Treas Reg § 1.148-2(e)(7)*.

(n352)Footnote 21. *Treas Reg § 1.148-2(e)(5)(ii)*.

(n353)Footnote 22. *Treas Reg § 1.148-2(e)(6)*.

(n354)Footnote 23. *IRC § 148(d)(1)*. *Rev Proc 85-38, 1985-2 CB 442*, contains the procedure for requesting advance rulings that the proper method of valuation will be used for acquired obligations in a reasonably required

reserve or replacement fund.

(n355)Footnote 24. *IRC § 148(d)(2)*.

(n356)Footnote 25. *IRC § 148(e)*.

(n357)Footnote 26. *Treas Reg § 1.148-5(b)(1)*. The yield on a variable rate investment is determined in a manner comparable to the determination of the yield on a variable rate issue.

(n358)Footnote 27. *Treas Reg § 1.148-5(b)(2)(i)*.

(n359)Footnote 28. *Treas Reg § 1.148-5(b)(2)(ii)*.

(n360)Footnote 29. *Treas Reg § 1.148-5(b)(3)*.

(n361)Footnote 30. *Id.*

(n362)Footnote 31. *Treas Reg § 1.148-5(d)(1)*.

(n363)Footnote 32. *Treas Reg § 1.148-5(d)(2)*.

(n364)Footnote 33. *Treas Reg § 1.148-5(d)(3)(i)*. Exceptions to this rule are set forth in *Treas Reg §§ 1.148-5(d)(2)*, *1.148-5(d)(3)(ii)*, and *148-5(d)(4)*.

(n365)Footnote 34. *Treas Reg § 1.148-5(e)(1)*.

(n366)Footnote 35. *Treas Reg § 1.148-5(e)(2)(i)*. For administrative costs to be reasonable, they must be comparable to administrative costs that would be charged for the same investment or a reasonably comparable investment if acquired with a source of funds other than tax-exempt bonds.

Qualified administrative costs include all reasonable administrative costs incurred by a publicly offered regulated investment company and a widely-held commingled fund in which no investor in the fund owns more than 10% of the beneficial interest in the fund. *Treas Reg § 1.148-5(e)(2)(ii)*. In addition, any broker commissions paid on behalf of either an issuer or the provider is treated as an administrative cost. *Treas Reg § 1.148-5(e)(2)(iii)*.

(n367)Footnote 36. *Treas Reg § 1.148-5(e)(3)*.

(n368)Footnote 37. *Treas Reg § 1.148-10(a)(1)*.

(n369)Footnote 38. *Treas Reg § 1.148-10(a)(2)*.

(n370)Footnote 39. *IRC § 10(a)(4)*. The Service has provided a safe harbor under which an issue of tax or revenue anticipation bonds will not be treated as outstanding longer than is necessary to accomplish the governmental purpose of the bonds under *Treas Reg § 1.148-10(a)(4)* if the final maturity date of the issue is not later than the end of the applicable temporary period under *Treas Reg § 1.148-2(e)(3)(i)* or *(ii)* for which proceeds of the issue qualify. *Rev Proc 2002-31, 2002-1 CB 916*

(n371)Footnote 40. *IRC § 148(d)(3)(B)*.

(n372)Footnote 41. *IRC § 148(f)(2), (3)*.

Ann 89-66, 1989-23 *IRB* 57, contains a plain-language overview of the arbitrage rebate rules to assist small issuers of state and local bonds.

The rebate requirement does not apply to qualified mortgage bonds and qualified veterans' mortgage bonds.

The amount rebated is not included in gross income; no deduction is allowed for the amount of the rebate. *IRC § 148(f)(5)*.

(n373)Footnote 42. The method of computing rebatable arbitrage can be found in *Treas Reg § 1.148-3(j)*.

(n374)Footnote 43. *IRC § 148(f)(4)(A), (B)*. When no bond of an issue is a private activity bond, the amount earned on a bona fide debt service fund is not subject to any dollar limitation if the average maturity of the issue (determined in accordance with *IRC § 147(b)(2)(A)*) is at least five years and the rates of interest on bonds that are part of the issue do not vary during the term of the issue.

Rev Proc 90-11, 1990-1 CB 469, contains guidance for issuers concerning the filing of (1) a request for an extension of time to pay a correction amount of arbitrage rebate; (2) an explanation of an innocent failure to meet a requirement for payment of an arbitrage rebate; or (3) a request for a ruling regarding any other failure to meet a requirement for an arbitrage repayment.

The portion of an issue used to reimburse an issuer for expenditures made prior to the issue (a reimbursement bond) is not subject to the arbitrage rebate provisions. The rule is applicable generally to bonds that are not private activity bonds, with the exception of qualified 501(c)(3) bonds and private activity bonds the proceeds of which are used to finance a facility that is owned by a governmental unit.

(n375)Footnote 44. *IRC § 148(f)(4)(B)(ii)*. For bonds issued on or before Aug 5, 1997, the additional six-month period was available if all but the lesser of 5 percent of the proceeds of the issue, or \$100,000 was spent for governmental purposes within the initial six-month period. The regulations also provide that an issue is deemed to meet the rebate requirements if gross proceeds of the issue are allocated to expenditures for a governmental purpose of the issue in accordance with the following 18-month schedule: (i) at least 15 percent within six months; (ii) at least 60 percent within 12 months; and (iii) 100 percent within 18 months. *Treas Reg § 1.148-7(d)*.

(n376)Footnote 45. *IRC § 148(f)(4)(C)(ii)*. The 100 percent test is deemed to be met if all of the net proceeds are spent within three years from the date of issuance and the failure to do so within two years is due to a reasonable retainage (not to exceed 5 percent of the net proceeds of the issue).

The rebate requirements will be treated as met even though the issuer fails to meet the percentage-time expenditure tests if the issuer elects to pay the penalty prescribed by *IRC § 148(f)(4)(C)(vii)* or pays a penalty at the end of each six-month period equal to 1.5 percent of the amount of net proceeds not spent as required. The issuer can also elect to terminate the penalty if certain conditions are met. *IRC § 148(f)(4)(C)(viii), (ix)*. The procedures for making all elections and paying the penalties can be found in *Rev Proc 92-22, 1992-1 CB 736*.

If the spending requirements of *IRC § 148(f)(4)(C)(ii)* are met with respect to the available construction proceeds of a construction issue, the rebate requirement does not apply to earnings on a bona fide debt service fund of the issue. *IRC § 148(f)(4)(C)(xvii)*.

The Code does not provide any exception to the payment of all or a portion of the penalty in lieu of rebate if construction delays are caused by subsequent events outside the control of the issuer, nor does it allow the Service to waive any portion of the penalty in such cases. *Ltr Rul 9526002*.

Rev Proc 92-83, 1992-2 CB 487, contains guidance for issuers of tax-exempt bonds seeking to obtain refunds of arbitrage rebates.

(n377)Footnote 46. *IRC § 148(f)(4)(D)*.

(n378)Footnote 47. *IRC § 148(f)(4)(D)(vii)*. For bonds issued after Dec 31, 1997, and before Jan 1, 2002, the amount of increase was \$5 million.

(n379)Footnote 48. *IRC § 148(f)(4)(D)*.

(n380)Footnote 49. *Treas Reg § 1.148-7(d)(1)*. The 18-month exception does not apply to an issue any portion of which is treated as meeting the two-year exception discussed above. *Treas Reg § 1.148-7(d)(4)*.

(n381)Footnote 50. An issue does not fail to satisfy the spending requirement for the third spending period as a result of a reasonable retainage if the reasonable retainage is allocated to expenditures within 30 months of the issue date. *Treas Reg § 1.148-7(d)(2)*.

(n382)Footnote 51. *IRC § 148(f)(4)(B)(iii)(I)*.

(n383)Footnote 52. *IRC § 148(f)(4)(B)(iii)(II)*.

(n384)Footnote 53. *IRC § 148(f)(7)*.

(n385)Footnote 1. *IRC § 150(d)(2)*.

(n386)Footnote 2. *IRC § 150(d)(3)(A), (B)*.

(n387)Footnote 3. *IRC § 150(d)(3)(C)*.

(n388)Footnote 4. *IRC § 150(d)(3)(D)*.

(n389)Footnote 5. *IRC § 150(d)(3)(E)*. The term "officer" includes any individual having powers and responsibilities similar to those of officers.

(n390)Footnote 6. *IRC § 150(d)(3)(G)*.

(n391)Footnote 1. *IRC § 149(d)(1), (2)*; *Treas Reg § 149(d)-1(g)*.

(n392)Footnote 2. *IRC § 149(d)(5)*. A refunding that occurred before 1986 will be considered an advance refunding only if the refunding bond was issued 180 days before the redemption of the refunded bond. *IRC § 149(d)(6)(A)*.

Bonds are advance refunding bonds if the issuer loans proceeds of the bonds to a governmental unit, and within 90 days of the date the loan is made, but more than 90 days after the issue date of the bonds, the governmental unit uses the proceeds to redeem outstanding tax-exempt obligations of the governmental unit. *Rev Rul 2003-78, 2003-29 IRB 76*. The theory underlying the ruling is that the governmental unit is considered to be an obligor of the bonds.

(n393)Footnote 3. *IRC § 149(d)(3)(A)*. A bond issued before 1986 will be treated as advance refunded no more than once before March 15, 1986. *IRC § 149(d)(6)(B)*.

(n394)Footnote 4. *IRC § 149(d)(3)(B)*.

(n395)Footnote 5. *IRC § 149(d)(4)*.

(n396)Footnote 6. *IRC § 1400N(b)* will not apply to any advance refunding of a bond that is part of an issue the proceeds of which were used (or will be used) to provide any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business

of which is the sale of alcoholic beverages for off-premises consumption. *IRC § 1400N(b)(6)*.

(n397)Footnote 7. *IRC § 1400N(b)(4)*.

(n398)Footnote 1. *IRC § 150(e)(2)*. Other fire fighting services provided in an area are disregarded in determining whether an organization is a qualified volunteer fire department if the other fire fighting services are provided by a qualified volunteer fire department and both have been continuously providing fire fighting services to the area since Jan 1, 1981.

(n399)Footnote 2. *IRC § 150(e)(3)*.

(n400)Footnote 1. *IRC § 149(f)(1), (4)*. The provision applies generally to bonds issued after Oct 21, 1988. In the case of a bond issued to refund a bond issued before Oct 22, 1988: (1) if the three-year loan origination period would otherwise expire before Oct 22, 1989, the period expires on Oct 21, 1990; (2) if the period expires after Oct 22, 1989, the portion of the proceeds of the issue of which the refunded bond is a part that is available on the date of issuance of the refunding bond to provide loans is treated as the proceeds of a separate issue issued after Oct 21, 1989, for purposes of applying *IRC § 149(f)*.

(n401)Footnote 2. *IRC § 149(f)(7)*.

(n402)Footnote 3. *IRC § 149(f)(2)*.

(n403)Footnote 4. *IRC § 149(f)(4)*.

(n404)Footnote 5. *IRC § 149(f)(5)*.

(n405)Footnote 1. *IRC § 149(g)(1), (2)*. The rule is effective for bonds issued after Sept 14, 1989. However, bonds issued before Oct 15, 1989 are not covered by the provisions if the bonds were sold before Sept 15, 1989.

Expectations as to changes in interest rates or in the income tax laws cannot be taken into account in determining whether expectations regarding hedge bonds are reasonable. *IRC § 149(g)(4)(B)*.

(n406)Footnote 2. *IRC § 149(g)(4)(A)*.

(n407)Footnote 3. *IRC § 149(g)(3)(A)*. A nonpurpose investment is one that is acquired with the proceeds of an issue, but is not acquired in order to carry out the governmental purposes of the issue.

(n408)Footnote 4. *IRC § 149(g)(3)(B)*. Amounts in a bona fide debt service fund and investment earnings held for not more than 30 days pending reinvestment or bond redemption are treated as invested in tax-exempt bonds that are not private activity bonds.

Qualified § 501(c)(3) bonds are not private activity bonds for this purpose.

(n409)Footnote 5. *IRC § 149(g)(3)(C)*.

(n410)Footnote 1. *IRC § 149(e)(1), (2); Treas Reg § 1.149(e)-1*. An extension of time to file the statement can be granted if the failure to file the statement in timely fashion is not due to willful neglect. *IRC § 149(e)(3)*.

Issuers of small issue bonds--those with issue prices of less than \$100,000--have the choice of filing a separate return for any small issue. *Treas Reg § 1.149(e)-1(c)(2)*.

Rev Proc 2002-48, 2002-2 CB 531, provides guidance to issuers of state and local bonds for requesting an extension of time to file, or for amending, the information required by *IRC § 149(e)*.

(n411)Footnote 1. An essential governmental function does not include any function that is not customarily performed by state and local governments with general taxing powers. *IRC § 7871(e)*.

(n412)Footnote 2. *IRC § 7871(c)(2)*.

(n413)Footnote 1. *IRC § 171(a)(2)*. This is due to the fact that the premium reflects the receipt of tax-exempt interest by the investor.

If the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the excess is a nondeductible loss. In the case of a regulated investment company, the excess bond premium reduces its tax-exempt interest income on other tax-exempt obligations held during the accrual period. *Treas Reg § 1.171-2(a)(4)(ii)*.

(n414)Footnote 2. *IRC § 1016(a)(5)*. See *Treas Reg §§ 1.171-2(c)*, Ex 4; 1.1016-5(b)(3).

(n415)Footnote 3. See Ch 18.

(n416)Footnote 1. The specific types of qualifying bonds are designated in *IRC § 54A(d)*. These are currently: (A) qualified forestry conservation bonds; (B) new clean renewable energy bonds; (C) qualified energy conservation bonds; (D) qualified zone academy bonds; and (E) qualified school construction bonds. The particular characteristics of each type of qualifying tax credit bond are discussed in §§ 17.03[14][b]thru [f]; this subsection discusses the rules common to all types.

(n417)Footnote 2. *IRC § 54A(f)*.

(n418)Footnote 3. *IRC § 54A(b)(1)*. In statutory terms, a credit equal to "25 percent of the annual credit determined with respect to the [qualified tax credit] bond" is determined on each "credit allowance date;" i.e., each of the dates referred to above. *IRC § 54A(e)(1)*.

(n419)Footnote 4. *IRC § 54A(a)*. Provision is made for pro rata adjustments to the quarterly credit for quarters in which the bond is issued, redeemed or matures. *IRC § 54A(b)(4)*. There are also special rules for holders that are pass-thru or special entities. Thus, if a qualified tax credit bond is owned by a partnership or S corporation, the allocation of the credit to partners or shareholders is treated as a distribution *IRC § 54A(g)*. If the owner of the bond is a real estate investment trust (REIT), the credit is required to be distributed (and will be allowed) to beneficiaries of the trust under rules to be prescribed by the Treasury. *IRC § 54A(h)*. If the owner of the bond is a regulated investment company (RIC), the RIC may elect to pass through to each shareholder that shareholder's proportionate share of the *IRC § 54A* credits to which the RIC is entitled, along with gross income attributable to such credits. *IRC § 853A*.

(n420)Footnote 5. That is, it may not exceed in any year the sum of the holder's liability for regular income tax and alternative minimum tax for that year, less the sum of nonrefundable credits allowable for the year (other than tax credits on other qualified tax credit bonds or on "Build America" bonds under *IRC § 54AA*, discussed *infra*). *IRC § 54A(c)(1)*.

(n421)Footnote 6. *IRC § 54A(c)(2)*.

(n422)Footnote 7. *IRC § 54A(j)*.

(n423)Footnote 8. 2010-15 IRB 541 .

(n424)Footnote 9. See § 17.04[5], *infra*, for a discussion of the rules announced in Notice 2010-28 that are applicable to transactions in which tax credits are stripped from qualified tax credit bonds.

(n425)Footnote 10. Notice 2010-28 , § 3.02(a)(2). See Ch 2, § 2.07[1][b] and [c] and § 17.03[1] and [2] of this

Chapter for the definition and significance of qualified stated interest in the context of the OID provisions.

(n426)Footnote 11. *Notice 2010-28*, § 3.02(a)(3).

(n427)Footnote 12. *IRC § 54A(b)(2)*. The rate must be determined as of the first day on which there is a binding, written contract for the sale or exchange of the bond. *IRC § 54A(b)(3)*.

(n428)Footnote 13. *IRC § 54A(b)(3)*. The Internal Revenue Service has announced that these rates (referred to in the statute as "applicable credit rates") will be calculated based on estimates of the yields on outstanding bonds from market sectors selected by the Treasury Department in its discretion that have an investment grade rating between A and BBB for bonds of a similar maturity for the business day immediately preceding the sale date of the qualified tax credit bond. *Notice 2009-15*, 2009-6 *IRB* 449. In the case of new clean renewable energy bonds (*IRC § 54C*) and qualified energy conservation bonds, (*IRC § 54D*), the applicable credit rate will be reduced to 70% of the rate so estimated. See *IRC §§ 54C(b)* and *54D(b)*; *IRS 2009 IRB LEXIS 168*, *Notice 2009-33*; *IRS Notice 2009-29*, 2009-16 *IRB* 849.

(n429)Footnote 14. *IRC § 54A(d)*.

(n430)Footnote 15. "Available project proceeds" are defined as the excess of the proceeds from the sale of the bond issue over the issuance costs financed by the issue (not to exceed 2 percent of the sales proceeds), plus the proceeds from any temporary investments of such available project proceeds. *IRC § 54A(e)(4)*.

(n431)Footnote 16. As defined in the Code section governing the particular type of tax credit bond being issued. See *IRC § 54A(d)(2)(C)*. If the issuer receives reimbursement for an expenditure (the "original expenditure") out of the proceeds, the reimbursement will be treated as made for a "qualified purpose" if (i) the original expenditure was made for a qualified purpose, (ii) the original expenditure was made after the issuer received an allocation of bond limitation from the Treasury, (iii) before making the original expenditure, the issuer declared its intent to obtain reimbursement out of the proceeds of a qualified tax credit bond issue, (iv) within 60 days after the original expenditure, the issuer adopts an official intent to reimburse the expenditure out of the bond proceeds, and (v) the reimbursement is accomplished within 18 months from the date the original expenditure was made. *IRC § 54A(d)(2)(D)*.

(n432)Footnote 17. *IRC § 54A(d)(2)(A)*.

(n433)Footnote 18. The "expenditure period" begins on the date the bond is issued, but includes any additional time beyond three years allowed by the IRS in an authorized extension of the expenditure period. *IRC § 54A(d)(2)(B)(ii)*. To obtain an extension, the issuer must establish that its failure to spend all of the proceeds within three years was due to reasonable cause and that expenditures for qualified purposes will continue to proceed with due diligence. *IRC § 54A(d)(2)(B)(iii)*.

(n434)Footnote 19. *IRC § 54A(d)(2)(B)(i)* and see also *Treas Reg § 1.142-2(e)*.

(n435)Footnote 20. *IRC § 54A(d)(3)* and see *IRC § 149(e)(2)* and *Treas Reg § 1.149(e)-1*. The information reporting requirements of *IRC § 149(e)* are discussed in § 17.03[10].

(n436)Footnote 21. See § 17.03[4].

(n437)Footnote 22. *IRC § 54A(d)(4)*. In the case of an otherwise qualified forest conservation bond, the requirement that the sinking fund not be funded more rapidly than equal annual installments is disregarded. *IRC § 54B(g)*.

(n438)Footnote 23. *IRC § 54A(d)(5)(A)*.

(n439)Footnote 24. *IRC § 54A(d)(5)(B)*. For purposes of calculating present value, the discount rate prescribed in the statute is the average annual interest rate of tax-exempt obligations having a term of 10 years or more which are

issued during the month. However, interim guidance issued by the IRS indicates that it intends to use a rate equal to 110 percent of the long-term adjusted federal rate ("AFR"), compounded semiannually, for the month in which the bond is sold. See IRS Notice 2009-29, 2009-16 IRB 849, 850, § 3.03; IRS Notice 2009-30, 2009 IRB 852, 854, § 3.03; IRS 2009 IRB LEXIS 168, Notice 2009-33, § 9(c) and (d); IRS 2009 IRB LEXIS 162, Notice 2009-35, § 3.03. The IRS similarly used the long-term AFR rate in determining the maximum term of Qualified Zone Academy Bonds when such bonds were authorized under IRC § 1397E, see *Treas Reg § 1.1397E-1(d)*, even though IRC § 1397E(d)(3), like IRC § 54A(d)(5), called for the discount rate to be based on the average interest rate on tax-exempt obligations. Apparently the IRS considers the AFR to be a fair approximation of the statutory rate and one that is considerably more accessible.

(n440)Footnote 25. IRC § 54A(d)(6).

(n441)Footnote 26. A qualified issuer means a State or any political subdivision or instrumentality thereof or a section 501(c)(3) organization (as defined in IRC § 150(a)(4)). IRC § 54B(f).

(n442)Footnote 27. IRC § 54B(a). Under IRC § 54B(b), the maximum aggregate face amount of bonds which may be designated by any issuer may not exceed the limitation amount allocated to the issuer by the Treasury Department under IRC § 54B(d). The allocation methodology is discussed below.

(n443)Footnote 28. See IRC § 54B(e).

(n444)Footnote 29. For purposes of this requirement, a parcel of land is adjacent to USFS land if (a) it touches any unit of the National Forest System, as defined in 16 USC § 1609(a); (b) shares a common boundary with any unit of the National Forest System, or (c) is located within the boundaries of a unit of the National Forest System. If at least one portion of the land acquired is adjacent to USFS Land in one of these senses, it is irrelevant that other non-contiguous acquired parcels are not adjacent to it. IRS Notice 2008-70, 2008-36 IRB 575, 576.

(n445)Footnote 30. As to the first part of this requirement, "no net cost to the United States" means that the transferor must cover all costs directly incident to the transfer of the land to the USFS (for example, any survey costs, title insurance, transfer taxes, recordation fees, etc.) but not indirect costs such as USFS salary and overhead and expenses for travel, legal review and clearance. IRS Notice 2008-70 at 576. The second part means that whatever portion of the land is not transferred to the USFS must be either retained by the State that acquired the land, conveyed by that State to one or more other States, or, if the land was not acquired by a State, conveyed to one or more States. *Id.* Not later than six months after the acquisition of the land, the portion(s) required to be transferred to the USFS or to a State must either have been transferred to the ultimate recipient, or be the subject of an appropriately recorded contract to transfer the land which meets certain minimum requirements and is effective to vest in the ultimate recipient equitable title under State or Federal law. IRS Notice 2008-70 at 579.

(n446)Footnote 31. See IRC § 54A(a)(1); Notice 2008-70 at 578.

(n447)Footnote 32. IRC § 54B(c).

(n448)Footnote 33. IRC § 54B, along with IRC § 54A, was enacted by section 15316 of the Food, Conservation and Energy Act of 2008, Pub L No 110-246, 122 Stat 1651 (June 18, 2008).

(n449)Footnote 34. 2008-2 CB 575. As required by IRC § 54B(d)(2), the solicitation was made within 90 days of the date of enactment.

(n450)Footnote 35. Notice 2008-70, *supra*, 2008-2 CB at 581.

(n451)Footnote 36. IRC § 54B(h).

(n452)Footnote 37. The IRS is not allowed to use the deemed payment as an offset or credit against any tax

liability of the issuer but may only refund the deemed payment to the issuer, *IRC § 54B(h)(2)(A)*, without interest. *IRC § 54B(h)(2)(B)*.

(n453)Footnote 38. *IRC § 54B(h)(3)(A)*.

(n454)Footnote 39. *IRC § 54B(h)(3)(B)*.

(n455)Footnote 40. *IRC § 54*, enacted by Section 1303 of the Energy Tax Incentives Act of 2005, Pub L No 109-58, *119 Stat 594 (2005)* (2005 Act), initially provided for a national volume cap on CREBs of \$800 million, with a deadline of December 31, 2007 for issuing the CREBs. Section 202 of the Tax Relief and Health Care Act of 2006, Pub L No 109-432, *120 Stat. 2922 (2006)* (2006 Act) increased the cap to \$1.2 billion, and extended the deadline to December 31, 2008. Section 107 of the Energy Improvement and Extension Act of 2008, Division B of Pub L No 110-343, *122 Stat 3765 (2008)* (the "2008 Energy Act"), which added *IRC § 54C* and New CREBs to the Code, also provided a final extension of the deadline for issuing original CREBs to December 31, 2009, see *IRC § 54(m)*, while leaving the national volume cap at \$1.2 billion.

(n456)Footnote 41. The "applicable credit rate," it will be recalled, is the rate that allows issuance of the bonds without discount and without interest cost to the qualified issuer. *IRC § 54A(b)(3)*. Qualified energy conservation bonds are also limited to a reduced tax credit equal to 70 percent of the applicable credit rate. See *IRC § 54D(b)*.

Other differences between New CREBs and original CREBs arise from the fact that New CREBs are now governed, in part, by *IRC § 54A*. For example, the *IRC § 54A* rules make it possible for issuers of New CREBs to make unrestricted investments of available project proceeds during the three year expenditure period, and to invest in sinking funds within prescribed limitations, and holders of New CREBs are permitted to strip the right to credits from ownership of the bond and sell them separately. See IRS Notice 2009-33, § 2.01; § 17.03[14][a].

(n457)Footnote 42. Public power providers, defined as "a State utility with a service obligation, as such terms are defined in section 217 of the Federal Power Act," were not eligible to receive such funds from CREBs.

(n458)Footnote 43. *IRC § 54C(a)(1)*.

(n459)Footnote 44. *IRC § 54C(d)(1)*.

(n460)Footnote 45. In addition to public power providers, cooperative electric companies, and governmental bodies, qualified issuers include a "clean renewable energy bond lender" (an entity in existence on February 1, 2002 that is owned by, or has outstanding loans to, 100 or more cooperative electric companies, or any affiliated entity which is controlled by such lender) and a not-for-profit electric utility which has received a loan or loan guarantee under the Rural Electrification Act.

(n461)Footnote 46. *IRC § 54C(a)*.

(n462)Footnote 47. This is the "national limitation" on New CREBs. Initially set at \$800 million in *IRC §§ 54C(c)(2)* by the 2008 Energy Act, an additional authorization of \$1.6 billion was made by section 1111 of Title 1 of Division B of the American Recovery and Reinvestment Act of 2009, Pub L No 111-5, *123 Stat 115 (2009)* ("ARRA of 2009"), adding *IRC § 54C(c)(4)* to the Code.

(n463)Footnote 48. *IRC § 54C(c)(2)(A),(B), and (C)*.

(n464)Footnote 49. Subject to one further requirement: once the Treasury (IRS) identifies qualified projects eligible for funding through allocations to public power providers, it is to make the actual allocations, to the maximum extent practicable, in the ratio that the volume cap for public power providers bears to the total cost of public power provider projects approved by the Treasury. In other words, if \$800 million in New CREB allocations is available to

public power providers, but the Treasury finds that projects costing \$1 billion are appropriate for New CREB funding, instead of taking an all-or-nothing approach the Treasury is to make allocations to each project covering 80 percent of each project's cost.

(n465)Footnote 50. Including Indian tribal governments. See *IRC § 54D(h)*.

(n466)Footnote 51. For the definition of "private activity bond," see *IRC § 141* and § 17.03[3][a]. The interest on such bonds, even if issued by a State or local government, are generally not exempt from tax under *IRC § 103*. See *IRC § 103(b)(1)*. As noted above, however, the credit on tax credit bonds is not exempt from tax but is fully includible in gross income. *IRC § 54A(f)*.

(n467)Footnote 52. *IRC § 54D(e)(3)*. In applying this rule, a bond issued for the purpose of providing loans, grants, or other repayment mechanisms for capital expenditures to implement green community programs is not to be treated as a private activity bond. *IRC § 54D(e)(4)*.

(n468)Footnote 53. *IRC § 54D(f)(2)*.

(n469)Footnote 54. *IRC § 54D(a)*.

(n470)Footnote 55. *IRC § 54D(d)*.

(n471)Footnote 56. *IRC § 54D(e)(1)*.

(n472)Footnote 57. *IRC § 54D(e)(2)*. The large local government's share of the State allocation is determined by the ratio of its population to the population of the entire State. *IRC § 54D(e)(2)(A)*. A county that has within it a municipality that is a large local government, and is therefore entitled to a portion of the State allocation, must deduct the population of that municipality from its own county population in determining whether it is also entitled to a share of the State allocation. *IRC § 54D(g)(2)*.

(n473)Footnote 58. Defined as a "local education agency" within the meaning of section 9101 of the Elementary and Secondary Education Act of 1965. *IRC § 54E(d)(2)*.

(n474)Footnote 59. *IRC § 54E(d)(1)*.

(n475)Footnote 60. Pub L No 105-34, 111 Stat 788 (1997).

(n476)Footnote 61. See IRS Notice 2009-30, 2009-16 IRB 852, 853 .

(n477)Footnote 62. See Notice 2009-30 , § 2.01. As was the case with New CREBs versus CREBs, the differences between 1397E QZABs and 54E QZABs result mostly from the application to 54E QZABs of the uniform tax credit rules in *IRC § 54A*. For example, instead of requiring that 95 percent of the proceeds of a QZAB issue be spent within a 5-year period, § 54E QZABs are required to spend 100 percent of "available project proceeds" within a 3-year period. See *IRC § 54A(d)(1)* and compare *IRC § 1397E(f)(1)(A)*. Also, exceptions to the arbitrage rules for investments made during the expenditure period and sinking funds under *IRC § 54A* were not available under *IRC § 1397E*. Moreover, the credit on § 54E bonds is determined quarterly rather than annually as in § 1397E QZABs, and there is no provision for credit stripping in *IRC § 1397E* as there is in *IRC § 54A(i)*. The national limitation amount for QZABs under § 54A is also significantly greater for 2009 and 2010 than it was under § 1397E (\$1.4 billion vs. \$400 million).

(n478)Footnote 63. *IRC § 54E(c)(4)(C)*.

(n479)Footnote 64. Qualified purposes are (A) rehabilitating or repairing the public school facility in which the academy is established, (B) providing equipment for use at such academy, (C) developing course materials for education to be provided at such academy, and (D) training teachers and other school personnel in such academy. *IRC §*

54E(d)(3).

(n480)Footnote 65. *IRC § 54E(a)*.

(n481)Footnote 66. *IRC § 54E(b)* Private entities include any person other than the United States, a state or local government, or an agency or instrumentality thereof or related party with respect thereto. *Treas Reg § 1.1397E-1(c)(2)*. The term "proceeds" means sale proceeds as defined in *Treas Reg § 1.48-1(b)*. *Temp Treas Reg § 1.1397E-1T(a)(2)(ii)(B)*. In determining the "present value" of qualified contributions, a reasonable discount rate must be used. The applicable credit rate on the QZAB should be considered reasonable for this purpose. See *Treas Reg § 1.1397E-1(c)(1)*.

(n482)Footnote 67. *IRC § 54E(d)(4)*. Cash received from a private entity (other than cash received indirectly from a person that is not a private entity as part of a plan to avoid the private business contribution requirement) constitutes a qualified contribution. Services of the employees of the eligible local education agency do not. *Treas Reg § 1.1397E-1(c)(3)*.

(n483)Footnote 68. *IRC § 54E(c)(1)*; *IRS Notice 2009-30*.

(n484)Footnote 69. *IRC § 54E(c)(2)*. The state by state allocations for 2010 were announced in *Notice 2010-22, 2010-10 IRB 435*.

(n485)Footnote 70. *IRC § 54E(c)(4)(A)* and *(B)*. In applying the carryover rule, unused allocations are to be treated as used on a first-in, first-out basis. *IRC § 54E(c)(4)(B)*.

(n486)Footnote 71. *IRC § 54(F)(c)*. The QSCB is also the latest qualified tax credit bond to be created by Congress, authorized by the addition of 54F to the Code by section 1521 (a) of ARRA of 2009.

(n487)Footnote 72. Part of the proceeds of such an issue may also be used to acquire land on which such a facility is to be constructed. *IRC § 54F(a)(1)*.

(n488)Footnote 73. Large local educational agencies qualifying for allocations are to be determined by the Treasury in two steps. Qualifying first are the 100 local educational agencies with the largest numbers of children aged 5 through 17 who are from families living below the poverty level. *IRC § 54(F)(d)(E)(i)*. Next, the Treasury is to add not more than 25 local educational agencies chosen by the Secretary of Education (not including any of the 100 selected in the first step) as being in particular need of assistance based on a low level of resources for school construction, a high level of enrollment growth, or such other factors as the Treasury deems appropriate. *IRC § 54(F)(d)(E)(ii)*; *Notice 2009-35*, § 2.02.

(n489)Footnote 74. *IRC § 54(F)(d)(2)(C)* and *(D)*.

(n490)Footnote 75. *IRC § 54(F)(d)(1)*. The statute also provides special rules for making allocations to possessions of the United States (other than Puerto Rico) and for Indian schools. *IRC §§ 54(F)(d)(3)* and *(4)*.

(n491)Footnote 76. *IRC § 54(F)(e)*. A carryover is also made available to Indian tribal governments with respect to excess allocations of QSCBs for Indian schools. No carryover is allowed for excess allocations to a large local educational agency, unless such excess was reallocated back to the State.

(n492)Footnote 77. *Id.*

(n493)Footnote 78. Only qualified forestry conservation bonds (QFCBs) authorized by *IRC § 54B* are not eligible for the direct interest reimbursement option. However, an issuer that receives an allocation to issue QFCBs may elect instead to receive 50 percent of the allocation in the form of a direct cash payment from the federal government for use in purchasing forest land. See § 17.02[12][b], *supra*.

(n494)Footnote 79. See §§ 17.02[13] and [14], *infra*, for a discussion of Build America and recovery zone bonds.

(n495)Footnote 80. See § 301 of the Hiring Incentives to Restore Employment Act, Pub L No 111-147, 124 Stat 71 (2010) (the HIRE Act"), adding IRC § 6431(f) to the Code.

(n496)Footnote 81. Notice 2010-35, 2010-19 IRB 660 , provides guidance on the refundable tax credit payment procedures for this option, required elections, information reporting, and other interim guidance. The irrevocable election to receive reimbursement of interest must be made on the books and records of the issuer on or before the issue date of the bonds. Notice 2010-35, § 4. A new IRS Form 8038-TC must be filed at least 30 days before filing requests for reimbursement of interest costs on Form 8038-CP. Notice 2010-35, § 5.

(n497)Footnote 82. IRC § 6431(f)(1)(C).

(n498)Footnote 83. As provided by IRC § 54A(b)(3), this is the rate which the Secretary estimates would permit issuance of bonds with the same maturity or redemption date without discount and without interest cost to the bond issuer, assuming federal tax credits at such rate were allowed to holders of the bonds. See § 17.02[12][a], fn 9, for a description of the manner in which the IRS has announced applicable credit rates will be calculated.

(n499)Footnote 84. IRC § 6431(f)(2). The lower reimbursement rate is consistent with the lower federal tax credits allowed to holders of CREBs and QECBs when the direct reimbursement option is not exercised by the issuer.

(n500)Footnote 85. The effective date of new IRC § 6431(f) is the date of enactment of the HIRE Act. See § 301(c)(1) of Pub L No 111-147.

(n501)Footnote 86. IRC § 6431(a), IRC § 6431(f)(1)(B).

(n502)Footnote 1. IRC § 54AA(a) and (b). If the credit is issued to the issuer rather than the holder, the bond must also be a "qualified bond;" i.e., a Build America Bond in which the available project proceeds, less amounts in a reasonably required reserve, are used exclusively for capital expenditures. See IRC § 54AA(g), discussed further below. Whether a qualified bond or not, current statutory provisions require that all Build America Bonds be issued before January 1, 2011. IRC §§ 54AA(d)(1)(B) and 54AA(g).

(n503)Footnote 2. IRC § 54AA(d)(1).

(n504)Footnote 3. IRC § 54AA(d)(2)(C). Whether the amount of premium is "de minimis" is to be determined under rules similar to IRC § 1273(a)(3). That subsection provides that original issue discount on a bond will be disregarded if the difference between the stated redemption price at maturity over the issue price is less than 1/4 of 1 percent of the stated redemption price at maturity multiplied by the number of complete years to maturity.

(n505)Footnote 4. IRC § 54AA(d)(2)(A).

(n506)Footnote 5. This rule applies whether the credit is given to the holder of the bond, see IRC § 54AA(d)(2)(B), or the issuer, see IRC § 6431(c).

(n507)Footnote 6. Compare IRC § 54A(b)(3) with IRC § 54AA(b).

(n508)Footnote 7. See HR Conf Rep 111-16, 111th Cong, 1st Sess (February 12, 2009) at 594 and at 593, n 146 (original issue discount is not treated as a payment of interest for purposes of determining the credit); cited in IRS Notice 2009-26, 2009-16 IRB 833, 834 , § 2.2). The Conference Committee anticipates that "Because the credit that the taxpayer claims is also included in income ... State and local issuers will issue bonds paying interest at rates approximately equal to 74.1 percent of comparable taxable bonds ... For example, if a taxable bond of comparable risk pays a \$1,000 coupon and sells at par, then if a State or local issuer issues an equal-sized bond with coupon of \$741, such a bond should also sell at par. The taxpayer who acquires the latter bond will receive an interest payment of \$741

and may claim a credit of \$259 (35 percent of \$741). The credit and the interest payment are both included in the taxpayer's income. Thus, the taxpayer's taxable income from this instrument would be \$1,000. This is the same taxable income that the taxpayer would recognize from holding the comparable taxable bond. Consequently the issuer's bond should sell at the same price as would the taxable bond." HR Conf Rep 111-16 at 594.

(n509)Footnote 8. See *IRC Section 54A(e)(1)*.

(n510)Footnote 9. See *IRC § 54AA(e)*.

(n511)Footnote 10. See *IRC §§ 54A(a)* and *54AA(a)*.

(n512)Footnote 11. *IRC § 54A(c)(1)* and *IRC § 54AA(c)(1)*.

(n513)Footnote 12. *IRC § 54A(c)(2)* and *IRC § 54AA(c)(2)*.

(n514)Footnote 13. See and *IRC § 54AA(f)* and *IRC §§ 54A(f),(g),(h)*, and *(i)*. See also *IRC § 853A* (providing for an election by which RICs may pass through credits on both § 54A and § 54AA bonds to their shareholders).

(n515)Footnote 14. See IRS Notice 2009-26 at 835 , § 2.3. As noted above, the Conference Committee expects that an issuer will be able to set interest rates on tax credit Build America Bonds at a level that is 74.1 percent of the rate it would have to pay if the bonds were fully taxable, giving the issuer an effective subsidy of 25.9 percent of its interest cost. The fact that the subsidy to the issuer is less than the 35 percent credit is due to the fact that the holder must include the full amount of interest (including the credit) on the bond in his gross income. By electing to take the credit itself, however, the issuer can increase the subsidy to the full 35 percent, reducing the issuer's net interest cost in the hypothetical case given in n. 7 (a Build America Bond with the same risk as a taxable bond yielding \$1,000 annually) from \$741 to \$650. HR Conf Rep 111-16 at 594-595.

(n516)Footnote 15. The Conference Report indicates that the refund may be paid by the Treasury either in advance or as reimbursement. HR Conf Rep 111-16 at 595. The IRS has announced that, in 2009, it will issue refunds up to 45 days in advance on fixed rate bonds, and will pay refunds on a reimbursement basis for variable rate bonds. *IRS Notice 2009-26 at 836* , § 3.1. Issuers are required to file Form 8038-CP by the 45th day before the applicable interest payment date, in the case of fixed rate bonds, or by the 45th day after the applicable interest payment date in the case of variable rate bonds. *Id.*

(n517)Footnote 16. *IRC § 54AA(g)(2)(A)*. The House Conference Committee report looks to *Treas Reg § 1.150-1(b)* for a definition of "capital expenditures" (generally, an amount properly chargeable to capital account "under general Federal income tax principles"), and provides that for purposes of determining whether proceeds are used for capital expenditures an issuer should be treated as though it were a corporation subject to taxation under Subchapter C. H R Conf Rep. 111-16 at 594, n 147. An eligible financing of capital expenditures includes a reimbursement of capital expenditures under the reimbursement rules contained in *Treas Reg § 1.150-2*. However, qualified bonds may not be issued to refinance capital expenditures in "refunding issues (as defined in *Treas Reg § 1.150-1*)." For this purpose, an issue of qualified bonds used to reimburse otherwise-eligible capital expenditures that were paid or incurred after the effective date of ARRA of 2009, and that were financed originally with temporary short-term financing issued after such effective date, will not be treated as a "refunding issue." *IRS Notice 2009-26 at 835* , § 2.3.

(n518)Footnote 17. *IRS Notice 2009-26 at 835* , § 2.3). *IRC § 148(d)(2)* provides, for purposes of applying the arbitrage rules and specifically the rule under *IRC § 148(d)(1)* allowing higher yielding investments in a reasonably required reserve or replacement fund, that "a bond issued as part of an issue shall be treated as an arbitrage bond if the amount of the proceeds from the sale of such issue which is part of any reserve or replacement fund exceeds 10 percent of the proceeds of the issue (or such higher amount which the issuer establishes is necessary to the satisfaction of the Secretary)." "Accordingly, a Build America Bond (Direct Payment) will be an arbitrage bond if the amount of the sale proceeds of such an issue that is part of any reserve or replacement fund exceeds 10 percent of the proceeds. As such,

the interest on such bond would not be tax-exempt under *IRC § 103* and thus would not be a qualified bond for purposes of this provision. [HR Conf Rep. 111-16 at 596, n 150.]" *IRS Notice 2009-26 at 835* , § 2.3.

(n519)Footnote 1. See § 1531 of Title I of Division B of ARRA 2009.

(n520)Footnote 2. *IRC § 1400U-2(b)*.

(n521)Footnote 3. *IRC § 1400U-2(b)*.

(n522)Footnote 4. *IRC § 1400U-2(a)*.

(n523)Footnote 5. See *IRC §§ 1400U-2(b)(2)* and *1400U-1*.

(n524)Footnote 6. *IRC § 1400U-2(b)(1)(A)*. See §§ *17.03[14][a]* and *17.03[15]* for a discussion of "available project proceeds" and "reasonably required reserve."

(n525)Footnote 7. Although RZEDBs must qualify as Build America Bonds, they do not need to be "Qualified Bonds" within the meaning of *IRC § 54AA(g)*, even though they are "treated" as Qualified Bonds for purposes of obtaining the direct credit under *IRC § 6431*. Thus, the proceeds of an RZEDB are not limited to use for capital expenditures.

(n526)Footnote 8. *IRC § 1400U-1(b)*.

(n527)Footnote 9. *IRC §§ 1400U-2(b)(1)(B)* and *1400U-2(b)(2)*.

(n528)Footnote 10. See § *17.03[3][b]*. See also HR Conf Rep. 111-16, 111th Cong, 1st Sess (Feb 12, 2009) at 601.

(n529)Footnote 11. The amount of bonds an issuer may designate as RZFBs may not exceed that issuer's allocated share of the national limitation on RZFBs, which is \$15 billion, *IRC § 1400U-1(a)(4)(B)*. *IRC § 1400U-3(b)(2)*. The method of allocation is discussed below. See *IRC § 1.1400U-1*.

(n530)Footnote 12. *IRC § 1400U-3(c)(1)*. Rules similar to the rules of *IRC §§ 1397D(a)(2)* and *1397D(b)*, regarding substantial renovations and sale and leasebacks of property, respectively, are to apply for purposes of determining whether property qualifies as "recovery zone property." *IRC § 1400U-3(c)(3)*.

(n531)Footnote 13. *IRC § 1400U-3(c)(2)*.

(n532)Footnote 14. *IRC § 1400U-3(d)*; HR Conf Rep 111-16 at 601.

(n533)Footnote 15. *IRC § 1400U-1(a)(1)(A)*.

(n534)Footnote 16. *IRC § 1400U-1(a)(2)*.

(n535)Footnote 17. *IRC § 1400U-1(a)(1)(B)*.

(n536)Footnote 18. A "large municipality" is one with a population of 100,000 or more. *IRC § 1400U-1(a)(3)(B)*.

(n537)Footnote 19. *IRC § 1400U-1(a)(3)(A)*.

(n538)Footnote 20. *IRC § 1400U-1(a)(3)(C)*.

(n539)Footnote 21. *IRC § 1400U-1(a)(3)(A)*.

(n540)Footnote 1. See Notice 88-130, *1988-2 CB 543* , § 1.1; *Notice 2008-41, 2008-1 CB 742, 743* , § 2 ("Subject

to limited exceptions, a debt instrument generally is treated as retired or extinguished when, among other circumstances, an issuer acquires its own debt because a merger of the interests of the issuer and the holder occurs.")

(n541)Footnote 2. See Chapter 1, § 1.02[3][a][ii].

(n542)Footnote 3. See Notice 2008-41, 2008-1 CB 742, 744 , § 3.1. See also *Notice 2008-41, 2008-1 CB 742, 743-744* , § 2:

" ... A reissuance of an issue of tax-exempt bonds may result in various negative consequences to a bond issuer, including, among other things, changes in yield for purposes of the arbitrage investment restrictions, acceleration of arbitrage rebate payment obligations, deemed terminations of integrated interest rate swaps under the qualified hedge rules for arbitrage purposes, new public approval requirements for qualified private activity bonds, and change in law risk.

* * *

A borrowing, whether taxable or tax-exempt, that is treated as retiring or reissuing a separate borrowing, generally constitutes an issue of refunding bonds which are viewed as financing the same governmental purpose or project as the original bonds (or "stepping into the shoes") of the original bonds) and trigger consequences involving the need to retest certain tax-exempt bond program requirements.

Tax-exempt bonds that are treated as retired through a debt extinguishment without a link to another borrowing, such as potentially an issuer's purchase of its own tax-exempt bonds using equity or other non-borrowed funds, may trigger additional consequences, including the potential[ly] adverse consequence of generally limiting the ability to refinance those extinguished bonds later with tax-exempt refunding bonds for the same governmental purpose as the original bonds."

(n543)Footnote 4. See fn 1, *supra*. *Notice 2008-41* clarified, amended, supplemented and superseded *Notice 2008-27, 2008-1 CB 543*, the IRS's previous guidance on these issues.

(n544)Footnote 5. See fn 1, *supra*.

(n545)Footnote 6. Another interest rate mode used is an auction rate mode in which the interest rate is reset at predetermined intervals (generally under one year) using a modified Dutch auction process in which the issuer of the bonds may participate in certain circumstances. Auction rate bonds generally trade at par and are callable at par on any interest payment date at the option of the issuer. Unlike bonds in a tender option mode, bonds in an auction rate mode have no ongoing tender options or put options to support the interest rate-setting process. A third type of interest rate mode is a variable rate which floats periodically in accordance with various market-based interest-rate setting mechanisms. Issuers often include multi-modal interest rate features in the preauthorized terms of the bond documents which provide issuers with the flexibility to change interest rate modes under conditions set forth in the bond documents. See Notice 2008-41, 2008-1 CB 742, 743-744 .

(n546)Footnote 7. See Notice 2008-41, 2008-1 CB 742, 743 .

(n547)Footnote 8. See fn 3, *supra*.

(n548)Footnote 9. See Notice 2008-41, 2008-1 CB 742, 744 , § 3.2(1).

(n549)Footnote 10. As defined in *Treas Reg § 1.1275-5(b)*. In general, a variable interest rate is a qualified floating rate if variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which the debt instrument is denominated. See § 17.02A[2][d], *supra*.

(n550)Footnote 11. Under *Treas Reg § 1.1275-5(c)(1)*, an objective rate is any rate determined using a single fixed formula based on objective financial or economic information. However, under *Treas Reg § 1.1275-5(c)(5)*, a rate can only be an "objective rate" in the case of a tax-exempt obligation if it is a "qualified inverse floating rate" (i.e., a rate that varies inversely with contemporaneous variations in a qualified floating rate (*Treas Reg § 1.1275-5(c)(3)*) or is a "qualified inflation rate" (i.e., a rate that measures contemporaneous changes in inflation based on a general inflation index).

(n551)Footnote 12. The 120 percent weighted average economic life of financed facilities test under *IRC § 147(b)* can be used as a safe harbor for this purpose.

(n552)Footnote 13. See Notice 2008-41, 2008-1 CB 742, 744-745 , § 3.2(2).

(n553)Footnote 14. Notice 2008-41, 2008-1 CB 742, 745 , § 3.1.

(n554)Footnote 15. See Notice 2008-41, 2008-1 CB 742, 745 , § 3.2(3)(a)).

(n555)Footnote 16. Notice 2008-41 (Section 3.1), 2008-1 CB 742, 744 . The safe harbor is effective for purposes of *IRC §§ 103 and 141-150* only. It does not, for example, apply for purposes of determining whether discount on a remarketed qualified tender bond should be treated as original issue discount or market discount for purposes of *IRC §§ 1271-1288*. See "Bond Lawyers Comment on State and Local Bonds Reissuance Standards," 2008 TNT 134-15 (July 10, 2008); Notice 2008-88, 2008-2 CB 933 , § 3.3 (no inference should be drawn regarding any other Federal tax issues affecting tax-exempt bonds or any other security).

(n556)Footnote 17. Recall that a qualified tender right must, in accordance with the terms of the bond instrument, require the issuer (or its remarketing agent) to use best efforts to resell the tendered bond.

(n557)Footnote 18. Defined in Notice 2008-41 as an issuer of a tax-exempt bond that is a governmental unit or an agency or instrumentality thereof. Notice 2008-41 (Section 3.2(b)(4)), 2008-1 CB 742, 745 .

(n558)Footnote 19. Notice 2008-41, 2008-1 CB 742 originally allowed a 180 period only to qualified tender bonds purchased by the governmental issuer before October 1, 2008. Notice 2008-41, 2008-1 CB 742, 745, § 3.2(b)(3). The purchase date was extended to December 31, 2009 by Notice 2008-88, 2008-2 CB 933 , § 3.2, and extended again, to December 31, 2010, by Notice 2010-7, 2010-3 IRB 296 , § 3.2.

(n559)Footnote 20. Since the bond is still considered outstanding during the safe harbor period, the governmental issuer may refund the reacquired bond with a refunding bond during this period upon a failed remarketing. Notice 2008-41, 2008-1 CB 742, 745 , § 3.2(3)(b).

(n560)Footnote 21. Notice 2008-41, 2008-1 CB 742, 745 , § 3.2(b)(3)).

(n561)Footnote 22. *Treas Reg § 1.150-1(c)(4)(ii)*. A program will be deemed to satisfy the maximum term requirement if the weighted average maturity of the issue does not exceed 120 percent of the weighted average expected economic life of the property financed by the issue.

(n562)Footnote 23. Notice 2008-41 , § 8.

(n563)Footnote 24. Notice 2008-88 , § 3.1. Literally construed, this language would require governmental issuers who reacquired tender option bonds or tax-exempt commercial paper under the terms of the Notice 2008-41 safe harbor to dispose of such reacquired bonds by December 31, 2010, regardless of the amount of time left in their safe harbor holding period. At best, it would appear to end on December 31, 2010 the exception for qualified tender bonds initially created by Notice 88-130, 1988-2 CB 543 (and extended to tax-exempt commercial paper by Notice 2008-88) even using a 90-day (or, under Notice 88-130, 30 -day) safe harbor holding period.

(n564)Footnote 25. See Notice 2008-41, *2008-1 CB* 742, 746 , § 7, Examples 1 and 2.

(n565)Footnote 1. Obligations of the US are not subject to state and local income or property taxes. *31 USC* § 742.

(n566)Footnote 2. The last pre-March 1, 1941 issue was called for redemption in 1962. Treasury Department Release, Aug 14, 1962, *27 Fed Reg* 8124 (1962) .

(n567)Footnote 3. *IRC* § 135(a), (c)(2). Contributions to qualified tuition programs and education IRAs also qualify. The amount of qualified educational expenses taken into account is net of any scholarships, fellowships, employer provided educational assistance amounts, and other tuition reduction benefits and does not include expenses for any course involving sports, games, or hobbies other than as part of a degree program. The amount of qualified educational expenses must also be reduced by the amount of expenses taken into account in determining the Hope and lifetime learning credits and the amount of expenses taken into account in determining the exclusion for distributions from a qualified tuition program or an education IRA. *IRC* § 135(d)(2).

The bonds must be redeemed by the owner, rather than being transferred to the educational institution. HR Rep No 1104, 100th Cong, 2d Sess 141 (1988).

(n568)Footnote 4. *IRC* § 135(c)(1). HR Rep No 1104, 100th Cong, 2d Sess 141 (1988). However, the taxpayer can designate any individual (including a child) as a beneficiary of the bond (payable at death). *IRS Notice* 90-7, *1990-1 CB* 304.

(n569)Footnote 5. *IRC* § 135(d)(3).

(n570)Footnote 6. *IRC* § 135(b)(1). The taxpayer would be well advised, however, to defer if possible redeeming a portion of the bonds to a year in which the redemption proceeds will be fully shielded from taxation by qualified educational expenses.

(n571)Footnote 7. For taxable years beginning in 2010, the exclusion begins to phase out for married couples filing jointly with modified adjusted gross income (MAGI) above \$105,100 and for other filers with MAGI above \$70,100. The exclusion is completely phased out for taxpayers with MAGI of \$135,100 or more for joint returns and \$85,100 or more for other returns. See Rev Proc 2009-50, *2009 IRB LEXIS* 652, *12-13 .

(n572)Footnote 8. *IRC* § 135(b)(2)(A).



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Taxation of Securities Transactions

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CHAPTER 17 Transactions in Bonds and Other Debt Instruments

2-17 Taxation of Securities Transactions § 17.03

§ 17.03 Bonds With Original Issue Discount

[1] Original Issue Discount Defined.

We have already seen how the Internal Revenue Code imputes interest into a loan transaction when the parties fail to provide adequate stated interest in the contract or debt instrument.ⁿ¹ That discussion primarily concerned sales of property made in exchange for a wholly or partially deferred consideration, which in some cases results in the substitution of interest income for what otherwise would have been reported as capital gain on the property sold. The focus of the following discussion is not on the character of income received in a debt-financed sale of property, but on the method by which the seller or any other holder of a debt instrument (whether acquired for cash or property) takes imputed interest into income, and a purchaser or other issuer of a debt instrument amortizes or deducts the imputed interest over time.ⁿ²

This section is principally concerned with the tax treatment of original issue discount or "OID," which arises when the issuer of a debt instrument accepts less than the instrument's face value at maturity as the issue price.ⁿ³ It is thus distinguishable from market discount, which arises when a debt instrument is issued at par but thereafter sells on the open market at less than par due to independent market forces.ⁿ⁴ After briefly reviewing the meaning of terms used in the Code's OID provisions (*IRC Sections 1271-1275*),ⁿ⁵ this section will examine the tax treatment of OID.

OID is defined as the excess of a debt instrument's stated redemption price at maturity over its issue price.ⁿ⁶ The stated redemption price at maturity is sum of all payments provided by the debt instrument other than qualified stated interest payments.ⁿ⁷ Accordingly, the stated redemption price at maturity will be the same as the stated principal amount or face value of the debt instrument as long as all payments under the instrument are either fixed payments of principal or "qualified stated interest" payments; *i.e.*, interest that is unconditionally payable at least annually at a single fixed rate.ⁿ⁸ Interest is unconditionally payable only if reasonable legal remedies exist to compel timely payment, or the debt instrument provides terms and conditions that make the likelihood of late payment (other than a late payment that occurs within a reasonable grace period) or nonpayment a remote contingency.ⁿ⁹ Remedies or other terms and conditions are not taken into account if the lending transaction does not reflect arm's-length dealing and the holder does not intend to enforce the remedies or other terms and conditions.ⁿ¹⁰

The "issue price" of publicly offered debt instruments not issued for property is the initial offering price to the public (excluding bond houses and brokers) at which a substantial amount of the instruments comprising the issue was

sold.ⁿ¹¹ If the bonds are privately placed and not issued for property, the issue price is determined on a bond-by-bond basis, and is the amount paid for the particular obligations by the first buyer thereof.ⁿ¹² For this purpose, property includes services and the right to use property, but does not include money.ⁿ¹³ Notwithstanding the difference in the statutory language of issue price between publicly offered and privately issued instruments issued for money, the regulations fix the issue price of each debt instrument in an issue at the first price at which a substantial amount of the debt instrument is sold for money.ⁿ¹⁴

A special rule applies to Treasury securities. Generally, the issue price of an issue of Treasury securities is the average price of the securities sold; the issue date of the issue is the first settlement date of a substantial amount of the securities.ⁿ¹⁵ Additional Treasury securities issued in a qualified reopening are part of the same issue as the original Treasury securities and have the same issue price and issue date, and (with respect to holders) the same adjusted issue price as the original Treasury securities.ⁿ¹⁶ A qualified reopening on or after March 13, 2001, is a reopening that occurs not more than one year after the original Treasury securities that were first issued to the public, or a reopening in which the additional Treasury securities are issued with no more than a *de minimis* amount of OID.ⁿ¹⁷ For a reopening of Treasury securities that occurred before March 13, 2001, a qualified reopening is one that occurs not more than one year after the original Treasury securities were issued to the public.ⁿ¹⁸ However, for a reopening of Treasury securities (other than Treasury Inflation-Indexed Securities) that occurred before November 5, 1999, an additional requirement of a qualified reopening was that it was intended to alleviate an acute, protracted shortage of the original Treasury securities.

Generally, two or more debt instruments that are not Treasury securities are treated as part of the same issue if (1) they have the same credit and payment terms, (2) are issued either pursuant to a common plan or as part of a single transaction or a series of related transactions, (3) are issued within a period of 13 days beginning on the date on which the first debt instrument that would be part of the issue is issued to a person other than a bond house, broker, or similar person or organization acting in the capacity of an underwriter, placement agent, or wholesaler, and (4) are issued on or after March 13, 2001.ⁿ¹⁹ However, additional debt instruments issued in a qualified reopening are part of the same issue as the original debt instruments.ⁿ²⁰ As a result, the additional debt instruments have the same issue date, the same issue price, and (with respect to holders) the same adjusted issue price as the original debt instruments.

A qualified reopening is a reopening of original debt instruments if the reopening occurs within six months after the issue date of the original debt instruments or the additional debt instruments are issued with no more than a *de minimis* of OID.ⁿ²¹ For both reopenings, the original debt instruments must be publicly traded. For the six-month reopening, an additional requirement is that, on the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date), the yield of the original debt instruments (based on their fair market value) is not more than 110 percent of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with no more than a *de minimis* amount of OID, the coupon rate).ⁿ²²

For this purpose, original debt instruments are debt instruments comprising any single issue of outstanding debt instruments.ⁿ²³ Additional debt instruments are debt instruments that are part of a single issue of debt instruments, are not part of the same issue as the original debt instruments, and have terms that are in all respects identical to the terms of the original debt instruments as of the reopening date.ⁿ²⁴

If a substantial amount of the debt instruments in an issue is traded on an established securities market and is issued for property, the issue price of each debt instrument in the issue is the fair market value of the debt, determined as of the issue date (the first date on which a substantial amount of the traded debt instruments in the issue is issued).ⁿ²⁵

If a substantial amount of the debt instruments in an issue (a) is issued for stock or securities that are publicly traded, or (b) is issued for property (other than stock or securities) of a kind regularly traded on an established market, the issue price of the instrument is the fair market value of the property.ⁿ²⁶

In other cases in which obligations are issued for property, the issue price may be the redemption price at maturity, the stated principal amount, or the imputed principal amount (the present value of all payments due under the instrument).ⁿ²⁷

IRC Section 1274 determines the issue price of a debt instrument issued for property when neither the debt instrument nor the property is publicly traded. Under that section, no interest is imputed if the debt instrument calls for the unconditional payment of interest at a rate that is at least equal to a safe harbor or test rate based on the "applicable federal rate" or AFR.ⁿ²⁸ If there is adequately stated interest--the safe-harbor rate is satisfied--the issue price of the obligation is its stated principal amount.ⁿ²⁹ If not, its issue price will be an imputed principal amount calculated by discounting all payments due under the instrument by a rate equal to the AFR.ⁿ³⁰ However, in a potentially abusive situation (where, for example, the debt instrument is part of a tax shelter as defined in *IRC Section 6662(d)(2)(C)(ii)*) the imputed principal amount will be equal to the fair market value of the property for which the obligation was given.ⁿ³¹

If an obligation is issued as part of an investment unit consisting of the debt instrument and an option, security, or other property, the issue price for the entire unit is determined as if it were a debt instrument. That issue price is then allocated to each element of the unit on the basis of relative fair market values, with the issue price of the debt instrument included in the unit being its allocated price.ⁿ³²

If the debt instrument is issued pursuant to a plan of reorganization for another debt instrument, and the amount that would be the issue price of the new instrument is less than the adjusted price of the old instrument, the issue price of the new obligation is deemed to be equal to the adjusted issue price of the old one.ⁿ³³

[2] Tax Treatment of Original Issue Discount Bonds.

[a] In General.

The tax treatment of original issue discount bonds depends on the status of the issuer and the date of issuance. The holder of a bond issued by a corporation on or before May 27, 1969, takes OID into account when the bond is retired at maturity or sold prior to maturity.ⁿ¹ For corporate bonds issued after May 27, 1969 and before July 2, 1982 (and to bonds issued thereafter pursuant to a written commitment binding on July 1, 1982), *IRC Section 1272(b)* requires the holder to include the monthly portion of OID in income on a ratable basis over the life of the bond. The ratable portion is determined by dividing the OID by the number of complete months from the date of original issue--the date on which the issue was first sold to the public at the issue price, or if sold privately for money, the date on which each bond was sold by the issuer--to the stated maturity date of the obligation.ⁿ² A complete month "commences with the date of original issue and the corresponding day of each succeeding month. ... "ⁿ³

A subsequent purchaser of the bond must report the amount of OID not previously included by prior holders. However, if the subsequent holder's cost for the bond is in excess of (1) the issue price of the bond, and (2) the portion of the OID previously includable in income by any other holder of the bond, such excess reduces the amount of unearned discount otherwise includable in gross income.ⁿ⁴ If the subsequent holder purchases the bond at a premium, the purchaser is not required to include any OID in gross income.ⁿ⁵

Example 1:

On January 1, 1981, A purchased a newly issued 20-year \$10,000 corporate bond for \$6,400. The instrument did not provide for the payment of interest prior to maturity. For A, the ratable monthly portion of OID was \$15. A sold the bond to B on January 1, 1984 for \$7,450. B's cost exceeded \$6,940 (the sum of (i) \$6,400 the original issue price of the bond, and (ii) \$540, the amount of OID included in income by A during the three-year period that A held the bond) by \$510. This reduced the unreported

OID of \$3,060 to \$2,550, making *B*'s ratable monthly portion of OID only \$12.50.

The holder of an original issue discount debt instrumentⁿ⁶ that is a capital asset in the hands of the holder and is issued after July 1, 1982, must include in income "an amount equal to the sum of the daily portions of the original issue discount for each day during the taxable year on which [the] holder held [the] debt instrument."ⁿ⁷ Certain debt instruments are excepted from the ambit of this rule, namely, (1) tax-exempt obligations; (2) United States Savings Bonds; (3) obligations issued by natural persons before March 2, 1984; (4) loans by a natural person to another natural person if not made in the course of a trade or business and if the aggregate of loans by the lender to the borrower does not exceed \$10,000; and (5) obligations with a maturity date of not more than one year after the issue date.ⁿ⁸

The daily accrual of income called for by the Code is accomplished by allocating to each day in any accrual period its ratable portion of the increase in the adjusted issue price of the debt instrument during the accrual period.ⁿ⁹ This increase is found by multiplying the adjusted issue priceⁿ¹⁰ at the beginning of the period by the yield to maturity (determined on the basis of compounding at the close of each accrual period) and then subtracting the interest payable on the instrument during the accrual period. The steps in determining the amount of OID includable in income for the taxable year are: (1) determine the debt instrument's yield to maturity; (2) determine the accrual periods; (3) determine the OID allocable to each accrual period; (4) determine the daily portions of OID; and (5) add together the daily portions of OID for each day during the taxable year on which the taxpayer held the debt instrument.ⁿ¹¹

Example 2:

On January 1, 1997, *A* pays *X Corp.* \$600,000 for a five-year bond that is to be redeemed at maturity for \$1 million. The bond does not provide for stated interest payments. The amount of OID is \$400,000 the difference between the stated redemption price at maturity (\$1 million) and the issue price (\$600,000). The yield to maturity is approximately 10.48 percent, compounded semiannually. (The yield to maturity is the discount rate that, when used in computing the present value of all principal and interest payments to be made under the debt instrument, produces an amount equal to the issue price of the debt instrument; the yield must be constant over the term of the debt instrument.)ⁿ¹² The amount of interest for each year is determined by multiplying the adjusted issue price by the yield to maturity, as shown in the following table. This interest is includable in the income of the holder and deductible by the borrower.

Year	Interest	Adjusted Issue Price
1	\$64,540	\$664,540
2	71,482	736,022
3	79,171	815,193
4	87,687	902,880
5	97,120	1,000,000

A subsequent holder of the bond is allowed a reduction in the amount includable in income if the purchase price exceeds the issue price plus the daily portions of original issue discount for all days before the date of purchase.ⁿ¹³ This reduction also occurs on a daily basis, the amount of the offset determined by multiplying the daily portion by a fraction, the numerator of which is the excess price and the denominator of which is the sum of the daily portions for the debt instrument for all days after the date of purchase and ending on the stated maturity date.ⁿ¹⁴

IRC Section 1272(a)(6) prescribes a special rule for determining the daily portion of regular interests in a REMIC (see Chapter 13A), qualified mortgages held by a REMIC, any other debt instrument on which payments may be accelerated by reason of prepayments of other obligations securing the debt instrument, or any pool of debt instruments the yield on which may be affected by reason of prepayments (or to the extent provided in regulations, by reason of other events).

The present value calculation for such interests and instruments is made by (1) using the yield to maturity determined at the time of issuance (determined on the basis of compounding at the close of each accrual period and properly adjusted for the length of the accrual period), calculated on the assumption that, as prescribed by regulations, certain prepayments will occur, and (2) taking into account any prepayments that have occurred before the close of the accrual period.ⁿ¹⁵

Accounting for OID in a case governed by *IRC Section 1274* can be illustrated by the following example:

Example 3:

Seller sells property to Buyer for \$5 million under a three-year note with interest at 5 percent, payable annually. Assume that the applicable federal short-term rate at the time of the transaction is 6 percent, compounded semi-annually. The includable and deductible OID equals the interest on the issue price at a rate of 6 percent compounded semiannually, less the amount of stated interest paid during the year. Thus:

Year	Adjusted Issue Price	Yield at 12%	Stated Interest	OID
1	\$4,854,700	\$295,600	\$250,000	\$45,600
2	4,900,300	298,400	250,000	48,400
3	4,948,700	301,300	250,000	51,300
		\$895,300	\$750,000	\$145,300

The OID rules can affect the timing of interest income inclusion and interest expense deduction even though the debt instrument provides for sufficient stated interest, as the following example illustrates:

Example 4:

Seller sells nonpublicly traded property to Buyer for \$5 million. The purchase price is represented by a three-year note bearing interest at 6 percent, compounded semiannually. The entire purchase price (\$5 million) and all of the interest (\$970,261) are payable at the end of the three-year period. The applicable federal short-term rate is 6 percent. Since the interest rate called for in the note equals the safe-harbor rate, there is adequate stated interest. However, the interest must be accrued annually, as follows:

Year	Adjusted Issue Price	Yield at 12%	OID
1	\$5,000,000	\$304,500	\$304,500
2	5,304,500	323,044	323,044
3	5,627,544	342,717	342,717
		\$970,261	\$970,261

Although *IRC Section 1272* does not apply to a short-term obligation--a debt instrument that has a fixed maturity date not more than one year from the date of issuance¹⁶--*IRC Section 1281* requires certain holders of such an obligation (other than a tax-exempt short-term obligation) to include in gross income the sum of the daily portions of the acquisition discount (the excess of the stated redemption price at maturity over the taxpayer's basis¹⁷) for each day during the taxable year on which the taxpayer held the obligation, while any interest on the obligation (other than interest taken into account in determining the amount of acquisition discount) must be included in income as it accrues.ⁿ¹⁸ Normally the daily portion is determined by dividing the discount amount by the number of days beginning after the day on which the taxpayer acquired the obligation and continuing up to and including the day of maturity.ⁿ¹⁹ However, the taxpayer can elect to accrue economically at a constant interest rate on the basis of the taxpayer's yield to

maturity, compounding daily.ⁿ²⁰ The amount included in gross income increases the basis of the short-term obligation.ⁿ²¹

IRC Section 1281 applies generally just to short-term obligations held by: (1) any taxpayer using an accrual method of accounting; (2) a taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business; (3) a bank;ⁿ²² (4) a regulated investment company or common trust fund; or (5) a taxpayer who identifies the obligation as being part of a hedging transaction under *IRC Section 1256(e)(2)*.ⁿ²³ The provision also applies to any stripped bond or stripped coupon held by the person who stripped the bond or coupon (or by any other person whose basis is determined by reference to the basis in the hands of the stripping person). In addition, *IRC Section 1281* will apply to any obligation held by pass-thru entities (eg, partnerships, corporations, limited liability companies, or trusts) that are formed or availed of for purposes of avoiding the provisions of the section, or to any short-term obligation acquired by a pass-thru entity during a period beginning with the first taxable year in which 20 percent or more of the value of the interests in the pass-thru entity are held for at least 90 days by persons subject to the provisions of *IRC Section 1281* or by other pass-thru entities to which the section applies.ⁿ²⁴

A taxpayer, not otherwise subject to *IRC Section 1281*, can elect to be subject to its provisions.ⁿ²⁵ If the election is made, it applies to all short-term obligations acquired by the taxpayer on or after the first day of the first taxable year to which the election applies. Once made, the election cannot be revoked.

The rules governing corporate original issued discount bonds issued after July 1, 1982, apply with equal force to government bonds except tax-exempt bonds, United States savings bonds, and short-term government obligations (obligations issued on a discount basis and payable without interest no later than one year from the date of issue).ⁿ²⁶

A cash-basis taxpayer, holding a noninterest-bearing government obligation issued at a discount and redeemable for fixed amounts at stated intervals is not required to include the annual increase in the redemption price in income for the taxable year.ⁿ²⁷ Instead, the time for reporting the income comes when the bond is redeemed.ⁿ²⁸ Moreover, inclusion of the accrued discount can be deferred further if the obligation is held beyond maturity, or exchanged for another nontransferable obligation of the United States in a tax-free exchange governed by *IRC Section 1037*.ⁿ²⁹

The taxpayer can elect to change this treatment and report the yearly increase in redemption price as income received in such year.ⁿ³⁰ If the election is made, it applies to all obligations owned by the taxpayer at the beginning of the taxable year to which the election first applies, and to all obligations thereafter acquired, and is binding for all subsequent years unless the Commissioner permits a change to a different method.ⁿ³¹ The amount includable in income in the first year to which the election applies is not limited to the increase in redemption price for that year; the taxpayer who holds noninterest-bearing discount obligations at the beginning of the year of election is also required to report the previous increase in redemption price of those obligations (the increase occurring between the date of acquisition and the first day of the election year) as income in such year.ⁿ³² Furthermore, if the previously acquired obligation is a nontransferable, noninterest-bearing obligation acquired in exchange for a savings bond, the taxpayer's year of election income includes not only the increase in redemption price of the obligation then held, but also the increase in redemption price of the savings bond between the date of its acquisition and the date of exchange.ⁿ³³

There is one category of noninterest-bearing government obligations issued on a discount basis as to which the election cannot be made, namely, those with a maturity date not exceeding one year from the date of issue, eg, Treasury bills. Under *IRC Section 454(b)*, "the amount of discount at which such obligation is sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of." The rule of *IRC Section 454(b)* must be considered in light of the discussion above of *IRC Section 1281*; *IRC Section 454(b)* will not apply if *IRC Section 1281* is operative.

[b] Contingent Payment Debt Instruments.

The Code is silent regarding the proper treatment of obligations that call for contingent payments. This gap is filled by *Regulations Section 1.1275-4*.ⁿ³⁴ However, the regulations do not define what a contingent payment is, other than by excepting certain debt instruments from the scope of the rules.

Regulations Section 1.1275-4 does not apply to: (1) a debt instrument that has an issue price equal to the stated redemption price at maturity pursuant to *IRC Section 1273(b)(4)* (a nonpublicly traded debt instrument issued for property that is not publicly traded and to which *IRC Section 1274* does not apply); (2) a variable rate debt instrument; (3) a debt instrument subject to *Regulations Section 1.1272-1(c)* (a debt instrument that provides for an alternative payment schedule (or schedules) applicable upon the happening of a contingency or contingencies); (4) a foreign currency debt instrument subject to *IRC Section 988*, except as provided therein or in regulations thereunder; (5) a debt instrument to which *IRC Section 1272(a)(6)* applies (certain interests in or mortgages held by a REMIC and certain other debt instruments with payments subject to acceleration); (6) a debt instrument (other than a tax-exempt obligation) described in *IRC Section 1272(a)(2)* (e.g., United States savings bonds, certain loans between natural persons, and short-term taxable obligations); (7) state-sponsored prepaid tuition plans; or (8) an inflation-indexed debt instrument.ⁿ³⁵

A payment is not contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances, or if, as of the issue date, the contingency is either remote or incidental.ⁿ³⁶ Furthermore, a debt instrument does not provide for contingent payments merely because it contains a right to convert the debt into the stock of the issuer, into the stock or debt of a related party (within the meaning of *IRC Section 267(b)* or *707(b)(1)*), or into cash or other property in an amount equal to the approximate value of such stock or debt.ⁿ³⁷

The regulations employ a noncontingent bond method for all contingent payment debt instruments that are publicly traded or issued for money or publicly traded property.ⁿ³⁸ Under the noncontingent bond method, interest on a debt instrument must be taken into account whether or not the amount of any payment is fixed or determinable in the taxable year. The amount of interest that is taken into account for each accrual period is determined by constructing a projected payment schedule for the debt instrument and applying rules similar to those for accruing OID on a noncontingent debt instrument. If the actual amount of a contingent payment is not equal to the projected amount, appropriate adjustments are made to reflect the difference.

The computation of income, deductions, gain, and loss under the noncontingent bond method requires the following steps.ⁿ³⁹ First, the issuer must determine the comparable yield for the debt instrument as of the instrument's issue date. Then, the issuer must determine a projected payment schedule for the debt instrument as of the instrument's issue date. Next, the daily portions of interest on the debt instrument for a taxable year are determined under normal OID rules; no amount of interest on a contingent debt instrument is qualified stated interest, but must be treated as OID.ⁿ⁴⁰ Finally, adjustments are made to reflect differences between projected and actual contingent payments as described below.

The comparable yield for a debt instrument is the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument (the comparable fixed rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions.ⁿ⁴¹ For example, if a *Regulations Section 1.1275-6* hedge (or the substantial equivalent) is available, the comparable yield is the yield on the synthetic fixed rate debt instrument that would result if the issuer entered into the *Regulations Section 1.1275-6* hedge. If a *Regulations Section 1.1275-5* hedge (or similar equivalent) is not available, but similar fixed rate debt instruments of the issuer trade at a price that reflects a spread above a benchmark rate, the comparable yield is the sum of the value of the benchmark rate and the spread. In determining the comparable yield, no adjustments are made for the riskiness of the contingencies or the liquidity of the debt instrument. The comparable yield must be a reasonable yield for the issuer and must not be less than the applicable federal rate for the term of the debt instrument.

A rate equal to the applicable federal rate (based on the overall maturity of the debt instrument) is presumed to be the comparable yield if the debt instrument provides for one or more contingent payments not based on market information

and the instrument is part of an issue that is marketed or sold in substantial part to persons for whom the inclusion of interest will not have a substantial effect on their federal tax liability.ⁿ⁴² A taxpayer can overcome the presumption only with clear and convincing evidence that the comparable yield for the debt instrument should be a specific yield that is higher than the applicable federal rate. The presumption cannot be overcome with appraisals or other valuations of nonpublicly traded property. Evidence used to overcome the presumption must be specific to the issuer and must not be based on comparable issuers or general market conditions.

The projected payment schedule includes each noncontingent payment and the projected amount of each contingent payment due on the instrument.ⁿ⁴³ The schedule is determined as of the issue date and remains fixed throughout the term of the debt instrument (except for a contingent payment that becomes fixed more than six months before it is due). In determining the projected amount of contingent payments, the regulations divide the payments into two categories: market-based payments (payments based on market information)ⁿ⁴⁴ and other (or non-market-based) payments.

If a contingent payment is a market-based payment, the projected amount of the contingent payment is the forward price of the payment, that is, an amount one party would agree, as of the issue date, to pay an unrelated party for the right to the payment on the settlement date (eg, the date the contingent payment is to be made).ⁿ⁴⁵ For example, if the right to a contingent payment is substantially similar to an exchange-traded option, the forward price is the spot price of the option (the option premium) compounded at the applicable federal rate from the issue date to the date the contingent payment is due. If a contingent payment is non-market based, the amount of the projected payment is the expected value of the contingent payment as of the issue date.ⁿ⁴⁶

If the projected payment schedule does not produce the comparable yield, the schedule must be adjusted to do so.ⁿ⁴⁷ For example, the adjusted amounts of non-market-based payments must reasonably reflect the relative expected values of the payments and must not be set to accelerate or defer income or deductions. If the debt instrument contains both market-based and non-market-based payments, adjustments are generally made first to the non-market-based payments because more objective information is available for market-based payments.

The projected payment schedule used by the issuer to compute interest accruals and adjustments determines the accruals and adjustments of the holder.ⁿ⁴⁸ The issuer must provide the projected payment schedule to the holder in a manner consistent with the issuer disclosure rules of *Regulations Section 1.1275-2(e)*.ⁿ⁴⁹ If the issuer does not create a projected payment schedule for a debt instrument or the payment schedule set by the issuer is unreasonable, the holder of the debt instrument must determine the comparable yield and the projected payment schedule for the debt, and explicitly disclose this fact and the reason why the holder set its own schedule (eg, why the projected payment schedule prepared by the issuer is unreasonable). Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed return for the taxable year that includes the acquisition date of the debt instrument

The issuer's determination of the comparable yield and projected payment schedule will be respected unless the schedule is unreasonable.ⁿ⁵⁰ A comparable yield or projected payment schedule will generally be considered unreasonable if the schedule is set with a purpose to overstate, understate, accelerate or defer interest accruals on the debt instrument. In determining whether a comparable yield or projected payment schedule is unreasonable, consideration will be given to whether the treatment of the debt instrument will have a significant effect on the issuer's or holder's federal tax liability. For example, if an issuer markets a debt instrument to a holder not subject to federal taxation, the comparable yield will be closely scrutinized and will not be respected unless contemporary documentation shows that the yield is not too high.

The following example illustrates the determination of a comparable yield and a projected payment schedule that uses market-based payments:

Example 1:

On December 31, 1996, A Corp. issues for \$2 million a 10-year debt instrument providing for annual interest payments at 6 percent beginning in 1997, and for a payment at maturity of \$2 million plus the excess, if any, of the price of 20,000 shares of publicly traded stock in an unrelated corporation over \$700,000, or less the excess, if any, of \$700,000 over the price of 20,000 shares of the stock on the maturity date. On the issue date, the forward price to purchase 20,000 shares of stock on the maturity date is \$700,000.

The debt instrument's comparable yield is the yield on the synthetic debt instrument that would result if A Corp. entered into a *Regulations Section 1.1275-6* hedge. In this instance, a *Regulations Section 1.1275-6* hedge is a forward contract to purchase 20,000 shares of the stock on the maturity date. If A Corp. entered into this hedge the resulting synthetic debt instrument would yield 6 percent, compounded annually. This causes the comparable yield on the debt instrument to be 6 percent, compounded annually.

The projected payment schedule for the debt instrument consists of 10 annual payments of \$120,000 and a projected amount for the contingent payment due at maturity. Because the right to the contingent payment is market-based, the projected amount of the contingent payment is the forward price of the payment. The right to the payment is substantially similar to a right to a payment of \$2 million coupled with a cash-settled forward contract for the purchase of 20,000 shares of stock for \$700,000 on the maturity date. Because the forward price to purchase 20,000 shares of stock on the maturity date is \$700,000, the amount to be received or paid under the forward contract is projected to be zero. Thus, the projected amount of the contingent payment at maturity is limited to the \$2 million base price.

If, on the issue date, the forward price to purchase the 20,000 shares of stock on the maturity date is \$740,000, the resulting synthetic debt instrument would yield 6.15 percent, compounded annually, producing a comparable yield for the debt instrument of 6.15 percent, compounded annually. The projected payment for the debt instrument consists of 10 yearly payments of \$120,000 and a projected amount for the contingent payment of \$2,040,000, consisting of the \$2 million base price and the excess of \$40,000 of the forward price of the stock over the purchase price of the stock under the forward contract.

If the forward price to purchase the stock on the maturity date is less than \$700,000, the comparable yield will be less than 6 percent. The projected payment schedule will continue to consist of 10 annual payments of \$120,000, but the projected amount for the contingent payment at maturity will be reduced below \$2 million by the amount of the excess of the purchase price of the stock under the forward contract over the forward price of the stock.

The following example illustrates the determination of the comparable yield and projected payment schedule with non-market-based contingent payments:

Example 2:

A corporation issues a four-year \$2 million debt instrument that has a stated principal amount of \$2 million payable at maturity and provides for the payment on December 31 of each year of \$40,000 plus 5 percent of the issuer's gross receipts, if any, for the year. The issuer has outstanding fixed rate debt instruments with maturities of 2 to 10 years that trade at a price that reflects an average of 100 basis points over Treasury bonds. The outstanding debt instruments have terms and conditions similar to the issued debt instrument. The applicable federal rate for a four-year debt instrument (mid-term rate) on the date of issue is 6.5 percent, compounded annually; no *Regulations Section 1.1275-6* hedge is available

for the debt instrument. The interest inclusions attributable to the debt instrument are expected to have a substantial effect on the holder's federal tax liability.

The comparable yield for the debt instrument is 7.5 percent, compounded annually. This is equal to the value on the issue date of the benchmark rate--the applicable federal rate for a four-year debt instrument--plus the spread of 100 basis points.

The issuer anticipates that it will have no gross receipts in the year the debt instrument is issued, but that it will have gross receipts that will grow each year during the remaining three years of the term of the instrument. Based upon business projections, the corporation believes that it is not unreasonable to expect that its gross receipts in year 2 and each year thereafter will grow by between 6 and 12 percent over the prior year. The issuer must take these expectations into account in establishing a projected payment schedule that results in a yield of 7.5 percent, compounded annually. The issuer could reasonably set the following projected payment schedule for the debt instrument:

Year	Non contingent Payment	Contingent Payment
1	\$40,000	\$0
2	40,000	140,000
3	40,000	151,200
4	2,040,000	167,700

Because it is unlikely that a contingent payment will actually equal the amount of the projected payment, the proposed regulations provide for adjustments under the noncontingent bond method. If the amount of the actual contingent payment is more than its projected amount, the difference is a positive adjustment on the date of payment; if less, the adjustment is a negative adjustment on that date.ⁿ⁵¹

As a first step, positive and negative adjustments with respect to a contingent debt obligation are netted for each taxable year in which payments are made under the obligation. The amount by which total positive adjustments on a debt instrument in a taxable year exceed total negative adjustments produces a net positive adjustment that is treated as additional interest for the taxable year.ⁿ⁵²

The amount by which total negative adjustments on a debt instrument exceed the total positive adjustments on the debt instrument in a taxable year results in a net negative adjustment that is treated as follows:

(1) A net negative adjustment first reduces the amount of interest for the taxable year that the taxpayer would otherwise take into account using the projected payment schedule.ⁿ⁵³

(2) If the net negative adjustment exceeds the interest for the taxable year that the taxpayer would otherwise take into account, the excess is treated as ordinary loss by the holder and ordinary income by the issuer.ⁿ⁵⁴ However, the amount treated as ordinary loss by the holder is limited to the amount by which the holder's total interest inclusions on the debt instrument exceed the total amount of the holder's net negative adjustments treated as ordinary loss in prior taxable years. The amount treated as ordinary income by the issuer is limited to the amount by which the issuer's total interest deductions on the debt instrument exceed the total amount of the issuer's net negative adjustments treated as ordinary income in prior taxable years.

(3) Any net negative adjustment that remains is carried forward and treated as a negative adjustment on the first day of the succeeding year.ⁿ⁵⁵ Any negative adjustment for a taxable year in which the debt

instrument is sold, exchanged, or retired reduces the amount realized by the holder on the disposition.ⁿ⁵⁶ If an obligation is retired, the issuer must treat any negative adjustment carryover as ordinary income.

Under the noncontingent bond method, the adjusted issue price of a debt instrument, the holder's basis in the debt instrument, and the amount of any contingent payment treated as made on the scheduled retirement of the debt instrument, are determined using the projected payment schedule rather than actual payments.ⁿ⁵⁷ Thus, the adjusted issue of the debt instrument is equal to the debt instrument's issue price, increased by the interest previously accrued on the debt instrument in accordance with the projected payment schedule (without any positive or negative adjustment to reflect differences in actual and projected payments), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument.ⁿ⁵⁸ A holder's basis in a debt instrument is increased by the interest previously accrued by the holder on the debt instrument in accordance with the projected payment schedule (without adjustment), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument to the holder.ⁿ⁵⁹

In determining the amount realized by a holder and the repurchase price paid by an issuer on the scheduled retirement of a debt instrument, a holder is treated as receiving, and the issuer is treated as paying, the projected amount of any contingent payment due at maturity.ⁿ⁶⁰ However, the amount realized on a scheduled retirement may be reduced by a negative adjustment carryover in the taxable year of the retirement, as discussed above. An unscheduled retirement of a debt instrument (or the receipt of a pro rata prepayment that is treated as a retirement of a portion of a debt instrument) is treated as a sale or exchange of the debt instrument (or a pro rata portion of the debt instrument) by the holder to the issuer for the amount paid by the issuer to the holder.ⁿ⁶¹

Example 3:

On December 31, 1996, A, a calendar year taxpayer, purchases a debt instrument at original issue for \$20,000. The debt instrument's comparable yield is 10 percent, compounded annually; the projected payment schedule provides for payments of \$10,000 (consisting of a noncontingent payment of \$7,500 and a projected amount of \$2,500) on December 31, 1997, and \$13,200 (noncontingent payment of \$12,000 and projected amount of \$1,200) on December 31, 1998. The debt instrument is a capital asset in A's hands.

Based upon the projected payment schedule, A's total daily portions of interest are \$2,000 (10 percent of issue price of \$20,000) for 1997. The payment actually made on December 31, 1997 is \$7,500, instead of the projected amount of \$10,000. Due to this, A has a negative adjustment of \$2,500 on December 31, 1997. Because A has no positive adjustments for 1997, A has a net negative adjustment of \$2,500 for 1997. This reduces to zero the \$2,000 daily portions of interest that A would otherwise include in income in 1997. The remaining \$500 of the net negative adjustment is a negative adjustment carryforward that results in a negative adjustment of \$500 on January 1, 1998.

The adjusted issue price of the debt instrument and A's adjusted basis in the debt instrument are increased by the daily portions of interest for 1997, namely, \$2,000, even though A does not include this amount in income because of the net negative adjustment for 1997. Furthermore, the adjusted issue price of the debt instrument and A's basis in the debt instrument are decreased on December 31, 1997 by the \$10,000 projected payment on that date, yielding an adjusted issue price and adjusted basis of \$12,000 (\$20,000 plus \$2,000 less \$10,000) for the debt instrument on January 1, 1998.

Based on the projected payment schedule, A's total portions of interest for 1998 are \$1,200 (10 percent of adjusted issue price of \$12,000). The payment actually made on December 31, 1998 is \$14,000, not the projected amount of \$13,200. A has a positive adjustment of \$800 on December 31, 1998. Because A has a negative adjustment of \$500 on January 1, 1998 due to the net negative

adjustment carryforward from 1997, A has a net positive adjustment of \$300 for 1998. Thus, A has interest income of \$1,500 for 1998 (\$300 net positive adjustment plus \$1,200 total daily portions of interest taken into account by A in 1998).

A's adjusted basis in the debt instrument immediately before the payment at maturity on December 31, 1998 is \$13,200 (\$12,000 plus \$1,200 total daily portions of interest for 1998). For purposes of determining the amount realized by A on retirement of the debt instrument, A is deemed to have received the projected amount of the payment on December 31, 1998 (\$13,200), not the actual amount (\$14,000). Because A's adjusted basis in the debt instrument immediately before retirement is \$13,200, A recognizes no gain or loss on retirement.

Example 4:

Assume the same fact as in Example 3, except that A sells the debt instrument for \$12,600 on January 1, 1998, when A's adjusted basis in the instrument is \$12,000. Because A has a negative adjustment of \$500 on the debt instrument in 1998 (due to the negative adjustment carryforward from 1997), and no positive adjustments on the debt instrument for 1998, A has a net negative adjustment for 1998 of \$500. The entire amount of the net negative adjustment for 1998 becomes a negative adjustment carryforward for that year and reduces the amount realized by A on the sale of the debt instrument from \$12,600 to \$12,100. Accordingly, A has a gain on the sale of \$100 (\$12,100 amount realized less \$12,000 adjusted basis); the gain is treated as ordinary interest income.ⁿ⁶²

Example 5:

Assume the same facts as in Example 3, except that the payment actually received by A on December 31, 1998 is \$12,300, not the projected \$13,200. This gives A a negative adjustment of \$900 on December 31, 1998 to go along with the negative adjustment of \$500 on January 1, 1998. Because A has no positive adjustments for 1998, A has a net negative adjustment of \$1,400 for 1998. Of this amount, \$1,200 reduces to zero the \$1,200 daily portions of interest that A would otherwise include in income in 1998; the remaining \$200 is a negative adjustment carryforward for 1998 that reduces the amount realized on the retirement of the debt instrument.

A is initially treated as having received \$13,200 on retirement (see Example 3). However, this amount must be reduced by the \$200 negative adjustment carryforward for 1998, producing an amount realized of \$13,000 and a loss of \$200 (\$13,200 adjusted basis, as determined in Example 5, less \$13,000 amount realized). A must treat this loss as a capital loss.ⁿ⁶³

Some special rules apply when a holder's basis in a debt instrument is not the same as the adjusted issue price of the instrument (as when a subsequent holder purchases the debt instrument for more or less than its adjusted issue price). In such case, the holder still accrues interest and makes adjustments based on the projected payment schedule determined as of the issue date of the debt instrument, but also must reasonably allocate any difference between the adjusted issue price and the basis to daily portions of interest or projected payments over the remaining term of the debt instrument.ⁿ⁶⁴ If the holder's basis exceeds the debt instrument's adjusted issue price, the amount allocated to a daily portion of interest or to a projected payment is treated as a negative adjustment on the date the daily portion accrues or the payment is made; the holder's adjusted basis in the debt instrument is reduced by the amount treated as a negative adjustment.ⁿ⁶⁵ If the holder's basis is less than the adjusted issue price of the instrument, the amount allocated to a daily portion of interest or to a projected payment is treated as a positive adjustment on the date the daily portion accrues or the payment is made; the holder's adjusted basis in the debt instrument is increased by the amount of the positive adjustment.ⁿ⁶⁶ In either case, the rules for accruing premium and discount found in *IRC Sections 171, 1272(a)(7), 1276, and 1281* do not apply.ⁿ⁶⁷

Example 6:

On July 1, 1998, A, a calendar year taxpayer, pays \$28,100 for a debt instrument that matures on December 31, 1999, and was originally issued on December 31, 1996 at an issue price of \$20,000. Under the terms of the instrument, the issuer agrees to pay on the maturity date the sum of \$20,000 plus the increase, if any, in the price of a specified commodity from the issue date to the maturity date. The comparable yield for the debt instrument is 10.25 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date) provides for a single payment at maturity of \$27,000. At the time of purchase, the debt instrument has an adjusted issue price of \$23,240, assuming semiannual accrual periods ending on December 31 and June 30. Assume that the increase in value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment and not to a decrease in market interest rates.

A's \$28,100 basis in the debt instrument on July 1, 1998 exceeds the adjusted issue price of the instrument on that date (\$23,240) by \$4,860. A allocates this difference to the contingent payment due at maturity. This allocation is reasonable because the increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment.

Based on the projected payment schedule, the \$23,240 adjusted issue price of the instrument on July 1, 1998, and the projected yield of 10.25 percent compounded semiannually, \$1,200 of interest accrues on the debt instrument from July 1, 1998 to December 31, 1998. A has no net negative or positive adjustments for 1998 and, therefore, includes \$1,200 of total daily portions of interest in income in 1998; A's basis in the debt instrument is increased from \$28,100 to \$29,300.

Assume that the payment actually made on December 31, 1999 is \$28,000 rather than the projected payment of \$27,000. This causes A to have a positive adjustment of \$1,000 on December 31, 1999. Because of the allocation of the excess of basis over the adjusted issue price of the debt instrument to the contingent payment, A has a negative adjustment of \$4,860 on December 31, 1999, resulting in a net negative adjustment for 1999 of \$3,860. This net negative adjustment reduces the \$2,560 total daily portions of interest that A would otherwise include in income in 1999 to zero. Because A included \$1,200 in interest in 1998, \$1,200 of the remaining \$1,300 net negative adjustment is treated as an ordinary loss for 1999. The remaining \$100 of the net negative adjustment is a negative adjustment carryforward for 1999 that reduces the amount realized on the retirement of the debt instrument from \$27,000 to \$26,900.

A's basis in the debt instrument on December 31, 1999 is \$27,000 (\$28,100 original basis, plus total daily portions of interest of \$1,200 for 1998 and \$2,560 for 1999, less the negative adjustment of \$4,860). This causes A to realize a capital loss of \$100 on the retirement of the debt instrument.

Example 7:

On January 1, 1999, B, a calendar year taxpayer, pays \$18,200 for a debt instrument that provides for annual interest of 7 percent payable semiannually on June 30 and December 31 of each year, and for the payment on December 31, 2001 of \$20,000 plus or minus \$200 times the positive or negative difference, if any, between a specified amount and the value of an index on December 31, 2001. However, the payment at maturity cannot be less than \$13,000. The debt instrument was originally issued on December 31, 1996, for an issue price of \$20,000. The comparable yield for the debt instrument is 9.8 percent, compounded semiannually, and the projected payment schedule provides for semiannual payments of \$700 and a contingent payment at maturity of \$23,500. Assuming accrual periods ending on June 30 and December 31 of each year, the debt instrument has an adjusted issue price of \$21,200 on January 1, 1999.

B's basis in the debt instrument on January 1, 1999 is \$18,200. *B* must allocate the \$3,000 difference between that basis and the \$21,200 adjusted issue price of the debt instrument on January 1, 1999 to daily portions of interest or to projected payments. The allocated amounts will be positive adjustments taken into account at the time the daily portions accrue or the payments are made.

Assume that, because of a decrease in the relevant index, the expected value of the contingent payment has decreased by about 9 percent. Based on forward prices on January 1, 1999, *B* determines that approximately \$2,100 of the difference between basis and adjusted issue price is allocable to the contingent payment. *B* allocates the remaining \$900 to daily portions of interest on a pro rata basis (that is, the amount allocated to an accrual period equals the product of \$900 and a fraction, the numerator of which is the total daily portions of interest for the accrual period and the denominator of which is the total daily portions remaining on the debt instrument on January 1, 1999). The allocation is reasonable.

Assume alternatively that, based on yields of comparable debt instruments and *B's* purchase price for the debt instrument, *B* determines that an appropriate yield for the debt instrument is 13 percent, compounded semiannually. Using this determination, *B* allocates \$1,115 of the difference between basis and adjusted issue price to daily portions of interest as follows: \$303.80 to the daily portions of interest for the taxable year ending December 31, 1999; \$368 to the daily portions of interest for the taxable year ending December 31, 2000; and \$443.20 to the daily portions of interest for the taxable year ending December 31, 2001. *B* allocates the remaining \$1,885 to the contingent payment at maturity. The allocation is reasonable.

A second set of special operating rules concerns interest accruals and adjustments when the amount of a contingent payment becomes fixed more than six months before the payment is due.ⁿ⁶⁸ The amount of the adjustment attributable to the payment is equal to the difference between the present value of the amount that is fixed and the present value of the projected amount of the contingent payment.ⁿ⁶⁹ The present value of each amount is determined by discounting the amount from the date the payment is due to the date the payment is fixed using a discount rate equal to the comparable yield on the debt instrument. The adjustment is treated as a positive or negative adjustment, as appropriate, on the date the contingent payment becomes fixed. The amount of any positive adjustment increases the adjusted issue price of the instrument and the holder's adjusted basis in the instrument; the amount of any negative adjustment works a decrease in both adjusted issue price and basis.ⁿ⁷⁰

Once the contingent payment becomes fixed, the payment is no longer treated as a contingent payment, the projected payment schedule for the debt instrument is modified prospectively to reflect the fixed amount of the payment, an accrual period ends on the day the contingent payment becomes fixed, and a new accrual period begins on the day after the day on which the contingent payment becomes fixed.ⁿ⁷¹

Example 8:

On December 31, 1996, *C*, a calendar year taxpayer, purchases a debt instrument at original issue for \$20,000. The instrument matures on December 31, 2002 and calls for the payment of \$20,000 at that time. The instrument also provides for payments on December 31, 1999 and December 31, 2002 of an amount equal to the excess of the average daily value of an index for the six-month period ending on September 30 of the preceding year over a specified amount. *C* uses annual accrual periods.

The debt instrument's comparable yield is 10 percent, compounded annually, and the instrument's projected payment schedule consists of a payment of \$5,000 on December 31, 1999 and a payment of \$28,800 on December 31, 2002. *C* includes \$2,000 of daily portions of interest in income in 1997. *C's*

adjusted basis in the debt instrument and the debt instrument's adjusted issue price on December 31, 1997 is \$22,000.

According to the projected payment schedule, *C* should include \$2,200 of total daily portions of interest in income in 1998. Assume, however, that on September 30, 1998, the payment due on December 31, 1999 is fixed at \$6,000 rather than \$5,000. This gives rise to an adjustment on September 30, 1998 equal to the difference between the present value of the \$6,000 fixed amount and the present value of the \$5,000 projected payment. These present values are determined by discounting each amount from December 31, 1999 (the date the payment is due) to September 30, 1998 (the date the payment is fixed), using a discount rate equal to 10 percent, compounded annually. The present value of the fixed payment is \$5,326 and the present value of the projected payment is \$4,438. Therefore, *C* has a positive adjustment of \$888 (\$5,326 less \$4,438) on September 30, 1998.

C's accrual period ends on September 30, 1998, the date the contingent payment due on December 31, 1999 is fixed. The daily portions of interest on the debt instrument from January 1, 1998 to September 31, 1998 total \$1,630. *C*'s adjusted basis in the instrument and its adjusted issue price are increased by \$2,518 (\$1,630 daily portions of interest plus \$888 positive adjustment) to \$24,518. For purposes of all future accrual periods, including the new accrual that begins on October 1, 1998 and ends on December 31, 1998, the debt instrument's projected payment schedule is modified to reflect a fixed payment of \$6,000 on December 31, 1999. Based on the new adjusted issue price of the instrument and the new projected payment schedule, the yield on the debt instrument does not change.

Based on the modified projected payment schedule, \$591 of interest accrues during the accrual period that begins on October 1, 1998 and ends on December 31, 1998. Because *C* has no other adjustments during 1998, the \$888 positive adjustment on September 30, 1998 is a net positive adjustment, and, thus, additional interest for 1998. *C*'s total interest inclusion for 1998 is \$3,109 (\$1,630 plus \$888 plus \$591). *C*'s adjusted basis in the debt instrument and the instrument's adjusted issue price on December 31, 1998 are increased from \$24,518 to \$25,109 to reflect the total daily portions of interest for the October 1, 1998 to December 31, 1998 accrual period.

C has no adjustments in 1999. Based on the modified projected payment schedule, *C* includes \$2,511 total daily portions of interest in income. (*C* would have included \$2,420 under the original projected payment schedule.) On December 31, 1999, *C*'s adjusted basis in the debt instrument and the adjusted issue price of the debt instrument are increased by the \$2511 daily portions of interest included in income in 1999, and reduced by \$6,000, the amount of the fixed payment on December 31, 1999.

If a taxpayer has an option to put or call the debt instrument, to exchange the debt instrument for other property, or to extend the maturity date of the debt instrument, the projected payment schedule is determined by using the principles of *Regulations Section 1.1272-1(c)(5)*.ⁿ⁷² Under that provision, the issuer will be deemed to exercise or not exercise an option in a manner that minimizes the yield on the debt instrument, and a holder will be deemed to exercise or not exercise an option in a manner that maximizes the yield on the debt instrument. If an option to put, call, or exchange the debt instrument is assumed to be exercised under the principles of *Regulations Section 1.1272-1(c)(5)*, it is generally reasonable to assume that the option is exercised immediately before it expires. If the option is exercised at an earlier time, it is treated as a sale or exchange of the debt instrument.

If all the remaining contingent payments on a debt instrument become fixed substantially contemporaneously, any positive or negative adjustment on the instrument is spread over the remaining term of the instrument in a reasonable manner.ⁿ⁷³ For this purpose, a payment is treated as a fixed payment if all remaining contingencies with respect to the payment are remote or incidental.

The regulations provide a method for contingent payment debt instruments not subject to the noncontingent bond

method. In general, the method applies to a debt instrument that is not publicly traded, is issued in a sale or exchange of nonpublicly traded property, and has an issue price determined under *IRC Section 1274*.ⁿ⁷⁴

Under the method, the payments on the "overall" debt instrument are divided into noncontingent payments and contingent payments.ⁿ⁷⁵ The noncontingent payments are treated as a separate debt instrument and are taxed under the general OID rules.ⁿ⁷⁶ However, no interest payments on the separate debt instrument are qualified stated interest payments, and the *de minimis* rules do not apply to the separate debt instrument. The issue price of the separate debt instrument is the issue price of the overall debt instrument determined under *IRC Section 1274*.

In general, a contingent payment is not taken into account until the payment is made.ⁿ⁷⁷ A contingent payment is treated as principal in an amount equal to the present value of the payment, calculated by discounting the payment at the test rate from the date that the payment is made to the issue date.ⁿ⁷⁸ The amount in excess of the portion treated as a payment of principal is considered a payment of interest.ⁿ⁷⁹

Example 9:

On January 1, 1997, A sells unencumbered real property to B. As consideration for the sale, B pays A \$2 million in cash and issues A a debt instrument that matures on December 31, 2001. The debt instrument provides for a payment of principal at maturity of \$10 million and a contingent payment of interest on December 31 of each year equal to a fixed percentage of the gross rents that B receives from the property in that year. Assume that the debt instrument is not issued in a potentially abusive situation. Assume further that, on January 1, 1997, the applicable federal short-term rate is 5 percent, compounded semiannually, and the applicable federal mid-term rate is 6 percent, compounded semiannually.

The stated principal amount of the debt instrument is \$10 million. The right to the noncontingent payment is treated as a separate debt instrument with an imputed principal amount and issue price of \$7,224,400 (the present value, as of the issue date, of the \$10 million noncontingent payment due at maturity, calculated using a discount rate equal to the applicable federal mid-term rate, compounded semiannually). Thus, the \$2,775,600 difference between the issue price and the stated principal amount of the debt instrument is OID.

Assume that the amount of contingent interest that is fixed and payable on December 31, 1997 is \$400,000. This payment is treated as consisting of a principal payment of \$380,700, the present value of the payment, determined by discounting the payment at a test rate of 5 percent (the applicable federal short-term rate), compounded semiannually from the date the payment is fixed to the issue date; the remainder of the payment, \$19,300, is treated as interest includable by A and deductible by B in their respective taxable years in which December 31, 1997 falls. The remaining contingent payments on the debt are accounted for in like fashion, using a test rate of 5 percent, compounded semiannually, for the contingent payments due on December 31, 1998 and December 31, 1999, and a test rate of 6 percent, compounded semiannually, for the contingent payments due on December 31, 2000 and December 31, 2001.

If a contingent payment on a debt instrument not subject to the noncontingent bond method becomes fixed more than six months before the payment is due, the issuer and holder are treated as if the issuer had issued a separate debt instrument on the date the amount of the payment becomes fixed, maturing on the date the payment is due.ⁿ⁸⁰ This separate debt instrument is treated as a debt instrument to which *IRC Section 1274* applies. The stated principal amount of this separate debt instrument is the amount of the payment that becomes fixed. An amount equal to the issue price is characterized as interest or principal under the rules set forth in the paragraph preceding Example 9, and accounted for in the year in which the payment becomes fixed, as if this amount had been paid by the issuer to the holder on the date

that the amount of the payment became fixed. To determine the issue price of the separate debt instrument, all payments under the separate debt instrument are discounted at the test rate from the maturity date of the separate debt instrument to the date the payment becomes fixed.ⁿ⁸¹

Example 10:

The facts are the same as in Example 9, except that the contingent payment of interest that is fixed at \$400,000 on December 31, 1997, is not payable until the maturity date, December 31, 2001. The treatment of the noncontingent payment is the same as in Example 9.

Because the \$400,000 payment fixed on December 31, 1997 is not payable until the maturity date, a separate debt instrument with a maturity date of December 31, 2001 (the date the payment is due) is deemed to be issued on December 31, 1997 (the date the payment is fixed). The stated principal amount of this separate debt instrument is \$400,000, the amount that became fixed on December 31, 1997. The imputed principal amount and issue price of the separate instrument is \$306,600, the present value as of December 31, 1997, of the \$400,000 payment, calculated by using a discount rate equal to the test rate of the overall debt instrument (6 percent, compounded semiannually). An amount equal to the issue price of the separate debt instrument is treated as an amount paid on December 31, 1997. The amount of the deemed payment characterized as principal is \$291,800, the present value, as of January 1, 1997 (the issue date of the overall debt instrument) of the deemed payment, determined by using a discount rate of 5 percent, compounded semiannually. The amount of the deemed payment treated as interest is \$14,800 (the difference between the imputed principal amount and issue price of \$306,600 and \$291,800, the portion of the deemed payment treated as principal), and is includable in gross income by *A* and deductible by *B* in their respective years in which December 31, 1997 occurs.

Just as in the case of debt instruments subject to the noncontingent bond method, the regulations dealing with debt instruments not subject to the noncontingent bond method contain rules for a holder whose basis in a debt instrument is different from the instrument's adjusted issue price. The rules do not apply if the holder is reporting income under the installment method.ⁿ⁸²

The holder must allocate basis to the right to receive noncontingent payments (the noncontingent component of the debt instrument) and to any separate debt instruments that arise when a contingent payment becomes fixed more than six months before the payment is due in an amount up to the adjusted issue price of the noncontingent component and the adjusted issue prices of the separate debt instruments; the remaining basis, if any, is allocated to the right to receive contingent payments (the contingent component of the debt instrument).ⁿ⁸³ Any difference between the holder's basis in the noncontingent component and the adjusted issue price of the noncontingent component, and any difference between the holder's basis in a separate debt instrument and the adjusted issue price of the separate debt instrument, is taken into account under the rules for market discount, premium, and acquisition premium that apply to a noncontingent debt instrument.ⁿ⁸⁴

For the contingent component, amounts received by the holder that are treated as principal payments reduce the holder's basis in the contingent component.ⁿ⁸⁵ If the holder's basis in the contingent component is reduced to zero, any additional principal payments on the contingent component are treated as gain from the sale or exchange of the debt instrument. Any basis remaining on the contingent component after the final contingent payment is made increases the holder's basis in the noncontingent component. If there are no remaining noncontingent payments, the remaining basis is treated as a loss on the sale or exchange of the debt instrument.

The Service has ruled that the noncontingent bond method applies to a debt instrument that is convertible into stock of the issuer and provides for one or more contingent cash payments.ⁿ⁸⁶ The tax consequences discussed in the ruling are

based upon the following example:

Example 11:

On January 1, 2002, X Corporation issues for \$6.25 million a 20-year debt instrument with a stated principal amount of \$10 million. Except for the contingent interest payments described below, the debt instrument does not provide for any stated interest. The debt instrument is convertible at any time into a number of shares of X Corporation common stock having a value, on the date of issue of the debt instrument, that is significantly less than \$6.25 million. The debt instrument is part of an issue that is not marketed or sold in substantial part to persons for whom the inclusion of interest from the instrument in the issue is not expected to have a substantial effect on their United States tax liability.

The debt instrument provides that, beginning after January 1, 2005, interest ("contingent interest") is payable for any six-month period ending on June 30 or December 31 if the average market price of the instrument for a measurement period before the applicable six-month period is greater than 120 percent of the instrument's accreted value (the issue price of the instrument plus the economic accrual to any date of determination of a portion of the difference between the issue price and the stated principal amount at maturity). The amount of contingent interest that is payable is equal to the greater of (1) the regular cash dividend per share of X Corporation common stock for the six-month period multiplied by the number of shares into which the debt instrument may be converted, or (2) a given percent of the average market price of the debt instrument for the measurement period. The contingent interest is neither a remote nor incidental contingency within the meaning of *Regulation Section 1.1275-2(h)*.

On or after January 1, 2005, X Corporation has the option to redeem the debt instrument for cash in an amount equal to the instrument's accreted value as of the redemption date. In addition, the holder of the debt instrument has the option to put the instrument to the corporation on January 1, 2005, or January 1, 2012, for an amount equal to the instrument's accreted value as of each such date. If the holder exercises the option, X Corporation can satisfy its obligation with cash, shares of X Corporation's common stock, or a combination of cash and shares. Taking into account the likelihood of conversion of the debt instrument and the likelihood that the instrument will be put by the holder, it is not substantially certain that a substantial amount of the principal or interest on the debt instrument will be required to be paid in stock or will be payable in stock at the option of the issuer.

After having ruled that the noncontingent bond method applies to the type of debt instrument issued by X Corporation, the Service then stated that the yield at which the corporation would issue a comparable fixed rate nonconvertible debt instrument is the yield to be used to determine the instrument's comparable yield and the accruals of interest on it. The Service also ruled that the debt instrument is not a disqualified debt instrument under *IRC Section 163(l)*,ⁿ⁸⁷ and that *IRC Section 249* does not affect the corporation's ability to deduct periodic interest accruals on the instrument.ⁿ⁸⁸ However, if the debt instrument is converted into X Corporation stock having a value in excess of the debt instrument's adjusted issue price, *IRC Section 249* may preclude a deduction of the excess.

[c] Tax-Exempt Contingent Payment Debt Instruments.

The noncontingent bond method described in § 17.02A[2][b] is generally, but not entirely, applicable to tax-exempt obligations that provide for contingent payments.ⁿ⁸⁹ The first exception relates to the tax-exempt nature of the obligation; the daily portions of interest are not included in gross income by the holder.ⁿ⁹⁰

The regulations divide tax-exempt obligations into two categories: (1) certain tax-exempt obligations with interest-based or revenue-based payments, and (2) all other tax-exempt obligations.ⁿ⁹¹ Different modifications to the noncontingent bond method apply to the two categories.

A tax-exempt obligation provides for interest-based payments if the obligation would otherwise qualify as a variable rate debt instrument except that: (1) the obligation provides for more than one fixed rate; (2) the obligation provides for one or more caps, floors, or governors (or similar restrictions) that are fixed as of the issue date; (3) the interest on the obligation is not compounded or paid at least annually; or (4) the obligation provides for interest at one or more rates equal to the product of a qualified floating rate and a fixed multiple greater than zero and less than .65, increased or decreased by a fixed rate.ⁿ⁹² A tax-exempt obligation provides for revenue-based payments if the obligation: (1) is issued to refinance (including a series of refinancings) an obligation (in a series of refinancings, the original obligation), the proceeds of which were used to finance a project or enterprise; and (2) would otherwise qualify as a variable rate debt instrument except that it provides for stated interest payments at least annually based on a single fixed percentage of the revenue, value, change in value, or other similar measure of the refinanced project or enterprise.ⁿ⁹³

The following modifications to the noncontingent bond method apply to any tax-exempt obligation with interest-based or revenue-based payments:ⁿ⁹⁴

- (1) All daily portions of interest and any net positive adjustment is treated as interest that is tax-exempt under *IRC Section 103*.
- (2) A net negative adjustment reduces the amount of tax-exempt interest the holder would otherwise account for on the obligation for the taxable year. If the net negative adjustment exceeds this amount, the excess is a nondeductible, noncapitalizable loss, except as indicated in the next paragraph. If a regulated investment company has such a loss, the company must use the loss to reduce its tax-exempt interest on other tax-exempt obligations held during the taxable year.
- (3) Any gain recognized on the sale, exchange, or retirement of the obligation is gain from the sale or exchange of the obligation; this means that the gain will be capital gain if the obligation is a capital asset in the hands of the holder. Any loss recognized on disposition is treated as a net negative adjustment. However, the holder can claim a loss from the sale or exchange of the obligation to the extent the holder has not received in cash or property the sum of the holder's original investment in the obligation and any amounts includable in income because the holder's basis in the obligation is less than the obligation's adjusted issue price.

The following modifications to the noncontingent bond method apply if the tax-exempt obligation does not provide for interest-based or revenue based payments:ⁿ⁹⁵

- (1) The comparable yield for the obligation is the greater of the obligation's yield, determined without regard to the contingent payments, and the tax-exempt applicable federal rate that applies to the obligation.
- (2) The daily portions of interest are interest that is tax-exempt under *IRC Section 103*.
- (3) A net positive adjustment on the obligation is treated as gain to the holder from the sale or exchange of the obligation in the taxable year of the adjustment. A net negative adjustment on the obligation is treated as a loss to the holder from the sale or exchange of the obligation in the year of the adjustment.
- (4) Any gain or loss recognized on the sale, exchange, or retirement of the obligation is gain or loss from the sale or exchange of the obligation, producing capital gain or loss if the obligation is a capital asset in the hands of the holder.

The following special rules apply to all tax-exempt contingent payment obligations where the holder's basis in the

obligation is different from the adjusted issue price of the obligation:ⁿ⁹⁶

- (1) If the holder's basis exceeds the adjusted issue price, the holder, upon acquiring the obligation, must allocate the difference to daily portions of interest on a yield to maturity basis over the remaining term of the obligation. The amount allocated to a daily portion of interest is not deductible by the holder, but the holder's basis in the obligation is reduced by the amount allocated to a daily portion of interest on the date the daily portion accrues.
- (2) If the holder's basis is less than the adjusted issue price, the holder must make the same allocation, but now the allocated amount is includable in income by the holder as ordinary income on the date the daily portion of interest accrues. The holder's adjusted basis is increased by the amount includable in income on the date the daily portion accrues.
- (3) The rules for accruing premium and discount in *IRC Sections 171, 1276, and 1288* do not apply.

[d] Variable Rate Debt Instruments.

A variable rate debt instrument is one that meets the following conditions:ⁿ⁹⁷

- (1) The issue price of the debt instrument must not exceed the total noncontingent principal payments by more than an amount equal to the lesser of (i) .015 multiplied by the product of the total noncontingent payments and the number of complete years to maturity from the issue date (or, in the case of an installment obligation, the weighted average maturity); or (ii) 15 percent of the total noncontingent principal payments.
- (2) The debt instrument must provide for stated interest (compounded or paid at least annually) at (a) one or more qualified floating rates; (b) a single fixed rate and one or more qualified floating rates; (c) a single objective rate; or (d) a single fixed rate and a single objective rate that is a qualified inverse floating rate.
- (3) The debt instrument must provide that a qualified floating rate or objective rate in effect at any time during the term of the instrument is set at the current value of that rate, that is, the value of the rate on any day that is no earlier than three months prior to the first day on which that value is in effect and no later than one year following that fixed date.
- (4) The debt instrument must not provide for any contingent principal payments.

A variable rate is a qualified floating rate if variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which the debt instrument is denominated.ⁿ⁹⁸ The rate may measure contemporaneous variations in borrowing costs for the issuer of the debt instrument or issuers in general. If a debt instrument provides for two or more qualified floating rates that can reasonably be expected to have approximately the same values throughout the term of the instrument, the qualified floating rates together constitute a single qualified floating rate. Two or more qualified floating rates will be conclusively presumed to meet the requirements of the preceding sentence if the values of all rates on the issue date are within .25 percentage points (25 basis points) of each other.

Example 1:

A issues a debt instrument that provides for annual payments of interest at a rate equal to the value on the one-year London Interbank Offered Rate (LIBOR) at the end of each year. Because variations in the

value of one-year LIBOR over the term of the debt instrument can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds over that term, the rate is a qualified floating rate.

Example 2:

A issues a debt instrument that provides for annual payments of interest at a rate equal to 2 percent plus the current value, at the end of each year, of the average yield of one-year Treasury securities. As in Example 1, the rate is a qualified floating rate because variations in the value of the interest rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds.

Example 3:

A issues a debt instrument that provides for a rate of interest that is periodically adjusted to equal the current interest rate of B Bank's commercial paper. The rate is a qualified floating rate; variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds.

Generally, a multiple of a qualified floating rate is not a qualified floating rate.ⁿ⁹⁹ However, a variable rate is a qualified floating rate if it is equal to either (i) the product of a qualified floating rate and a qualified fixed multiple that is greater than .65 but not more than 1.35; or (ii) the product of a qualified floating rate and a fixed multiple that is greater than .65 but not more than 1.35, increased or decreased by a fixed rate.ⁿ¹⁰⁰

Example 4:

A issues a debt instrument with annual interest payments at a rate equal to twice the value of one-year LIBOR as of the payment date. Although the value of one-year LIBOR is a qualified floating rate, the interest rate of twice that value is a multiple that exceeds 1.35 of a qualified floating rate, and, thus, cannot be a qualified floating rate.

A variable rate is not a qualified floating rate if the maximum or minimum stated interest rate, or increase or decrease in the stated interest rate, (cap, floor, or governor) is subject to restrictions.ⁿ¹⁰¹ Nevertheless, a variable rate subject to the following restrictions will be a qualified floating rate: (i) a cap, floor, or governor that is fixed throughout the term of the debt instrument; (ii) a cap or similar restriction that is not reasonably expected as of the issue date to cause the yield on the debt instrument to be significantly less than the expected yield determined without the cap; (iii) a floor or similar restriction that is not reasonably expected as of the issue date to cause the yield on the debt instrument to be significantly more than the expected yield determined without the floor; or (iv) a governor or similar restriction that is not reasonably expected as of the issue date to cause the yield on the debt instrument to be significantly more or less than the expected yield without the governor.

An objective rate is a rate (other than a qualified floating rate) that is determined using a single fixed formula and that is based on objective financial or economic information.ⁿ¹⁰² Under this definition, an objective rate generally includes a rate that is based on one or more qualified floating rates or on the yield of actively traded personal property (within the meaning of *IRC Section 1092(d)(1)*). An objective rate does not include a rate that is based on information that is within the control of the issuer (or a related party within the meaning of *IRC Section 267(b)* or *707(b)(1)*), such as dividends, profits, or the value of the issuer's stock; it does include a rate based on the credit quality of the issuer.

Example 5:

A issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to the percentage increase, if any, in the value of an index for the year immediately preceding the

payment. The rate is an objective rate because it is based on objective financial information.

Example 6:

A issues a debt instrument that provides for annual interest payments equal to 20 percent of A's net profits during the year immediately preceding the payment. The rate is not an objective rate because it is based on objective information that is unique to the issuer's circumstances.

Example 7:

A issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to 4 percent plus the annual percentage change in a general inflation index. Under the proposed regulations, the rate is an objective rate because it is based on objective economic information.

An objective rate is treated as a qualified inverse floating rate if (i) the rate is equal to a fixed rate minus a qualified floating rate; and (ii) the variations in the rate can reasonably be expected to inversely reflect contemporaneous variations in the cost of newly borrowed funds, disregarding any caps, floors, or governors.ⁿ¹⁰³ In the case of a tax-exempt obligation, a variable rate is an objective rate only if it is a qualified inverse floating rate or a qualified inflation rate.ⁿ¹⁰⁴ A rate is a qualified inflation rate if the rate measures contemporaneous changes in inflation based on a general inflation index, such as the Consumer Price Index.

Example 8:

A issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to 12 percent minus the value of one-year LIBOR as of the payment date. On the issue date, the value of one-year LIBOR is 6 percent. Because the rate can reasonably be expected to inversely reflect contemporaneous variations in the cost of newly borrowed funds, the rate is a qualified inverse floating rate. If the value of one-year LIBOR on the issue date was 11 percent rather than 6 percent, the rate would not be a qualified inverse floating rate because the rate could not reasonably be expected to inversely reflect contemporaneous variations in the cost of newly borrowed funds.

Example 9:

On January 1, 1997, a municipality issues a tax-exempt debt instrument that provides for annual interest payments at the end of each year at a rate of 4 percent plus the annual percentage change in the Consumer Price Index. However, the rate cannot be less than zero. The rate is a qualified inflation rate because it is based on a general inflation index.

A variable rate of interest on a debt instrument is not an objective rate if it is reasonably expected that the average value of the rate during the first half of the instrument's term will be either significantly less or significantly greater than the average value of the rate during the final half of the instrument's term.ⁿ¹⁰⁵

In ascertaining whether a variable rate debt instrument to which *IRC Section 1274* applies provides for adequate stated interest, the imputed principal amount of a variable debt instrument that provides for stated interest at a qualified floating rate or rates is determined by assuming that the instrument provides for a fixed rate of interest for each accrual period to which a qualified floating rate applies.ⁿ¹⁰⁶ The assumed fixed rate for each accrual period is the greater of (a) the value of the applicable qualified floating rate as of the first date on which there is a binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated; or (b) the value of the applicable qualified floating rate as of the date on which the sale or exchange occurs.

Example 10:

On January 1, 1997, A sells B nonpublicly traded property. In partial consideration for the sale, B issues a debt instrument in the principal amount of \$2 million, payable in 5 years. The debt instrument provides for interest payable monthly at a rate of one percentage point above the average prime rate of C Bank for the month preceding the month of the interest payment. Assume that the test rate applicable to the debt instrument is 6.5 percent, compounded monthly. Assume further that one percentage point above the prime lending rate of C Bank on the date of sale is 8 percent, compounded monthly, which is greater than one percentage point above the prime lending rate of C Bank on the first date on which there is a binding written contract that substantially sets forth the terms under which the sale is consummated.

The debt instrument is a variable rate debt instrument that provides for stated interest at a qualified floating rate. The debt instrument is treated as if it provided for a fixed rate of interest equal to 8 percent, compounded monthly. Because this rate is greater than the test rate of 6.5 percent, compounded monthly, the debt instrument provides for adequate stated interest.

If, as a result of interest rate restrictions (such as a cap), the expected yield of the debt instrument taking the restrictions into account is significantly less than the expected yield of the debt instrument without regard to the restrictions, the interest payments on the debt instrument (other than fixed interest payments) are treated as contingent payments.ⁿ¹⁰⁷ The imputed principal amount of a variable rate debt instrument that provides for stated interest at a single objective rate is also determined by treating the interest payments as contingent payments.ⁿ¹⁰⁸

Example 11:

On July 1, 1997, A sells nonpublicly traded property to B in return for a debt instrument of \$20 million, payable on July 1, 2007. The instrument provides for interest to be paid on each July 1 during the term of the instrument, at the federal short-term rate for June of the same year, but with an interest rate cap of 9 percent, compounded annually. Assume that, as of the date the test rate of interest for the debt instrument is determined, the federal short-term rate is 8.5 percent, compounded annually, and that, as a result of the interest rate cap, the expected yield of the debt instrument is significantly less than the expected yield without the interest rate cap. The variable payments will be treated as contingent payments.

The amount and accrual of OID and qualified stated interest on a variable rate debt instrument depends on the stated interest provision. If the instrument provides for stated interest at a single qualified floating rate or objective rate that is payable in cash or in property (other than a debt instrument of the issuer), or that will be constructively received under *IRC Section 451*, at least annually, all stated interest with respect to the debt instrument is qualified stated interest, and the amount of OID, if any, is determined under the rules applicable to fixed rate instruments by assuming that the variable rate is a fixed rate equal to (a) in the case of a qualified floating rate or qualified inverse floating rate, the value, as of the issue date, of the qualified floating rate or qualified inverse floating rate; or (b) in the case of an objective rate (other than a qualified inverse floating rate), a fixed rate that is reasonably expected for the debt instrument.ⁿ¹⁰⁹ If a variable rate debt instrument does not provide for stated interest at a single qualified floating rate or objective rate that is unconditionally payable in cash or property and does not provide for interest payable at a fixed rate (other than an initial fixed rate), the amount of interest and OID accruals are determined by the following process:ⁿ¹¹⁰

(1) Determine the fixed rate substitute for each variable rate provided under the debt instrument. The fixed rate substitute for each qualified floating rate provided for in the debt instrument is the value of each rate as of the issue date. If, however, a variable rate debt instrument provides for two or more qualified floating rates with different intervals between interest adjustment dates, the fixed rate substitutes for the rates must be based on intervals that are equal in length. The fixed rate substitute for a qualified inverse floating rate is the value of the qualified inverse floating rate as of the issue date. The

fixed rate substitute for an objective rate (other than a qualified inverse floating rate) is a fixed rate that reflects the yield that is reasonably expected for the debt instrument.

(2) Construct the equivalent fixed rate debt instrument. The equivalent fixed rate debt instrument has terms that are identical to those provided under the variable rate debt instrument, except that the equivalent fixed rate debt instrument provides for the fixed rate substitutes determined above instead of the qualified floating rates or objective rate provided under the variable rate debt instrument.

(3) Determine the amount of qualified stated interest and OID with respect to the equivalent fixed rate debt instrument. The amount of qualified stated interest and OID, if any, are determined for the equivalent fixed rate debt instrument under the rules applicable to fixed rate debt instruments and are taken into account as if the holder held the equivalent fixed rate debt instrument.

(4) Make appropriate adjustments for actual variable rates. Qualified stated interest or OID allocable to an accrual period must be increased (or decreased) if the interest actually accrued or paid during an accrual period exceeds (or is less than) the interest assumed to be paid during the accrual period under the equivalent fixed rate debt instrument. The increase or decrease is an adjustment to qualified stated interest for the accrual period if the equivalent fixed rate debt instrument provides for qualified stated interest and the increase or decrease is reflected in the amount actually paid during the accrual period. Otherwise, the increase or decrease is an adjustment to OID for the accrual period.

Example 12:

On January 1, 1997, A purchases at original issue for \$180,000, a variable rate debt instrument that matures on January 1, 1999 and has a stated principal amount of \$200,000, payable at maturity. The instrument provides for annual payments of interest on January 1 of each year, beginning January 1, 1998. The amount of interest payable is the value of annual LIBOR on the payment date. The value of annual LIBOR on January 1, 1997 and January 1, 1998 is 5 percent, compounded annually. The value of annual LIBOR on January 1, 1999 is 7 percent compounded annually. A uses annual accrual periods.

The equivalent fixed rate debt instrument for the variable rate debt instrument is a two-year debt instrument that has an issue price of \$180,000 and a stated principal amount of \$200,000. The equivalent fixed rate debt instrument provides for interest payments of \$10,000 at the end of each year.

The equivalent fixed rate debt instrument has \$20,000 of OID; it provides for qualified stated interest payments of \$10,000 annually. Thus, the equivalent fixed rate debt instrument has a yield of 10.82 percent, compounded annually. The amount of OID allocable to the first annual accrual period is \$9,476 ($(\$180,000 \times 10.82 \text{ percent}) - \$10,000$), and the amount of OID allocable to the second annual accrual period is \$10,524 ($\$200,000 - \$189,476$). The \$4,000 difference between the \$14,000 interest payment actually made at maturity and the \$10,000 payment assumed to be made at maturity under the equivalent fixed rate debt instrument is treated as additional qualified stated interest for the period.

If a variable rate debt instrument provides for stated interest either at one or more floating rates or at a qualified inverse floating rate and, in addition, provides for stated interest at a single fixed rate (other than an initial fixed rate), the first three steps in the OID and interest determination process described above are modified by treating the debt instrument as if it provided for a qualified floating rate (or qualified inverse floating rate, if the debt instrument provides for such a rate) rather than the fixed rate. The replacement rate must be such that the fair market value of the variable rate debt instrument as of the issue date would be approximately the same as the fair market value of an otherwise identical debt instrument that provides for a qualified floating rate (or qualified inverse floating rate) instead of the fixed rate.ⁿ¹¹¹

Example 13:

On January 1, 1997, A purchases at original issue, for \$200,000, a variable rate debt instrument with a stated principal amount of \$200,000 that matures on January 1, 2003. The debt instrument provides for payment of interest on each January 1 during the term of the instrument. The interest rate for the first four years is 5 percent, compounded annually. For the last two years, the interest rate is the value of one-year LIBOR, as of the payment date, plus 300 basis points (3 percent). On January 1, 1997, the value of one-year LIBOR is 3 percent, compounded annually. On January 1, 1997, the variable rate debt instrument has approximately the same fair market value as an otherwise identical debt instrument that provides for an interest rate equal to the value of one-year LIBOR, as of the payment date, for the first four years.

The variable rate debt instrument is treated as if it provided for an interest rate equal to the value of one-year LIBOR, as of the payment date, for the first four years of the term of the instrument. The equivalent fixed rate debt instrument for the variable rate debt instrument is a six-year debt instrument that has an issue price and stated principal amount of \$200,000 and provides for interest payments of \$6,000 for the first four years and \$12,000 for the last two years.

The equivalent fixed rate debt instrument has OID of \$12,000 because a portion of the interest (300 basis points) is not a qualified stated interest payment. The \$12,000 of OID is allocated over the six-year term of the debt instrument. The difference between the \$10,000 actually paid in the first four years and the \$6,000 assumed to be paid on the equivalent fixed rate debt instrument in those years is an adjustment to qualified stated interest, as is any difference between the amount actually paid in the last two years and the \$12,000.

If a variable rate debt instrument provides for stated interest at a fixed rate for an initial period, and further provides that on the date immediately following the end of the initial interval (effective date), the stated interest rate will be a rate determined under a procedure (eg, an auction procedure) so that the fair market value on the effective date will be a fixed rate (reset value), the accrual of OID is calculated by treating the variable rate instrument as (a) maturing on the date immediately preceding the effective date for an amount equal to the reset value; and (b) reissued on the effective date for an amount equal to the reset value.ⁿ¹¹²

[e] Integration of Qualifying Debt Instruments.

Regulations Section 1.1275-6 provides for the integration of a qualifying debt instrument with a hedge or combination of hedges if the combined cash flows of the components are substantially equivalent to the cash flows on a fixed or variable rate debt instrument. The purpose of the rules is to permit a more appropriate determination of the character and timing of income, deductions, gains, or losses that would be permitted by a separate accounting for the components. The rules affect only the taxpayer who holds or issues the qualifying debt instrument and enters into the hedge.

A qualifying debt instrument is either a contingent payment debt instrument or variable rate debt instrument (including an integrated transaction), other than (a) a tax-exempt obligation, (b) a debt instrument to which *IRC Section 1276(a)(6)* applies (certain interests held in, or mortgages held by, a REMIC, and certain other debt instruments with payments subject to acceleration), and (c) contingent debt instruments issued for nonpublicly traded property.ⁿ¹¹³ An integrated transaction consists of a qualifying debt instrument and a "Section 1.1275-6 hedge" if all of the following requirements are satisfied:ⁿ¹¹⁴

- (1) The taxpayer satisfies a special identification requirement on or before the date the taxpayer enters into the hedge.ⁿ¹¹⁵

(2) None of the parties to the hedge are related within the meaning of *IRC Section 267(b)* or *707(b)(1)* or, if the parties are related, the party providing the hedge uses, for federal income tax purposes, a mark-to-market method of accounting for the hedge and all similar or related transactions.

(3) Both the qualifying debt instrument and the hedge are entered into by the same individual, partnership, trust, estate, or corporation (regardless of whether the corporation is a member of an affiliated group of corporations that files a consolidated return).

(4) With respect to a foreign person engaged in a United States trade or business that issues or acquires a qualifying debt instrument or enters into a Section 1.1275-6 hedge, all items of income and expense associated with the instrument or hedge (other than interest that is deductible by a foreign corporation under *Regulations Section 1.882-5*) would have been effectively connected with the United States trade or business throughout the term of the synthetic debt instrument had Proposed *Regulations Section 1.1275-6* not applied.

(5) The qualifying debt instrument, any other debt instrument that is part of the same issue as the qualifying debt instrument, or the hedge cannot have been part of an integrated transaction entered into by the taxpayer that has been terminated or otherwise legged out within the 30 days immediately preceding the date that would be the issue date of the synthetic debt instrument.

(6) The qualifying debt instrument is issued or acquired by the taxpayer on or before the date of the first payment on the *Regulations Section 1.1275-6* hedge, whether or not received by the taxpayer (including a payment made to purchase the hedge). If the qualifying debt instrument is issued or acquired by the taxpayer after, but substantially contemporaneously with, the date of the first payment on the hedge, the qualifying debt instrument is treated as meeting the requirements of the preceding sentence.

(7) Neither the *Regulations Section 1.1275-6* hedge nor the qualifying debt instrument was, with respect to the taxpayer, part of a straddle prior to the issue date of the synthetic debt instrument.

A Section 1.1275-6 hedge is any financial instrument such that the combined cash flows of the financial instrument and the qualifying debt instrument permit the calculation of a yield to maturity, or the right to the combined cash flows would qualify as a variable rate debt instrument that pays interest at a qualified floating rate or rates (except for the requirement that the interest payments be stated as interest).ⁿ¹¹⁶ However, a taxpayer cannot treat a debt instrument it issues as a Section 1.1275-6 hedge of a debt instrument it holds, and cannot treat a debt instrument it holds as a Section 1.1275-6 hedge of a debt instrument it issues.ⁿ¹¹⁷

For this purpose, a financial instrument is a spot, forward, or futures contract, an option, a notional principal contract, a debt instrument, or a similar instrument, or combination or series of financial instruments; stock is not a financial instrument.ⁿ¹¹⁸

The Service can treat a qualifying debt instrument and a financial instrument entered into by the taxpayer or a related party as an integrated transaction if the combined cash flows on the qualifying debt instrument and financial instrument are substantially the same as the combined cash flows required for the financial instrument to be a Section 1.1275-6 hedge.ⁿ¹¹⁹ The circumstances under which the Service can require integration include, but are not limited to the following: (1) a taxpayer fails to identify a qualifying debt instrument and the Section 1.1275-6 hedge under the required identification rules; (2) a taxpayer issues or acquires a qualifying debt instrument and a related party enters into the Section 1.1275-6 hedge; (3) a taxpayer issues or acquires a qualifying debt instrument and enters into the Section 1.1275-6 hedge with a related party; and (4) the taxpayer legs out of an integrated transaction and within 30 days enters into a new Section 1.1275-6 hedge with respect to the same qualifying debt instrument or other debt instrument that is

part of the same issue.ⁿ¹²⁰

A taxpayer legs into an integrated transaction when a Section 1.1275-6 hedge is entered into after the date the qualifying debt instrument is issued or acquired by the taxpayer, and the requirements for an integrated transaction are satisfied on the date the hedge is entered into (leg-in date).ⁿ¹²¹ If a taxpayer legs into an integrated transaction, the taxpayer treats the qualifying debt instrument under the applicable rules for accruing interest and OID up to the leg-in date, with the day before the leg-in date being considered the end of an accrual period.ⁿ¹²² As of the leg-in date, the qualifying instrument is subject to the tax treatment of integrated transactions discussed below. If the taxpayer legs into an integrated transaction with a principal purpose of deferring or accelerating income or deductions on the qualifying debt instrument, the Service can (a) treat the qualifying debt instrument as sold for its fair market value on the leg-in date; or (b) refuse to allow the taxpayer to integrate the qualifying debt instrument and the Section 1.1275-6 hedge.ⁿ¹²³

If a taxpayer has integrated a qualifying debt instrument and a Section 1.1275-6 hedge, legging out means that, prior to the maturity of the synthetic debt instrument, the taxpayer disposes of or otherwise terminates all or a part of the qualifying debt instrument or Section 1.1275-6 hedge, the hedge ceases to meet the requirements for a Section 1.1275-6 hedge, or the taxpayer fails to meet any of the requirements of an integrated transaction.ⁿ¹²⁴ If the Service treats a qualifying debt instrument and a financial instrument as an integrated transaction, as described above, the Service can treat the taxpayer as not legging out. If, in a single nonrecognition transaction, a taxpayer disposes, or ceases to be primarily liable on, the qualifying debt instrument and the *Regulations Section 1.1275-6* hedge, the taxpayer is not treated as legging out, but, rather, the integrated transaction is treated under the rules governing the nonrecognition transaction.ⁿ¹²⁵

If the Service has integrated a qualifying debt instrument and financial instrument, legging out means that, prior to the maturity of the synthetic debt instrument, the requirements for integration either by the Service or the taxpayer are not met, and the Service agrees to allow the taxpayer to be treated as legging out.ⁿ¹²⁶

If a taxpayer legs out (or is treated as legging out) of an integrated transaction, the following rules apply:ⁿ¹²⁷

- (1) The transaction is treated as an integrated transaction during the time the transaction meets the requirements of an integrated transaction.
- (2) Immediately after the taxpayer legs out, the taxpayer is treated as selling or otherwise terminating the synthetic debt instrument for its fair market value and any income, deduction, gain, or loss is realized and recognized at that time.ⁿ¹²⁸ However, if a taxpayer legs out of an integrated transaction by disposing of or otherwise terminating a *Regulations Section 1.1275-6* hedge within 30 days of legging into the integrated transaction, any loss or deduction is not allowed. In such case, appropriate adjustments are made to the qualifying debt instrument for any disallowed loss; the adjustments are taken into account on a yield to maturity basis over the remaining term of the qualifying debt instrument.
- (3) If, immediately after the taxpayer legs out, the taxpayer holds or remains primarily liable on the qualifying debt instrument, adjustments are made to reflect any difference between the fair market value and the adjusted issue price of the debt instrument. If, immediately after the taxpayer legs out, the taxpayer is a party to a *Regulations Section 1.1275-6* hedge, the *Regulations Section 1.1275-6* hedge is treated as entered into at its fair market value.
- (4) If a holder of a contingent payment debt instrument legs into an integrated transaction with respect to the instrument and subsequently legs out, any gain recognized according to the rules described in the preceding two paragraphs is treated as income to the extent determined under the principles of *Regulations Section 1.1275-4(b)(8)(iii)(B)* (character of gain on the sale of a debt instrument all of the payments on which have been fixed). If the synthetic debt instrument would qualify as a variable rate

debt instrument, the equivalent fixed rate debt instrument determined under *Regulations Section 1.1275-5(e)* is used for this purpose.

An integrated transaction is generally treated as a single transaction by the taxpayer during the period that the transaction qualifies as an integrated transaction.ⁿ¹²⁹ With some exceptions discussed below, while a qualifying debt instrument and a Section 1.1275-6 hedge are part of an integrated transaction, neither the instrument nor the hedge is subject to the rules that would apply on a separate basis to each, including *IRC Section 1092* (governing the treatment of losses in straddles) or *Regulations Section 1.446-4* (accounting for hedge transactions). The rules that would govern the synthetic debt instrument generally govern the treatment of the integrated transaction. For example, the integrated transaction may be subject to *IRC Section 263(g)*, or, if the synthetic debt instrument would be part of a straddle, to *IRC Section 1092*. Generally, the synthetic debt instrument would be subject to the rules governing instruments with OID, as well as stripped bonds, with terms as follows:

- (1) The issue date of the synthetic debt instrument is the first date on which the taxpayer entered into all of the components of the synthetic debt instrument.
- (2) The term of the synthetic debt instrument is the period beginning on the issue date of the synthetic debt instrument and ending on the maturity date of the qualifying debt instrument.
- (3) The issue price of the synthetic debt instrument is the adjusted issue price of the qualifying debt instrument on the issue date of the synthetic debt instrument. If, as a result of entering into the *Regulations Section 1.1275-6* hedge, the taxpayer pays or receives one or more payments that are substantially contemporaneous with the issue date of the synthetic debt instrument, the payments reduce or increase the issue price as appropriate.
- (4) The adjusted issue price of the synthetic debt instrument is its issue price increased by the amount of any OID previously included in income and decreased by any payment made on the debt instrument other than a payment of qualified stated interest.
- (5) No amounts payable on the synthetic debt instrument are treated as qualified stated interest under the OID rules (*Regulations Section 1.1273-1(c)*).
- (6) If the synthetic debt instrument is a borrowing, the instrument's stated redemption price at maturity is the sum of all amounts paid or to be paid on the qualifying debt instrument and the Section 1.1275-6 hedge, reduced by amounts received or to be received on the hedge and any amounts treated as qualified stated interest on the synthetic debt instrument. If the synthetic debt instrument is held by the taxpayer, the instrument's stated redemption price at maturity is the sum of all amounts received or to be received on the qualifying debt instrument and the Section 1.1275-6 hedge, reduced by any amounts paid or to be paid on the hedge. If an amount paid or received on the *Regulations Section 1.1275-6* hedge is taken into account to determine the issue price of the synthetic debt instrument, the amount is not taken into account to determine the synthetic debt instrument's stated redemption price at maturity.
- (7) The source of interest income from the synthetic debt instrument is determined by reference to the source of income of the qualifying debt instrument under *IRC Sections 861(a)(1)* and *862(a)(1)* (see § 20.06[1][a][i]). For purposes of *IRC Section 904* (limitations on the foreign tax credit, discussed in § 20.02[4][e]), the character of interest from the synthetic debt instrument is determined by reference to the character of the interest income from the qualifying debt instrument. Interest expense is allocated and apportioned according to regulations under *IRC Section 861* or under *Regulations Section 1.882-5*.
- (8) Interest income resulting from the synthetic debt instrument entered into by a foreign person engaged

in a United States trade or business that issues or acquires a qualifying debt instrument or enters into a Section 1.1275-6 hedge is treated as effectively connected with a United States trade or business. Interest expense of such a foreign person is allocated and apportioned under *Regulations Section 1.882-5*.

(9) The synthetic debt instrument is not treated as a short-term obligation for purposes of *IRC Section 1272(a)(2)(C)*.

(10) If the Service requires integration, appropriate adjustments are made to the treatment of the synthetic debt instrument and, if necessary, the qualifying debt instrument and financial instrument. For example, the Service may treat a financial instrument that is not a Section 1.1275-6 hedge as such a hedge. The issue date of the synthetic debt instrument is the date determined appropriate by the Service to require integration.

The regulations provide for the retention of separate transaction rules in two instances. The first situation comes into play if a foreign person enters into an integrated transaction that gives rise to United States source interest income not effectively connected with a trade or business. In such case, the provisions of *IRC Section 871(a)* (taxation of nonresident aliens), 881 (taxation of foreign corporations), 1441 (withholding of tax on nonresident aliens), 1442 (withholding of tax on foreign corporations), and 6049 (information returns required of persons making interest payments) are applied to the qualifying debt instrument and the Section 1.1275-6 hedge on a separate basis.ⁿ¹³⁰ For example, if a United States corporation issues a qualifying debt instrument and enters into an interest rate swap that is a Section 1.1275-6 hedge, the source of the interest on the qualifying debt instrument will generally be United States source income because the obligation is issued by a domestic corporation, while the source of payments received on the swap by a foreign person not engaged in a trade or business in the United States will be determined by reference to the taxpayer's residence.ⁿ¹³¹

The second exception looks to the relationship between issuer and holder. Because the rules relating to integrated transaction affect only the taxpayer holding or issuing the qualifying debt instrument, any provisions of the Internal Revenue Code that govern the relationship between the issuer and holder of the qualifying debt instrument are applied on a separate basis.ⁿ¹³² For example, if the qualifying debt instrument is a contingent payment debt instrument, the issuer must provide the projected payment schedule to the holder.

If a taxpayer enters into a *Regulations Section 1.1275-6* hedge with a member of the same consolidated group (the counterparty) and the *Regulations Section 1.1275-6* hedge is part of an integrated transaction for the taxpayer, the *Regulations Section 1.1275-6* hedge is not treated as an intercompany transaction for the taxpayer for purposes of *Regulations Section 1.1502-13*.ⁿ¹³³ If the taxpayer legs out of an integrated treatment, the taxpayer and the counterparty are each treated as having disposed of the position in the *Regulations Section 1.1275-6* hedge. If the *Regulations Section 1.1275-6* hedge remains in existence after the leg-out date, the *Regulations Section 1.1275-6* hedge is treated under rules that would normally apply to the transaction.

The following examples illustrate the integrated transaction rules:

Example 1:

On January 1, 1997, A Corp., a domestic corporation, issues a five-year debt instrument for \$20,000. The instrument provides for annual payments of interest at a rate equal to the value of one-year LIBOR and for a principal payment of \$20,000 at maturity. On the same day, A Corp. enters into a five-year interest rate swap agreement with an unrelated party under which A Corp. pays 6 percent and receives a one-year LIBOR on a notional principal amount of \$20,000. Payments on the swap are fixed and made on the same days as payments on the debt instrument. On January 1, 1997, A Corp. identifies the debt instrument and interest rate swap as an integrated transaction.

The transaction is an integrated transaction. The debt instrument is a variable rate debt instrument and, thus, a qualifying debt instrument. The swap is a Section 1.1275-6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the swap and the debt instrument can be calculated.

The synthetic debt instrument is a five-year debt instrument that has an issue price of \$20,000 and provides for annual interest payments of \$1,200 and a principal payment at maturity of \$20,000. No amounts payable on the synthetic debt instrument are treated as qualified interest payments. The synthetic debt instrument is deemed to have a stated redemption price at maturity of \$26,000 (the sum of all amounts to be paid on the qualifying debt instrument and the swap, reduced by amounts to be received on the swap and the annual interest payments on the synthetic debt instrument). Therefore, the synthetic debt instrument has \$6,000 of OID.

Example 2:

On January 1, 1997, *B Corp.* receives \$20,000 for a debt instrument that matures on December 31, 1999. The debt instrument has a stated principal amount of \$20,000 payable at maturity, and also provides for a payment at maturity equal to \$200 times the increase, if any, in the value of a nationally known composite index of stocks from January 1, 1997 to December 31, 1999. On January 1, 1997, *B Corp.* pays \$5,000 to an unrelated party for an option that pays \$200 times the increase, if any, in the stock index from January 1, 1997 to the maturity date. *B Corp.* properly identifies the debt instrument and option as an integrated transaction.

The transaction qualifies as an integrated transaction. The debt instrument is a contingent payment debt instrument and, thus, a qualifying debt instrument. The option is a Section 1.1275-6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the option and the debt instrument can be calculated.

The issue price of the synthetic debt instrument is \$20,000 reduced by the \$5,000 payment for the option. Thus, the synthetic debt instrument is a three-year debt instrument with an issue price of \$15,000. The stated redemption price at maturity is \$20,000, so that the synthetic debt instrument has \$5,000 of OID.

Example 3:

On December 31, 1996, *C Corp.* pays \$2 million for a debt instrument that matures on December 31, 2006. The instrument provides for yearly payments of interest at a rate 6 percent and for a payment at maturity of \$2 million, increased by the excess, if any, of the price of 2,000 units of a commodity on December 31, 2006, over \$700,000, and decreased by the excess, if any, of \$700,000 over the price of 2,000 units of the commodity on the maturity date. The projected payment at maturity, determined under the contingent payment debt instrument regulations, is \$2,040,000. On December 31, 1999, *C Corp.* enters into a cash settled forward contract with an unrelated party to sell 2,000 units of the commodity on December 31, 2006 for \$900,000, and properly identifies the transaction as an integrated transaction. Assume one-year accrual periods.

The debt instrument is a qualifying debt instrument because it is a contingent payment debt instrument. The forward contract entered into on December 31, 1999 is a Section 1.1275-6 hedge.

Therefore, C Corp. legged into an integrated transaction on December 31, 1999. Prior to that date, the tax consequences attending the debt instrument are determined under the contingent payment debt regulations.

The issue price of the synthetic debt instrument is equal to the \$2,009,608 adjusted issue price of the qualifying debt instrument on the leg-in date. The term of the synthetic instrument is from December 31, 1999 to December 31, 2006. The synthetic debt instrument provides for yearly interest payments of \$120,000 and a principal payment at maturity of \$2,200,000 (\$2 million plus \$900,000 less \$700,000). No amounts payable on the synthetic debt instrument are qualified stated interest payments. The stated redemption price at maturity of the synthetic debt instrument is \$3,040,000 (the sum of all amounts to be received by C on the qualifying debt instrument and the Section 1.1275-6 hedge, reduced by all amounts to be paid by C on the hedge. Thus, the synthetic debt instrument has \$1,030,392 of OID.

[f] Inflation-Indexed Debt Instruments.

Inflation-indexed debt instruments are not subject to the regulations governing contingent payment debt instruments.ⁿ¹³⁴ They are governed instead by the rules in *Treasury Regulation 1.1275-7*, which cover all inflation-indexed debt instruments except (1) a debt instrument (other than a tax-exempt obligation) described in *IRC Section 1272(a)(2)* (eg, United States savings bonds, certain loans between natural persons, and other short-term taxable obligations), and (2) debt instruments issued by qualified state tuition programs.ⁿ¹³⁵ An inflation-indexed debt instrument as defined in the regulations is one that satisfies the following conditions:ⁿ¹³⁶

- (1) The debt instrument is issued for United States dollars and all payments on the instrument are denominated in United States dollars.
- (2) Except for a minimum guarantee payment, each payment on the debt instrument is indexed for inflation and deflation. A payment is so indexed if the amount of the payment is equal to (a) the amount that would be payable if there was no inflation or deflation over the term of the debt instrument, multiplied by (b) a ratio, the numerator of which is the value of the reference index for the date of payment and the denominator of which is the value of the reference index for the issue date.

The reference index is an index used to measure inflation and deflation over the term of a debt instrument.ⁿ¹³⁷ To qualify as a reference index, (i) the value of the index must be reset once a month to a current value of a single qualified inflation index, (ii) the reset must occur on the same day of each month (the reset date), and (iii) the value of the index for any date between reset dates must be determined through straight-interpolation.ⁿ¹³⁸ A qualified inflation index is a general price or wage index that is updated and published at least monthly by an agency of the United States Government (eg, the CPI-U published by the Bureau of Labor Statistics).ⁿ¹³⁹

A minimum guarantee payment is an additional payment made at maturity on a debt instrument if the total amount of inflation-adjusted principal paid on the instrument is less than the instrument's stated principal amount. The amount of the additional payment must not be more than the excess, if any, of the debt instrument's stated principal amount over the total amount of inflation-adjusted principal paid on the instrument. An additional payment is not a minimum guarantee payment unless the qualified inflation index used to determine the reference index is either the CPI-U or an index designated for this purpose by the Commissioner in the Federal Register or the Internal Revenue Bulletin.

- (3) No payment on the debt instrument is subject to a contingency other than (a) the inflation contingency, (b) a minimum guarantee payment, or (c) payments under one or more alternate payment schedules if the payments under each payment schedule are indexed for inflation and deflation and a payment schedule can be determined under *Regulations Section 1.1272-1(c)* (assuming that no inflation or deflation will occur over the term of the instrument).

Qualified stated interest and inflation adjustments on inflation-indexed debt instruments can be accounted for under the coupon-bond method if (a) the debt instrument is issued at par (the difference between its issue price and principal amount for the issue date is less than the de minimis amount, and (b) all stated interest on the debt instrument is qualified stated interest--the interest is unconditionally payable in cash, or is constructively received, at least annually at a single fixed rate.ⁿ¹⁴⁰ Interest is payable at a single fixed rate if the amount of each interest payment is determined by multiplying the inflation-adjusted principal amount for the payment date by the single fixed rate.ⁿ¹⁴¹

Under the coupon bond method, qualified stated interest is taken into account under the taxpayer's regular method of accounting.ⁿ¹⁴² The amount of accrued but unpaid qualified stated interest as of any date is determined by using the principles of *Regulations Section 1.446-3(e)(2)(ii)*.ⁿ¹⁴³ For example, if the interval between interest payment dates spans two taxable years, a taxpayer using an accrual method of accounting determined the amount of accrued qualified stated interest for the first taxable year by reference to the inflation-adjusted principal amount at the end of the first taxable year.

An inflation adjustment is taken into account under the coupon bond method for each taxable year in which the debt instrument is outstanding.ⁿ¹⁴⁴ The amount of the inflation adjustment is equal to the sum of the inflation-adjusted principal amount at the end of the relevant period (taxable year or the portion of the taxable year during which the taxpayer held the debt instrument) and the principal payments made during the period, minus the inflation-adjusted principal amount at the beginning of the period.ⁿ¹⁴⁵ A positive inflation adjustment is OID and is treated in the manner discussed in § 17.03[2][a].ⁿ¹⁴⁶

A negative inflation adjustment (a deflation adjustment) reduces the amount of interest otherwise includable in income by a holder with respect to the debt instrument for the taxable year.ⁿ¹⁴⁷ If the amount of the deflation adjustment exceeds the interest otherwise includable in income by the holder for the taxable year, the excess is treated as an ordinary loss by the holder for the taxable year. However, the amount treated as an ordinary loss is limited to the amount by which the holder's total interest inclusions on the debt instrument in prior years exceed the total amount treated by the holder as an ordinary loss on the debt instrument in prior years. If the deflation adjustment exceeds the interest otherwise includable in income by the holder for the taxable year and the amount treated as an ordinary loss for the taxable year, the excess is carried forward to reduce the amount of interest otherwise includable in income by the holder in subsequent taxable years.

A deflation adjustment reduces the interest (qualified stated interest and OID) otherwise deductible by the issuer with respect to the debt instrument for the taxable year.ⁿ¹⁴⁸ If the amount of the deflation adjustment exceeds the interest otherwise deductible by the issuer for the taxable year, the excess is treated as ordinary income for the taxable year. However, the amount treated as ordinary income is limited to the amount by which the issuer's total interest deductions on the debt instrument in prior taxable years exceed the total amount treated by the issuer as ordinary income in prior taxable years. If the deflation adjustment exceeds the interest otherwise deductible by the issuer for the taxable year and the amount treated as ordinary income for the taxable year, the excess is carried forward to reduce the interest otherwise deductible by the issuer for subsequent taxable years. If there is any excess remaining upon the retirement of the debt instrument, the issuer takes the excess amount into account as ordinary income.

A minimum guarantee payment is ignored until payment is made, and is then treated as interest on the date it is paid.ⁿ¹⁴⁹

Example 1:

On October 15, 1997, A pays \$200,000 at the time of original issue of a debt instrument that is indexed to the CPI-U for inflation and deflation. The debt instrument matures on October 15, 1999, has a stated principal amount of \$200,000, and a stated interest rate of 6 percent, compounded semiannually, payable

on April 15 and October 15 of each year; the amount of each interest payment is determined by multiplying the inflation-adjusted principal amount for each payment date by the stated interest rate, adjusted for the accrual period. The debt instrument also provides for a single payment of the inflation-adjusted principal amount at maturity and for the payment of a minimum guarantee amount, if required. A is a calendar year, cash receipts and disbursements method taxpayer.

Assume the relevant reference index values:

October 15, 1997:	100
January 1, 1998:	101
April 15, 1998:	102
October 15, 1998:	104
January 1, 1999:	98

Because A does not receive any payments of interest on the debt in 1997, A has no qualified stated interest income for that year. However, A must take into account the inflation adjustment for 1997 as OID in 1997. The inflation-adjusted principal amount for January 1, 1998 is \$202,000 (\$200,000 x 101/100), yielding an inflation adjustment for 1997 of \$2,000 (\$202,000 inflation-adjusted principal amount for January 1, 1998 less the \$200,000 principal amount for the issue date).

On April 15, 1998, A receives an interest payment of \$6,120 (\$200,000 x 102/100 x .06/2); on October 15, 1998, A receives a payment of \$6,240 (\$200,000 x 104/100 x .06/2). Thus, A's qualified stated interest income for 1998 is \$12,360. A must also take into account the inflation adjustment for 1998. The inflation-adjusted principal amount for January 1, 1999 is \$196,000 (\$200,000 x 98/100), producing a negative inflation adjustment (and a deflation adjustment) for 1998 of \$6,000 (inflation-adjusted principal amount of \$196,000 for January 1, 1999, less the inflation-adjusted principal amount of \$202,000 for January 1, 1998). The deflation adjustment reduces the interest income otherwise includable by A for 1998 to \$6,360 (qualified stated interest income of \$12,360 minus deflation adjustment of \$6,000).

A different method, the discount bond method, must be used to account for OID on an inflation-indexed debt instrument that does not qualify for the coupon bond method.ⁿ¹⁵⁰ Under the discount bond method, no interest is qualified stated interest.ⁿ¹⁵¹ The amount of OID that accrues on the debt instrument under the discount bond method is determined as follows:ⁿ¹⁵² First, determine the debt instrument's yield to maturity under the rules of *Section 1.1272-1(b)(1)(i) of the regulations*, with the payment schedule of the debt instrument determined as if there was no inflation or deflation over the term of the debt instrument. Second, determine the accrual periods using the rules of *Section 1.1272-1(b)(1)(ii) of the regulations*, but with no accrual period longer than one month. Third, determine the percentage change in the reference period during the accrual period. This change is equal to the ratio of the value of the reference index at the end of the period to the value of the reference index at the beginning of the period, minus one. Fourth, determine the OID allocable to an accrual period (n) by using the following formula:

$$\text{OID}(n) = \text{AIP}(n) \times [r + \text{inf}(n) + (r \times \text{inf}(n))]$$

in which r is the yield of the debt instrument, $\text{inf}(n)$ is the percentage change in the reference index for period (n), and $\text{AIP}(n)$ is the adjusted issue price at the beginning of period (n). Finally, determine the daily portions of OID and take those into account under the rules generally applicable to OID obligations, i.e., the holder includes in income the daily portions of OID for each day during the taxable year on which the holder held the instrument, while the issuer is allowed a deduction as provided in *IRC Section 163(e)*. However, if the daily portions are negative amounts, they are deflation adjustments taken into account in the same manner as under the coupon bond method.

Example 2:

On November 15, 1997, A, a cash basis, calendar-year taxpayer, purchases at original issue, for \$182,806, a zero-coupon debt instrument that is indexed for inflation and deflation. The principal amount of the debt instrument for the issue date is \$200,000. The instrument provides for a single payment on the maturity date, November 15, 2000. The amount of the payment will be determined by multiplying \$200,000 by a fraction, the numerator of which is the CPI-U for September, 2000, and the denominator of which is the CPI-U for September 1997, but cannot be less than \$200,000.

The coupon bond method does not apply to the debt instrument because its principal amount for the issue date (\$200,000) exceeds its issue price (\$182,806) by \$17,194, more than the *de minimis* amount of \$1,500 (one-fourth of one percent of \$200,000 times three, the number of complete years to maturity). Therefore, the discount bond method must be used to determine the amount of OID.

Assume that A chooses monthly accrual periods ending on the fifteenth day of each month. The yield of the debt instrument, determined as if there were no inflation or deflation over the term of the instrument, and based on the issue price of \$182,806 and an assumed payment of \$200,000 at maturity, is 3 percent, compounded monthly.

Assume that the CPI-U for September, 1997 is 160, for October, 1997 is 161.2, and for November, 1997 is 161.7. The value of the reference index for November 15, 1997 is 160, the value of the CPI-U for September, 1997. The value of the reference index for December 15, 1997 is 161.2, and for January 15, 1998 is 161.7. The percentage change in the reference index from November 15, 1997 to December 15, 1997 (inf1) is 0.0075 ($161.2/160-1$); the percentage change from December 15, 1997 to January 15, 1998 (inf2) is 0.0031 ($161.7/161.2-1$).

The yield of the debt instrument (r) for the accrual period beginning on November 15, 1997 and ending on December 15, 1997 is .0025 (3 percent/12). Substituting in the formula produces OID allocable to the accrual period ending on December 15, 1997 of \$1,831.ⁿ¹⁵³ The adjusted issue price of the debt instrument on December 15, 1997 is \$184,637 (\$182,806 + \$1,831). The yield of the debt instrument (r) for the accrual period ending on January 15, 1998 is, again, .0025 (3 percent/12). The percentage change in the reference index for the period (inf2) is .0031. Substituting in the formula using an adjusted issue price of \$184,637 results in OID allocable to the accrual period of \$1,035. Because the accrual period spans two taxable years, only \$518 of this amount ($\$1035/30 \text{ days} \times 15 \text{ days}$) is allocable to 1997. Thus, A must include \$2,349 of OID in income for 1997.

A holder's adjusted basis in an inflation-indexed debt instrument is increased by the amount of OID included in the holder's gross income and decreased by the amount of any payment from the issuer to the holder under the debt instrument other than qualified stated interest.ⁿ¹⁵⁴ In addition, the basis of an inflation-indexed debt instrument must be decreased by the amount of any deflation adjustment the holder takes into account to reduce the amount of interest otherwise includable in income or treats as an ordinary loss with respect to the instrument during the taxable year; the decrease occurs when the deflation adjustment is taken into account.

A holder determines the amount of acquisition premium or market discount on an inflation-indexed debt instrument by reference to the adjusted issue price of the instrument on the date the holder acquires the instrument.ⁿ¹⁵⁵ A holder determines the amount of bond premium on an inflation-indexed debt instrument by assuming that the amount payable at maturity is equal to the instrument's inflation-adjusted principal amount for the day the holder acquires the instrument. Any premium or market discount is taken into account over the remaining term of the debt instrument as if there were no further inflation or deflation.

[3] Reporting Requirements for Issuers of Original Issue Discount Bonds.

Within 30 days after the issue date of an issue, the issuer of a publicly traded OID obligation is required to make an information return on the form prescribed by the Service (presently Form 8281).ⁿ¹ The reporting rules do not apply to debt instruments excepted from the OID rules by *IRC Section 1272(a)(2)*, debt instruments issued by natural persons, certificates of deposit, REMIC regular interests or other debt instruments subject to *IRC Section 1272(a)(6)*, or stripped bonds or coupons.ⁿ² An issuer who fails to meet the filing requirement is subject to a penalty of 1 percent of the aggregate issue price of the issue up to a maximum of \$50,000 per issue, unless the failure is due to reasonable cause and not willful neglect.ⁿ³

The issuer of any instrument that is not publicly offered, is issued in physical form, and has OID, must legend the instrument by stating on its face that it was issued with OID.ⁿ⁴ In addition, the issuer must either: (i) set forth on the face of the debt instrument the issue price, the amount of OID, the issue date, the yield to maturity, and, in the case of a debt instrument subject to the noncontingent bond method, the comparable yield and projected payment schedule; or (ii) provide the name or title and either the address or telephone number of a representative of the issuer who will, beginning no later than ten days after the issue date, promptly make such information available to holders who request it. The issuer can satisfy the legend requirement at the time the debt is first issued in physical form, but need not do so before the first holder of the debt instrument disposes of the instrument.ⁿ⁵ The penalty for failure to legend is \$50 for each instrument unless due to reasonable cause and not willful neglect.ⁿ⁶

FOOTNOTES:

(n1)Footnote 1. See Ch 2, § 2.07[1]; *IRC §§ 1271-1275*.

(n2)Footnote 2. Unlike the discussion in Chapter 2, this section covers transactions in which debt obligations are issued for money or publicly traded property, as well as debt issued in exchange for nonpublicly traded property.

(n3)Footnote 3. See *IRC § 1273(a)(1)*; discussion at § 2.07[1][c][i].

(n4)Footnote 4. Such market forces may affect the price of debt instruments originally issued at a discount as well, so that a bond may have both original issue and market discount. The two types of discount are nevertheless treated differently for tax purposes, as explained in § 17.04[2], *infra*.

(n5)Footnote 5. For a more extensive discussion of the meaning and application of these terms, see Chapter 2, § 2.07[1].

(n6)Footnote 6. *IRC § 1273(a)(1)*.

(n7)Footnote 7. *Treas Reg § 1.1273-1(b)*.

(n8)Footnote 8. See *IRC § 1273(a)(2)*; *Treas Reg §§ 1.1273-1(b) and (c)*.

(n9)Footnote 9. See S Rep No 169 (Vol I), 98th Cong., 2d Sess 255 (1984) ("[I]n general, interest will be considered payable unconditionally only if the failure to timely pay interest results in an acceleration of all amounts under the debt obligation or similar consequences."), quoted in *Rev Rul 95-70, 1995-2 CB 124*. "If the terms of the debt instrument do not provide the holder with the right to compel payment, they must provide for a penalty that inures directly to the benefit of the holder and ... is large enough to ensure that, at the time the debt instrument is issued, it is reasonably certain that, absent insolvency, the issuer will make interest payments when due. *Rev Rul 95-70, supra*. Thus, the Service concluded in *Rev Rul 95-70* that a provision in a debt instrument that prohibited the issuer from paying dividends while interest was past due was not a sufficient penalty, and interest was therefore not payable "unconditionally," because, while the suspension of dividends was likely to result in a "significant decline" in the issuer's stock, the penalty did not inure directly to the benefit of the holders of the debt instrument. In a second situation

considered in *Rev Rul 95-70*, the issuer, in addition to the dividend restriction referred to above, the debt instrument required the issuer to pay a "penalty" rate on interest in arrears of 10 percent per annum, as compared with bond's stated rate of 8 percent. The Service held that this too was an insufficient penalty, although it inured to the benefit of the bonds' holders, because "it is possible that there may be circumstances in which the benefit of deferring is worth the additional cost." The Service did acknowledge, however, that, depending on the facts and circumstances, a "penalty rate" which increased the stated yield of the bond by 12 percentage points or more might be sufficient to assure that interest payments are reasonably certain to be paid when due.

(n10)Footnote 10. *Treas Reg § 1.1273-1(c)(1)(ii)*.

(n11)Footnote 11. *IRC § 1273(b)(1)*. The substantial amount requirement "is intended primarily to cover any attempt to rig an artificial price in order to obtain more favorable tax treatment." HR Rep No 1337, 83d Cong, 2d Sess, A-277 (1954). The term "initial offering price" includes the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof. *IRC § 1273(c)(1)*.

The issue price of a convertible debt instrument includes the amount paid for the option to convert the instrument into stock or another debt instrument of either the issuer or a related party (within the meaning of *IRC § 267(b)* or *IRC § 707(b)(1)*), or into cash or other property in an amount equal to the approximate value of the stock or debt instrument. *Treas Reg § 1.1273-2(j)*.

If a portion of the initial issue price is allocable to pre-issuance accrued interest, and the instrument provides for a payment of stated interest on the first payment date within one year of the issue date that equals the amount of the pre-issuance accrued interest, the instrument's issue price may be computed by subtracting from the normally computed issue price the amount of pre-issuance accrued interest. *Treas Reg § 1.1273-2(m)*.

(n12)Footnote 12. *IRC § 1273(b)(2)*. The price paid by the first buyer consists of the aggregate payments made by that buyer under the purchase agreement. *IRC § 1273(c)(1)*.

(n13)Footnote 13. *IRC § 1273(b)(5)*.

(n14)Footnote 14. *Treas Reg § 1.1273-2(a)(1)*.

(n15)Footnote 15. *Treas Reg § 1.1275-2(d)(1)*. For an issue of Treasury securities sold from Nov 1, 1998, to March 13, 2001, the issue price of the issue is the price of the securities sold at auction.

(n16)Footnote 16. *Treas Reg § 1.1275-2(d)(2)(i)*, effective for qualified reopenings that occurred on or after March 25, 1992. Additional Treasury securities are Treasury securities with terms that are identical in all respects to the terms of the original Treasury securities. *Treas Reg § 1.1275-2(d)(2)(ii)(A)*. Original Treasury securities are securities comprising any issue of outstanding Treasury securities. *Treas Reg § 1.1275-2(d)(2)(ii)(B)*.

(n17)Footnote 17. *Treas Reg § 1.1275-2(d)(2)(ii)(C)*. OID is *de minimis* whenever it is less than one-fourth of one percent (0.0025) of the redemption price at maturity times the number of complete years to maturity. *IRC § 1273(a)(3)*. The holder of a debt instrument can either disregard *de minimis* OID or elect to treat *de minimis* OID as OID, and to include in gross income all interest that accrues on the instrument by using the constant yield to maturity method described in *Treas Reg § 1.1272-3(c)*. Under this method, the debt instrument is treated as if (i) the instrument is issued for the holder's adjusted basis immediately after its acquisition by the holder; (ii) the instrument is issued on the holder's acquisition date; and (iii) none of the interest payments provided for in the instrument is a qualified stated interest payment.

(n18)Footnote 18. *Treas Reg § 1.1275-2(d)(2)(ii)(D)*.

(n19)Footnote 19. *Treas Reg § 1.1275-1(f)(1)*. For debt instruments issued on or after April 4, 1994, and before

March 13, 2001, two or more debt instruments are part of the same issue if they have the same credit and payment terms, and are sold reasonably close in time either pursuant to a common plan or as part of a single transaction or a series of related transactions. *Treas Reg* § 1.1275-1(f)(2).

(n20)Footnote 20. *Treas Reg* § 1.1275-1(k)(1).

(n21)Footnote 21. *Treas Reg* § 1.1275-1(k)(3). The provisions of *Treas Reg* § 1.1275-1(k)(3) do not apply to reopenings of tax-exempt obligations or contingent payment debt instruments.

(n22)Footnote 22. *Treas Reg* § 1.1275-1(k)(1).

(n23)Footnote 23. *Treas Reg* § 1.1275-1(k)(2)(i).

(n24)Footnote 24. *Treas Reg* § 1.1275-1(k)(2)(ii). The reopening date is the issue date of the additional debt instruments. *Treas Reg* § 1.1275-1(k)(2)(iii).

(n25)Footnote 25. *Treas Reg* § 1.1273-2(b)(1), (2). The issue date of a group of debt instruments issued for money is the first settlement date or closing date on which a substantial amount of the debt instruments is sold. *Treas Reg* § 1.1273-2(a)(2).

(n26)Footnote 26. *IRC* § 1273(b)(3). Publicly-traded property generally includes exchange listed property, property traded on a board of trade or an interbank market, property appearing on a quotation medium that provides a reasonable basis to determine fair market value, and debt instruments for which price quotations are readily available. *Treas Reg* § 1.1273-2(f).

Commodities traded on a board of trade that has been designated as a contract market constitute property traded on an established market. *Ltr Rul* 199901008 .

The issue date is the first date on which a substantial part of the debt instruments in the issue is issued for traded property. *Treas Reg* § 1.1273-2(c)(2).

(n27)Footnote 27. *IRC* §§ 1273(b)(4), 1274(a)(1), (2). See generally Davis, "Buying and Selling Property: The Determination and Treatment of Imputed Interest," 44 *NYU Inst on Fed Tax* Ch 33 (1986).

(n28)Footnote 28. The AFR itself is a rate, published monthly by the IRS, based on the average market yield on outstanding marketable obligations of the US over a one-month period. See *IRC* § 1274(d); *Treas Reg* § 1.1274-4(b). The calculation of the test rate based on the applicable AFR is explained in Ch 2, § 2.07[1][c][i].

(n29)Footnote 29. *IRC* § 1274(a)(1)(A). The "stated principal amount" of the debt instrument is the aggregate amount of all payments due under the instrument, excluding the amount of any stated interest and any payment from a buyer-borrower to a seller-lender designated as interest or points. *Treas Reg* § 1.1274-2(b).

(n30)Footnote 30. *IRC* § 1274(a)(2), (b)(1), (2). The OID resulting therefrom is includable in income ratably under the terms of *IRC* § 1272. See § 17.03[2].

(n31)Footnote 31. *IRC* § 1274(b)(3).

(n32)Footnote 32. *IRC* § 1273(c)(2).

(n33)Footnote 33. *IRC* § 1275(a)(4). The adjusted issue price is the original issue price increased by the portion of any original issue discount previously reported in income.

(n34)Footnote 1. *IRC* § 1271(c)(2).

(n35)Footnote 2. *IRC §§ 1272(b)(2), 1275(a)(2)*. If a debt instrument is not publicly offered and is sold for property, the date of original issue is the date on which the instrument was issued in a sale or exchange.

(n36)Footnote 3. *IRC § 1272(b)(3)*. For example, if the bond is originally issued on June 15th, the second complete month begins on July 15th and so on. If there is no corresponding day in a succeeding month, the commencement date in that month is the last day of the month.

A fractional month allocation of the amount of OID includable in income is required when the acquisition does not occur on the commencement of a complete month, or when there is a fractional part of the month falling between the commencement of a complete month and the end of the taxable year.

(n37)Footnote 4. *IRC § 1272(b)(4)*. A purchase is defined as any acquisition of a debt instrument where the basis is not determined in whole or in part by reference to the adjusted basis of the instrument or other evidence of indebtedness in the hands of the person from whom acquired. *IRC § 1272(d)(1)*.

(n38)Footnote 5. *IRC § 1272(c)(1)*.

(n39)Footnote 6. For this purpose, the term "debt instrument" includes a bond, debenture, note, certificate, or other evidence of indebtedness. *IRC § 1275(a)(1)(A)*.

(n40)Footnote 7. *IRC § 1272(a)(1)*. A holder who purchases a bond at a premium is not subject to this rule. *IRC § 1272(c)(1)*.

The basis of the instrument is increased by the amount included in income pursuant to *IRC § 1272(a)(1)*. *IRC § 1272(d)(2)*.

Holders of debt instruments having OID must accrue OID so long as they hold the debt instruments regardless of the financial condition of the issuer; there is no 'doubtful collectibility' exception from OID accrual. *TAM 9538007*.

The holder of a debt instrument includes any *de minimis* OID (other than *de minimis* OID treated as stated interest, such as *de minimis* OID attributable to a teaser rate or interest holiday) in income as stated principal payments are made. The amount includable in income with respect to each principal payment equals the product of the total amount of *de minimis* OID on the debt instrument and a fraction, the numerator of which is the amount of principal payment made and the denominator of which is the stated principal amount of the instrument. *Treas Reg § 1.1273-1(d)(5)*. A taxpayer can use the principal-reduction method of accounting to account for *de minimis* OID. *Rev Proc 97-39, 1997-2 CB 485*.

(n41)Footnote 8. *IRC § 1272(a)(2)*. The exception for loans between natural persons does not apply if the loan has as one of its principal purposes the avoidance of any federal tax. *IRC § 1272(a)(2)(E)(ii)*.

A husband and wife are treated as one person for purposes of the natural person loan exception unless the spouses lived apart at all times during the taxable year in which the loan was made. *IRC § 1272(a)(2)(E)(iii)*.

(n42)Footnote 9. *IRC § 1272(a)(3)*. The term "accrual period" means any six-month period (or shorter period from the date of original issue of the debt instrument) that ends on a day in the calendar year corresponding to the maturity date of the instrument or the date six months before such maturity date. *IRC § 1272(a)(5)*.

(n43)Footnote 10. The adjusted issue price at the beginning of any accrual period is the sum of the original issue price of the debt instrument plus the OID allocated to all prior accrual periods. *IRC § 1272(a)(4)*.

(n44)Footnote 11. *Treas Reg § 1.1272-1(b)(1)*; see *Treas Reg § 1.1272-1(j)*, Examples 1-10.

(n45)Footnote 12. *Treas Reg § 1.1272-1(b)(1)(i)*.

(n46)Footnote 13. *IRC § 1272(a)(7)*.

(n47)Footnote 14. *IRC § 1272(a)(7)*.

(n48)Footnote 15. If a taxpayer is required by *IRC § 1272(a)(6)(C)* to change its method of accounting for its first taxable year beginning after Aug 5, 1997, the change is treated as initiated by the taxpayer with the consent of the Service, and the net amount of the adjustments required to be taken into account by the taxpayer under *IRC § 481* must be taken into account ratably over the four-year period beginning with that first taxable year. Taxpayer Relief Act of 1997, § 1004(b)(2).

(n49)Footnote 16. *IRC § 1272(a)(2)*. *Treas Reg § 1.1273-1(c)(5)* states that no payments of interest are treated as qualified stated interest of a debt instrument with a term that is not more than one year from the date of issue. The Service is studying whether the provision should apply to stated interest payable at maturity on short-term tax-exempt bonds. Until the Service provides further guidance, taxpayers can treat such interest either as includable in the stated redemption price at maturity or as stated interest. However, a taxpayer must treat stated interest payable at maturity on all short-term tax-exempt bonds in a consistent manner. *Notice 94-84, 1994-2 CB 559*, applicable to tax-exempt bonds issued after April 4, 1994.

(n50)Footnote 17. *IRC § 1283(a)(2)*.

(n51)Footnote 18. Unless the taxpayer elects otherwise, the described rule will apply to OID instead of acquisition discount if the obligation is a nongovernmental obligation.

(n52)Footnote 19. *IRC § 1283(b)(1)*. OID on tax-exempt original issue discount bonds with a maturity of one year or less accrues in the manner provided in *IRC § 1283(b)*.

(n53)Footnote 20. *IRC § 1283(b)(2)*.

(n54)Footnote 21. *IRC § 1283(d)(1)*.

(n55)Footnote 22. The Tax Court has held, in a case of first impression, that *IRC § 1281* does not apply to short-term loans made by a bank in the ordinary course of its business. *Security Bank Minnesota v Commr*, 98 TC 33 (1992), *aff'd* 994 F2d 432 (8th Cir 1993). The Service will deny any request for a change in accounting method or any claim for refund based on *Security Bank Minnesota* filed by a taxpayer outside the Eighth Circuit. *Notice 95-57, 1995-2 CB 337*. Cash method banks located in the Eighth Circuit will be granted permission to make the change. *Rev Proc 97-37, 1997-2 CB 455*.

The Tax Court reaffirmed its position in *US Bancorp v Commr*, *TC Memo 1998-381*, and *Security State Bank v Commr*, 111 TC 210 (1998), *aff'd* 214 F3d 1254 (10th Cir 2000), *acq in part* 2001-5 IRB 431.

(n56)Footnote 23. *IRC § 1281(b)(1)*.

(n57)Footnote 24. *IRC § 1281(b)(2)*.

(n58)Footnote 25. *IRC § 1282(b)(2)*. A taxpayer making the election need not defer interest deductions in the manner provided by *IRC § 1282(a)*. See the discussion in § 19.05[1][f].

(n59)Footnote 26. *IRC § 1272(a)(2)(A), (B), (C)*.

(n60)Footnote 27. *IRC § 454(a)*.

(n61)Footnote 28. The entire increment on a jointly held bond (one registered in the names of two persons as co-owners) purchased with the funds of one of the co-owners is income to the one whose funds were used even though

the proceeds of the redemption are kept by the other co-owner. *Rev Rul 54-143, 1954-1 CB 12* . Had the purchaser caused the bond to be reissued in the sole name of the co-owner, the increment in value to the time of gift would have been income to the purchaser in the year of gift. *Rev Rul 55-278, 1955-1 CB 471* ; *cf Rev Rul 54-327, 1954-2 CB 50* .

A reissuance in the sole name of the original purchaser is not a taxable transaction. *Rev Rul 68-61, 1968-1 CB 346* . The same holds true for a reissuance in the name of another where done by mistake and the mistake is caught and rectified immediately. *Rev Rul 70-428, 1970-2 CB 5* .

(n62)Footnote 29. *IRC § 454(c)*. The rule does not apply if the taxpayer is a corporation, or if, after maturity, a savings bond is exchanged for a current income obligation.

For a discussion of *IRC § 1037*, see Ch 8.

(n63)Footnote 30. *IRC § 454(a)*. The election must be made in the taxpayer's return for the taxable year, provided that return is filed on or before its due date. *Treas Reg § 1.454-1(a)(iii)*; *Rev Rul 55-655, 1955-2 CB 253* . The amount that accrues in any taxable year to which the election applies is measured by the actual increase in the redemption price occurring that year. This amount does not accrue ratably between the dates on which the redemption price changes. *Treas Reg § 1.454-1(a)(2)*.

(n64)Footnote 31. *IRC § 454(a)*. *Rev Proc 97-37, 1997-2 CB 455* , sets forth the procedure to expedite the Service's consent to a reversal of a cash basis taxpayer's earlier election to report the annual increase in redemption value as income.

An election made by an executor is not binding on a testamentary trust to which the bonds are transferred, even though the executor is also the trustee of the trust. *Rev Rul 58-435, 1958-2 CB 370* . If not reported on the final return of the decedent, the increment will be income in respect of a decedent. *Rev Rul 64-104, 1964-1 CB 223* . *Rev Rul 58-435* and *Rev Rul 64-104* were distinguished in *Rev Rul 68-145, 1968-1 CB 203* , on the ground that they dealt with situations in which no one sought to make the election provided by *IRC § 454(a)* on the final return of the decedent.

A transfer of the bonds by the decedent's estate before redemption will cause the income to be returnable by the estate in the year of transfer. See, eg, *Ltr Rul 9507008* . If the bonds are distributed to a tax-exempt organization under the residuary clause in a will, the interest received will be exempt from tax. *Ltr Rul 9845026* . If the tax-exempt organization is a private foundation, the income will be included in the computation of gross investment income under *IRC § 4940(c)(2)*. *Rev Rul 80-118, 1980-1 CB 254* .

A purchaser of savings bonds, registered in her name and the name of her son as co-owners, never reported the annual increment in value as income, because the level of her entire income did not require her to file a return. The Tax Court concluded that the failure to file a return amounted to an election to report the interest when the bonds matured or were redeemed. *Apkin v Commr, 86 TC 692 (1986)* .

(n65)Footnote 32. *IRC § 454(a)*.

(n66)Footnote 33. *IRC 454(a)*; *Treas Reg § 1.454-1(a)(2)*. Where the taxpayer holds a current income obligation acquired in exchange for a savings bond, the amount included in gross income for the year of election is the increase in redemption price of the bond between its acquisition and its exchange. *Treas Reg § 1.454-1(a)(3)*.

(n67)Footnote 34. Proposed regulations apply the rules of *Treas Reg § 1.1275-4* to contingent payment debt instruments denominated in a nonfunctional currency. See *Prop Treas Reg § 1.988-6*, discussed in § 20.09[3].

(n68)Footnote 35. *Treas Reg § 1.1275-4(a)*.

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(n69)Footnote 36. *Treas Reg § 1.1275-4(a)(3), (5)*. A contingency is remote if there is a remote likelihood that the contingency will or will not occur. A contingency is incidental if the potential amount of the payment under any reasonably expected market conditions is insignificant relative to the total expected payments on the debt instrument.

(n70)Footnote 37. *Treas Reg § 1.1275-4(a)(4)*. See the end of this section for a discussion of convertible debt instruments that provide for contingent cash payments.

(n71)Footnote 38. *Treas Reg § 1.1275-4(b)(1), (2)*.

(n72)Footnote 39. *Treas Reg § 1.1275-4(b)(3)*.

(n73)Footnote 40. *Treas Reg § 1.1275-4(b)(5)*.

(n74)Footnote 41. *Treas Reg § 1.1275-4(b)(4)(i)(A)*.

(n75)Footnote 42. *Treas Reg § 1.1275-4(b)(4)(i)(B)*.

(n76)Footnote 43. *Treas Reg § 1.1275-4(b)(4)(ii)*. Under the rules of *IRC § 6001*, taxpayers must maintain adequate contemporaneous records to support the projected payment schedule.

(n77)Footnote 44. *Treas Reg § 1.1275-4(b)(4)(iii)*. Market information is any information on which an objective rate can be based under *Treas Reg § 1.1275-5(c)(1) or (2)* (see § 17.03[2][d]).

(n78)Footnote 45. *Treas Reg § 1.1275-4(b)(4)(ii)(A)*.

(n79)Footnote 46. *Treas Reg § 1.1275-4(b)(4)(ii)(B)*.

(n80)Footnote 47. *Treas Reg § 1.1275-4(b)(4)(ii)(C)*.

(n81)Footnote 48. *Treas Reg § 1.1275-4(b)(4)(iv)*.

(n82)Footnote 49. *Treas Reg § 1.1275-2(e)* requires the issuer to provide the relevant information to the holder in a reasonable manner, such as providing the name or title and either the address or telephone number of a representative of the issuer who will make the information available to the holders.

(n83)Footnote 50. *Treas Reg § 1.1275-4(b)(4)(v)*.

(n84)Footnote 51. *Treas Reg § 1.1275-4(b)(6)(i)*. A holder treats a negative adjustment and an issuer treats a positive adjustment as a loss with respect to a position in a straddle if the debt instrument is a position in a straddle and the contingency (or any portion thereof) to which the adjustment relates would be part of the straddle if entered into as a separate position. *Treas Reg § 1.1275-4(b)(9)(vi)*.

(n85)Footnote 52. *Treas Reg § 1.1275-4(b)(6)(ii)*.

(n86)Footnote 53. *Treas Reg § 1.1275-4(b)(6)(iii)(A)*. A net negative adjustment is not subject to *IRC § 67* (the 2-percent floor on miscellaneous itemized deductions). *Treas Reg § 1.1275-4(b)(6)(iii)(D)*.

(n87)Footnote 54. *Treas Reg § 1.1275-4(b)(6)(iii)(B)*.

(n88)Footnote 55. *Treas Reg § 1.1275-4(b)(6)(iii)(C)*.

(n89)Footnote 56. *Treas Reg § 1.1275-4(b)(6)(iii)(C)*.

(n90)Footnote 57. *Treas Reg § 1.1275-4(b)(7)(i)*. The Service views this as appropriate because positive and

negative adjustments are used to take into account the difference between actual amounts and projected amounts of contingent payments. The difference would be counted twice if adjusted issue price, adjusted basis, and the amount deemed paid on retirement, were based on the actual amounts of contingent payments rather than the projected amounts. 59 *Fed Reg* 64884, 64888 (Dec 16, 1994) .

(n91)Footnote 58. *Treas Reg* § 1.1275-4(b)(7)(ii).

(n92)Footnote 59. *Treas Reg* § 1.1275-4(b)(7)(iii).

(n93)Footnote 60. *Treas Reg* § 1.1275-4(b)(7)(iv).

(n94)Footnote 61. *Treas Reg* § 1.1275-4(b)(7)(v). A pro rata prepayment is a payment on a debt instrument made prior to maturity that (a) is not made pursuant to the instrument's payment schedule, and (b) results in a substantially proportional reduction of each payment remaining to be paid on the instrument. *Treas Reg* § 1.1275-2(f)(2).

Treas Reg § 1.1275-4(b)(7)(v) does not contain any reference to a reduction in the amount realized on an unscheduled retirement because of the existence of a negative adjustment carryover in the year of retirement; *Treas Reg* § 1.1275-4(b)(7)(iv) contains such a reference.

(n95)Footnote 62. *Treas Reg* § 1.1275-4(b)(8)(i).

(n96)Footnote 63. *Treas Reg* § 1.1275-4(b)(8)(ii).

(n97)Footnote 64. *Treas Reg* § 1.1275-4(b)(9)(i)(A). If a contingent payment debt instrument is exchange listed property, it is reasonable for a holder of the instrument to allocate any difference between the holder's basis and the adjusted issue price of the debt instrument pro rata to daily portions of interest over the remaining term of the instrument. *Treas Reg* § 1.1275-4(b)(9)(i)(E).

(n98)Footnote 65. *Treas Reg* § 1.1275-4(b)(9)(i)(B).

(n99)Footnote 66. *Treas Reg* § 1.1275-4(b)(9)(i)(C).

(n100)Footnote 67. *Treas Reg* § 1.1275-4(b)(9)(i)(D).

(n101)Footnote 68. *Treas Reg* § 1.1275-4(b)(9)(ii). A payment is treated as a fixed payment if all remaining contingencies with respect to the payment are remote or incidental.

(n102)Footnote 69. *Treas Reg* § 1.1275-4(b)(9)(ii)(A).

(n103)Footnote 70. *Treas Reg* § 1.1275-4(b)(9)(ii)(D).

(n104)Footnote 71. *Treas Reg* § 1.1275-4(b)(9)(ii)(B), (C). Because the projected payment schedule for the debt instrument is modified to reflect the fixed amount of the payment, no adjustment is made when the contingent payment is actually made.

(n105)Footnote 72. *Treas Reg* § 1.1275-4(b)(9)(iii)(A).

(n106)Footnote 73. *Treas Reg* § 1.1275-4(b)(9)(ii)(G).

(n107)Footnote 74. *Treas Reg* § 1.1275-4(c)(1). The provisions of *IRC* § 1274 are discussed in Ch 2, § 2.07[1][c].

(n108)Footnote 75. *Treas Reg* § 1.1275-4(c)(2).

(n109)Footnote 76. *Treas Reg* § 1.1275-4(c)(3).

(n110)Footnote 77. *Treas Reg § 1.1275-4(c)(4)(i)*.

(n111)Footnote 78. *Treas Reg § 1.1275-4(c)(4)(ii)(A)*. The test rate used for this purpose is the rate that would be the test rate for the overall debt instrument if the term of the overall debt instrument began on the issue date of the overall instrument and ended on the date the contingent payment was fixed. *Treas Reg § 1.1275-4(c)(4)(ii)(B)*. However, in the case of a contingent payment that consists of stated principal accompanied by a payment of stated interest that exceeds the test rate, the test rate is the stated interest rate.

(n112)Footnote 79. *Treas Reg § 1.1275-4(c)(4)(ii)(A)*.

(n113)Footnote 80. *Treas Reg § 1.1275-4(c)(4)(ii)(A)*.

(n114)Footnote 81. The test rate for the separate debt instrument is the test rate for the overall debt instrument if the term of the overall debt instrument began on the issue date of the overall debt instrument and ended on the date the contingent payment is due. *Treas Reg § 1.1275-4(c)(4)(iii)(B)*.

(n115)Footnote 82. *Treas Reg § 1.1275-4(c)(5)*.

(n116)Footnote 83. *Treas Reg § 1.1275-4(c)(5)(i)*.

(n117)Footnote 84. *Treas Reg § 1.1275-4(c)(5)(ii)*.

(n118)Footnote 85. *Treas Reg § 1.1275-4(c)(5)(iii)*.

(n119)Footnote 86. *Rev Rul 2002-31, 2002-1 CB 1023*.

(n120)Footnote 87. See § 19.05[1][i] for a discussion of *IRC § 163(l)*.

(n121)Footnote 88. See § 17.05[2] for a discussion of *IRC § 249*.

(n122)Footnote 89. *Treas Reg § 1.1275-4(d)(1)*.

(n123)Footnote 90. *Treas Reg § 1.1275-4(d)(2)(iv)(A), (3)(ii)(B)*.

(n124)Footnote 91. *Treas Reg § 1.1275-4(d)(1)*.

(n125)Footnote 92. *Treas Reg § 1.1275-4(d)(2)(ii)*.

(n126)Footnote 93. *Treas Reg § 1.1275-4(d)(2)(iii)*.

(n127)Footnote 94. *Treas Reg § 1.1275-4(d)(2)(iv)*.

(n128)Footnote 95. *Treas Reg § 1.1275-4(d)(3)*.

(n129)Footnote 96. *Treas Reg § 1.1275-4(d)(4)*. The rules contained in *Treas Reg § 1.1275-4(b)(9)*, applicable to taxable bonds with a basis different from issue price, do not apply to tax-exempt bonds.

(n130)Footnote 97. *Treas Reg § 1.1275-5(a)(1)-(4); Treas Reg § 1.1275-5(a)(5)*.

(n131)Footnote 98. *Treas Reg § 1.1275-5(b)(1)*.

(n132)Footnote 99. *Treas Reg § 1.1275-5(b)(1)*.

(n133)Footnote 100. *Treas Reg § 1.1275-5(b)(2)*.

(n134)Footnote 101. *Treas Reg § 1.1275-5(b)(3)*.

(n135)Footnote 102. *Treas Reg § 1.1275-5(c)(1)*.

(n136)Footnote 103. *Treas Reg § 1.1275-5(c)(3)*.

(n137)Footnote 104. *Treas Reg § 1.1275-5(c)(5)*.

(n138)Footnote 105. *Treas Reg § 1.1275-5(c)(4)*.

(n139)Footnote 106. *Treas Reg § 1.1274-2(f)(1)(i)*.

(n140)Footnote 107. *Treas Reg § 1.1274-2(f)(1)(ii)*. Reasonably symmetric caps, floors, or governors that are fixed throughout the term of the debt instrument do not result in the debt instrument being subject to this rule.

(n141)Footnote 108. *Treas Reg § 1.1274-2(f)(2)*. Under a proposed regulation, effective for debt instruments issued on or after the date that is 60 days after final regulations are printed in the Federal Register, the imputed principal amount will be determined by assuming that the debt instrument provides for a fixed rate that reflects the yield that is reasonably expected for the instrument. *Prop Treas Reg § 1.1274-2(f)(2)*.

(n142)Footnote 109. *Treas Reg § 1.1275-5(e)(2)*. The amount of stated interest allocable to an accrual period is increased or decreased if the interest actually paid during an accrual period exceeds (or is less than) the interest assumed to be paid during the accrual period.

(n143)Footnote 110. *Treas Reg § 1.1275-5(e)(3)*.

(n144)Footnote 111. *Treas Reg § 1.1275-5(e)(4)*.

(n145)Footnote 112. *Treas Reg § 1.1275-5(f)*.

(n146)Footnote 113. *Treas Reg § 1.1275-6(b)(1)*.

(n147)Footnote 114. *Treas Reg § 1.1275-6(c)(1)*. At the discretion of the Service, a transaction may not be integrated, if, prior to the time the integrated transaction is identified, the qualifying debt instrument is part of a straddle as defined in *IRC § 1092(c)*. See § 9.02[4][d] for a discussion of *IRC § 1092(c)*.

(n148)Footnote 115. To satisfy the identification requirement, the taxpayer must enter and retain as part of its books the following information: (i) the date the qualifying instrument was issued or acquired (or is expected to be issued or acquired) by the taxpayer and the date the hedge was entered into by the taxpayer; (ii) a description of the qualifying debt instrument and the hedge; and (iii) a summary of the cash flows and accruals resulting from treating the qualifying instrument and the hedge as an integrated transaction (that is, the cash flows and accruals on the synthetic debt instrument). *Treas Reg § 1.1275-6(e)*.

The synthetic debt instrument is the hypothetical debt instrument with the same cash flows as the combined cash flows of the qualifying debt instrument and the Section 1.1275-6 hedge. *Treas Reg § 1.1275-6(b)(4)*.

(n149)Footnote 116. *Treas Reg § 1.1275-6(b)(2)(i)*.

(n150)Footnote 117. *Treas Reg § 1.1275-6(b)(2)(ii)*.

(n151)Footnote 118. *Treas Reg § 1.1275-6(b)(3)*.

(n152)Footnote 119. *Treas Reg § 1.1275-6(c)(2)*.

(n153)Footnote 120. *Treas Reg § 1.1275-6(c)(2)(i)-(iv)*. For this purpose, parties are related within the meaning of *IRC § 267(b)* or *707(b)(1)*.

(n154)Footnote 121. *Treas Reg § 1.1275-6(d)(1)(i)*.

(n155)Footnote 122. *Treas Reg § 1.1275-6(d)(1)(ii)*.

(n156)Footnote 123. *Treas Reg § 1.1275-6(d)(1)(iii)*.

(n157)Footnote 124. *Treas Reg § 1.1275-6(d)(2)(i)(A)*.

(n158)Footnote 125. *Treas Reg § 1.1275-6(d)(2)(i)(C)*. For example, if the holder of an integrated transaction is acquired in a tax-free merger, the holder is treated as disposing of the synthetic debt instrument in the merger, and not as having legged out.

(n159)Footnote 126. *Treas Reg § 1.1275-6(d)(2)(i)(B)*.

(n160)Footnote 127. *Treas Reg § 1.1275-6(d)(2)(ii)(A)-(E)*.

(n161)Footnote 128. A corporation purchased two privately-placed debt instruments from unrelated issuers for \$1 million each. The purchase occurred after the effective date of the integration rules of *Treas Reg § 1.1275-6*. The first note had a 10-year term and provided for quarterly interest payments of 5.7 percent compounded quarterly. The note also provided for contingent payments based on an event that will occur (or not occur) with a probability of 50 percent (the reset event). The reset event did not depend on actively traded personal property. If the reset event occurred, the interest rate doubled; if not, the interest was reset at zero. The second note had the same terms as the first, except that the consequences of the contingency were reversed.

At the time the notes were purchased, it could be expected that, as a result of the reset, one note would increase significantly in value while the other would decrease by the same amount. The expected tax loss on the note that decreased in value significantly exceeded any reasonably expected economic loss on the two notes.

The reset event did not occur, so that the interest rate on the first note was reset at zero while the interest rate on the second note doubled. The corporation sold the first note for its fair market value on the following day and claimed a loss.

The Service held that the notes qualified for integration as of the issue date. Upon the sale of the first note, the requirements for integration were no longer met, and the corporation was treated as legging out of the integrated transaction under *Treas Reg § 1.1275-6(d)(2)(ii)*. Thus, immediately before the note was sold, the corporation was treated as disposing of the synthetic debt instrument for its fair market value, causing it to then realize and recognize any gain or loss on the deemed disposition. As a result, the corporation could not recognize the claimed loss on the sale of the first note while not recognizing the gain on the second. *Rev Rul 2000-12, 2000-1 CB 744*.

(n162)Footnote 129. *Treas Reg § 1.1275-6(f)*.

(n163)Footnote 130. *Treas Reg § 1.1275-6(f)(12)(i)*.

(n164)Footnote 131. *Treas Reg § 1.863-7*, discussed in § 9A.04[7].

(n165)Footnote 132. *Treas Reg § 1.1275-6(f)(12)(ii)*.

(n166)Footnote 133. *Treas Reg § 1.1275-6(f)(13)*.

(n167)Footnote 134. *Notice 96-51, 1996-2 CB 216*.

(n168)Footnote 135. *Treas Reg* § 1.1275-3(c)(3).

(n169)Footnote 136. *Treas Reg* § 1.1275-7(c)(1).

(n170)Footnote 137. *Treas Reg* § 1.1275-7(c)(2). A value of a qualified inflation index is current if the value has been updated and published within the preceding six-month period. *Treas Reg* § 1.1275-7(c)(2)(i).

(n171)Footnote 138. *Treas Reg* § 1.1275-7(c)(3).

(n172)Footnote 139. *Treas Reg* § 1.1275-7(c)(5).

(n173)Footnote 140. *Treas Reg* § 1.1275-7(d)(1), (2). See Ch 2, § 2.07[c][i] and Ch 17, § 17.03[2], which discuss the rules for calculating *de minimis* OID.

(n174)Footnote 141. For any date, the inflation-adjusted principal amount of an inflation-indexed debt instrument is an amount equal to the outstanding principal amount of the debt instrument (determined as if there were no inflation or deflation over the term of the instrument), multiplied by a ratio, the numerator of which is the value of the reference index for the date and the denominator of which is the value of the reference index for the issue date. *Treas Reg* § 1.1275-7(c)(4).

(n175)Footnote 142. *Treas Reg* § 1.1275-7(d)(3).

(n176)Footnote 143. See § 9A.04[3][b].

(n177)Footnote 144. *Treas Reg* § 1.1275-7(d)(4)(i).

(n178)Footnote 145. *Treas Reg* § 1.1275-7(d)(4)(ii).

(n179)Footnote 146. *Treas Reg* § 1.1275-7(d)(4)(iii).

(n180)Footnote 147. *Treas Reg* §§ 1.1275-7(d)(4), 1.1275-7(f)(1)(i).

(n181)Footnote 148. *Treas Reg* § 1.1275-7(f)(1)(ii).

(n182)Footnote 149. *Treas Reg* § 1.1275-7(f)(4).

(n183)Footnote 150. *Treas Reg* § 1.1275-7(e)(i). If a Treasury Inflation-Indexed Security is stripped under the Department of the Treasury's Separate Trading of Registered Interest and Principal of Securities (STRIPS) program, the holders of the principal and coupon components must use the discount bond method to account for the OID on the components. *Treas Reg* § 1.1286-2.

(n184)Footnote 151. *Treas Reg* § 1.1275-7(e)(2).

(n185)Footnote 152. *Treas Reg* § 1.1275-7(e)(3).

(n186)Footnote 153. $AIP(n)$ is \$182,806, $[r + inf1 + (r \times inf1)]$ is .01001875. Multiplying the two yields \$1,831, rounded to the nearest dollar.

(n187)Footnote 154. *Treas Reg* § 1.1272-1(g); *Treas Reg* § 1.1275-7(f)(2).

(n188)Footnote 155. *Treas Reg* § 1.1275-7(f)(3).

(n189)Footnote 1. *IRC* § 1275(c)(2); *Treas Reg* § 1.1275-3(c)(1), (2). A debt instrument is publicly offered if it is part of an issue of debt instruments the initial offering of which (i) is registered with the Securities and Exchange

Commission; or (2) would be required to be registered under the Securities Act of 1933, but for an exemption from registration (a) under § 3 of the Securities Act of 1933, (b) under any other law because of the identity of the issuer or the nature of the security, or (c) because the issue is intended for distribution to persons who are not US persons. *Treas Reg § 1.1275-1(h)*.

A foreign or domestic issuer is subject to the information reporting rules unless the issue of debt instruments is not offered for sale or resale in the US in connection with its original issuance. *Treas Reg § 1.1275-3(d)*.

(n190)Footnote 2. *Treas Reg § 1.1275-3(c)(3)*.

(n191)Footnote 3. *IRC § 6706(b)*; *Treas Reg § 1.1275-3(e)*.

(n192)Footnote 4. *Treas Reg § 1.1275-3(b)(1)*. The requirement of a legend does not apply to debt instruments excepted from the OID rules by *IRC § 1272(a)(2)*, debt instruments issued by natural persons, REMIC regular interests or other debt instruments subject to *IRC § 1272(a)(6)*, or stripped bonds or coupons. *Treas Reg § 1.1275-3(b)(4)*.

(n193)Footnote 5. *IRC § 1275(c)(2)*; *Treas Reg § 1.1275-3(b)(2)*. Any new physical security that is issued (for example, on registration of transfer of ownership) must contain any required legend. *Treas Reg § 1.1275-3(b)(3)*.

(n194)Footnote 6. *IRC § 6706(a)*.



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Taxation of Securities Transactions

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CHAPTER 17 Transactions in Bonds and Other Debt Instruments

2-17 Taxation of Securities Transactions § 17.04

§ 17.04 Disposition of Taxable and Tax-Exempt Bonds

[1] General Rule: Capital Gain or Loss.

Since a bond or other evidence of indebtedness is usually a capital asset, its sale or exchange is an event which normally gives rise to the realization of capital gain or loss.

The retirement of debt instruments by their issuer is not a "sale or exchange";ⁿ¹ nevertheless, it is treated as a sale or exchange by statute.ⁿ² Although deemed "sale or exchange" treatment on retirement was for many years limited to debt instruments issued by corporations, governments, or political subdivisions of governments, it was extended in 1997 to debt instruments issued by a natural person if such instruments are either issued after June 8, 1997 or purchased (regardless of the date of issuance) after that date.ⁿ³ Thus, capital gain or loss is the general rule for retirements as well as sales or exchanges of debt instruments.

The exemption accorded the interest on a state or municipal obligation does not extend to gain realized on the sale of that obligation. A constitutional challenge to the imposition of tax on gain from the sale of a municipal bond was mounted in *Willcuts v. Bunn*,ⁿ⁴ but was dismissed with this language:

"In the case of obligations of a state or of its political subdivisions, the subject held to be exempt from federal taxation is the principal and interest of the obligations. ... These obligations constituted the contract made by the State, or by its political agency pursuant to its authority, and a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of the government.

"But it does not follow, because a tax on the interest payable on state and municipal bonds is a tax on the bonds and therefore forbidden, that the Congress cannot impose a nondiscriminatory excise tax upon the profits derived from the sale of such bonds. The sale of the bonds by their owners, after they have been issued by the State or municipality, is a transaction distinct from the contracts made by the government in the bonds themselves, and the profits on such sales are in a different category of income from that of the interest payable on the bonds."ⁿ⁵

Under the general rule, therefore, gain on the sale, exchange or retirement of a tax-exempt bond is normally taxed as either long-term or short-term capital gain, depending on the length of the taxpayer's holding period. In similar fashion,

a realized loss is treated as a capital loss.

In certain cases, exchanges of taxable and even tax-exempt bonds can be effected tax-free. The conversion of a taxable bond into stock of the obligor is not a taxable event if the conversion privilege is embodied in the original debt instrument.ⁿ⁶ An exchange of corporate securities pursuant to a plan of reorganization may be one in which no gain or loss is recognized or in which gain is recognized only in part.ⁿ⁷ The exchange of bonds issued under the Second Liberty Bond Act can be achieved without the recognition of gain if the provisions of *IRC Section 1037* are met.ⁿ⁸ Finally, the receipt of a new instrument might be viewed as nothing more than the continuation of the debt represented by the one surrendered, a transaction that is not a taxable event.ⁿ⁹

We turn now to other exceptions to the general rule--situations in which all or part of the amount realized by the taxpayer on the sale, exchange or retirement of a debt obligation is taxed as ordinary income, usually interest, and not capital gain.

[2] Disposition of Bonds in Bearer Form.

IRC Section 1287(a) denies capital gain treatment with respect to the entire gain, if any, from the sale, exchange or retirement of any "registration required obligation" which is not in registered form. Every obligation is a registration required obligation (including any obligation issued by a governmental entity) unless it is (1) issued by a natural person, (2) is not of a type offered to the public, or (3) has a maturity at issue of not more than one year.ⁿ¹ An obligation is generally treated as issued in registered form if the issuer or its agent maintains a registration of the identity of the owner of the obligation and the obligation can be transferred only through this registration system.ⁿ² Both terms, "registration required obligation" and "registered form," have the same meaning in *IRC Section 1287(a)* as in *IRC Section 163(f)*, which denies an interest deduction to an issuer of a registration required obligation that is not in registered form.ⁿ³

[3] Disposition of Bonds with Accrued Interest.

"When bonds are sold between interest dates, part of the sales price represents interest accrued to the date of the sale and must be reported as interest income."ⁿ¹ The proceeds of the disposition, less the portion treated as interest, are then taken into account for the purpose of determining the bondholder's gain or loss. The amount paid by the buyer to the seller as interest becomes a capital amount to be recovered tax-free before any interest received by the buyer is includable in gross income.ⁿ² To illustrate:

Example:

On February 1, A buys a \$1,000 bond, bearing interest at 6 percent payable on January 1 and July 1, for \$1,010 plus \$5 accrued interest. He sells the bond to B on May 1 for \$1,045. A must treat \$15 of that amount as interest income. Although a total of \$20 of interest accrued on the bond from January 1 to the date of sale, the \$5 of accrued interest paid by A to his seller reduces the amount includable. A also has a short-term capital gain of \$15, determined by subtracting his cost basis, \$1,010, from the amount realized, \$1,025 (\$1,045-\$20). B holds the bond until July 1, when he receives an interest payment of \$30 from the obligor. Of this amount, only \$10 need be reported as interest income; the other \$20 is treated as a recovery of capital.

Prior to 1968, this principle might not have controlled in all events. An early Solicitor's Opinionⁿ³ ruled that accrued interest would be income to the vendor when the agreement of sale stipulated a payment of the agreed price plus accrued interest; otherwise the purchaser would report all of the income when received by him.ⁿ⁴ However, in 1968, the Opinion was ruled obsolete and not determinative with respect to future transactions.ⁿ⁵ Thus, it appears that the rule should be applied, without exception, in every case in which a bond is sold between interest dates.

The determination of the amount of gain or loss in a disposition of a tax-exempt obligation follows the method used in the case of taxable obligations. A sale between interest dates calls for an allocation of the amount received. The portion representing interest accrued to the date of sale is segregated from the selling price, and excluded from gross income, unless the obligation is an industrial development bond or an arbitrage bond; the balance of the selling price is the amount used in determining the taxpayer's gain or loss.ⁿ⁶ The same holds true for bonds issued at a discount. The earned discount is treated as the equivalent of interest exempt from taxation under *IRC Section 103(a)*.ⁿ⁷

If a tax-exempt bond is purchased "flat,"ⁿ⁸ payments on account of interest in arrears at the time of purchase, whether received directly from the obligor or indirectly through a sale to a third party, are not interest, but rather a return of capital. Payments made on account of interest accrued after purchase are treated as interest. So, if upon the disposition of a tax-exempt bond, the taxpayer receives more than his adjusted basis for the bond, the portion representing post-acquisition interest from the remainder of the proceeds of sale is nontaxable and excluded from the amount realized in determining gain or loss.

[4] Disposition of Bonds with OID.

The holder of an original issue discount bond is required to accrue as income the portion of OID earned during each taxable year in which the bond is held.ⁿ¹ Two consequences flow from this. First, the basis of the obligation in the hands of the holder is increased by the amount of OID included in gross income.ⁿ² Second, in accordance with the general rule, any gain realized on the sale, exchange, or retirement of the bond, if held for more than one year, will normally be long-term capital gain. To illustrate:

Example:

On January 1, 1997, Taxpayer purchased a 10-year \$10,000 corporate bond for \$9,500. He sells the bond on January 1, 1998, for \$9,600. Assume Taxpayer was required to include \$50 of OID in income in 1997; this raised Taxpayer's basis for the bond to \$9,550, reducing the gain realized in the sale by \$50. The remaining \$50 gain is long-term gain in its entirety.

However, gain on the disposition of a bond issued with OID will be treated as ordinary income rather than capital gain in an amount not exceeding the unrecognized OID if at the time of original issue the issuer intended to call the bond before maturity.ⁿ³ The regulations define the term "intention to call before maturity" to mean a written or oral agreement, or understanding not provided for in the debt instrument, between the issuer and the original holder of the obligation that the former will redeem the obligation before maturity.ⁿ⁴ In the case of debt instruments that are part of an issue, the agreement or understanding must be between the issuer and the original holders of a substantial amount of the debt instruments in the issue.ⁿ⁵ An intention to call before maturity can exist even if the intention is conditional (eg, the issuer's decision to call depends on the financial condition of the issuer on the potential call date) or is not legally binding.ⁿ⁶

Since OID is a form of interest, it is not includible in the income of the holder of a tax-exempt bond at any time.ⁿ⁷ Nevertheless, a taxpayer that purchases a tax-exempt bond with original issue discount must be allowed to increase the basis of the bond as OID accrues or risk being taxed on exempt interest income if the bond is sold before maturity.ⁿ⁸ Such adjustments to basis are provided for in *IRC Section 1288(a)(2)*, which allows the tax-exempt bondholder to make the same adjustments to basis in the same manner as those allowed to holders of taxable bonds that must include OID in income under *IRC Section 1272(a)*.

The holder of a short-term obligation, an obligation maturing not more than one year from the date of issuance (eg, commercial paper), will by definition be ineligible for long-term capital gain treatment on the sale or retirement of the obligation when long-term capital gain treatment requires a holding period of more than one year. In addition, under

IRC Section 1271(a)(3), gain on the disposition of a "short-term government obligation" is considered ordinary income, not capital gain, up to the amount of the seller's "ratable" share of the "acquisition discount" on such obligation. The seller's "acquisition discount" is the excess of the obligation's stated redemption price at maturity over the seller's basis in the obligation, while the ratable share of that discount (the measure of the amount treated as ordinary income) is the amount which bears the same ratio to the discount as the number of days during which the taxpayer held the obligation bears to the total number of days from the date the taxpayer acquired the obligation to (and including) its maturity date.⁹ *IRC Section 1273(a)(3)* applies almost exclusively to Treasury bills; although "short term government obligations" are initially defined as all obligations with a fixed maturity date not more than 1 year from the date of issue that are issued by the United States or its possessions, or by a State or any political subdivision thereof, or of the District of Columbia, tax-exempt obligations are then removed from the definition.¹⁰

IRC Section 1271(a)(4) extends the rule just described to short-term nongovernment bonds and tax-exempt obligations. As in the case of short-term government bonds, the holder can irrevocably elect to determine acquisition discount on an economic accrual basis.¹¹

Any gain recognized by a holder on the sale, exchange, or retirement of a contingent payment debt instrument subject to the noncontingent bond method¹² is interest income.¹³ Any loss recognized by the holder on the sale, exchange, or retirement of the debt instrument is an ordinary loss to the extent that the holder's total interest inclusions on the debt instrument exceed the total net negative adjustments on the debt instrument the holder took into account as ordinary loss.¹⁴ Any additional loss is treated as loss from the sale, exchange, or retirement of the debt instrument, and, thus, as a capital loss if the debt instrument is a capital asset in the hands of the holder. If, at the time of the sale, exchange, or retirement of the debt instrument, there are no remaining contingent payments due on the debt instrument, any gain or loss recognized by the holder is treated as gain or loss from the sale, exchange or retirement of the debt instrument.¹⁵

Example 1:

On January 1, 1998, A, a calendar year taxpayer, sells a contingent payment debt instrument, in which A has an adjusted basis of \$24,000, for \$27,000. A has a negative adjustment carryforward of \$1,000 for 1997 that results in a negative adjustment of \$1,000 on January 1, 1998. A has no positive adjustments on the debt instrument on January 1, 1998. The \$1,000 negative adjustment on January 1, 1998 results in a negative adjustment carryforward for 1998, and reduces the amount realized by A on the sale of the debt instrument from \$27,000 to \$26,000. This produces a gain for A of \$2,000 (\$26,000 amount realized minus \$24,000 basis) that A must treat as interest income.

Example 2:

On December 31, 1996, B, a calendar year taxpayer, purchases a debt instrument at original issue for \$20,000. The debt instrument is a capital asset in B's hands. The instrument provides for a single payment of \$20,000 on December 31, 1998 (the maturity date of the instrument), plus an amount equal to the increase, if any, in the price of a specified commodity over the term of the instrument. The comparable yield on the debt instrument is 9.54 percent, compounded annually, and the projected payment schedule provides for a payment of \$24,000 on December 31, 1998. Based upon the projected payment schedule, the total daily portions of interest would be \$1,900 for 1997 and \$2,100 for 1998.

Assume that B sells the debt instrument for \$21,000 on December 31, 1997. On that date, B has an adjusted basis in the debt instrument of \$21,900 (\$20,000 original basis plus total daily portions of interest of \$1,900 for 1997). Thus, B realizes a \$900 loss on the sale of the debt instrument. The entire loss is an ordinary loss. The amount of the loss is less than B's interest inclusions on the debt instrument and B had no negative adjustments on the instrument.

Assume, alternatively, that B realizes \$19,800 on the sale of the instrument on December 31, 1997. This produces a

\$2,100 loss, consisting of an ordinary loss of \$1,900 (the amount of B's interest inclusions on the debt instrument) and a capital loss of \$200.

If the debt instrument that is sold, exchanged, or retired is one that is not subject to the noncontingent bond method, the holder must allocate the amount received first to the noncontingent component and to any separate debt instruments that result from a contingent payment being fixed more than six months before it is due; the amount so allocated cannot exceed the total of the adjusted issue price of the noncontingent component and the adjusted issue prices of any separate debt instruments.ⁿ¹⁶ The remaining amount received, if any, is allocated to the contingent component. The amount allocated to the noncontingent component and any separate debt instruments is treated as an amount realized from the sale, exchange, or retirement of the noncontingent component or separate debt instrument.ⁿ¹⁷ The amount allocated to the contingent component is treated as a contingent payment that is made on the date of disposition and is characterized as interest and principal according to the rules governing contingent payments received on debt instruments not subject to the noncontingent bond method.ⁿ¹⁸

[5] Disposition of Bonds with Market Discount.

Market discount arises when the value of a debt instrument decreases after issuance. Prior to the Tax Reform Act of 1984, capital gain treatment was accorded to the appreciation in value attributable to market discount. Such treatment still obtains for obligations issued before July 19, 1984 and purchased before May 1, 1993. For market discount bonds issued after July 18, 1984, or issued before that date but purchased after April 30, 1993, the gain that would have been capital gain is treated as ordinary income to the extent of the accrued market discount on the bond.ⁿ¹ The amount of ordinary income is treated as interest except (1) when the bond is a tax-exempt bond purchased after April 30, 1993, and (2) for purposes of determining the tax on income of nonresident aliens and foreign corporations not effectively connected with a U.S. trade or business.ⁿ²

A market discount bond is defined as any bond, debenture, note, certificate or other evidence of indebtedness (but not (1) a short-term obligation with a fixed maturity date not exceeding one year from the date of issue; (2) a tax-exempt obligation if purchased before May 1, 1993; (3) a U.S. savings bond; or (4) an installment obligation to which *IRC Section 453B* applies), with a stated redemption price in excess of the basis of the bond immediately after its acquisition by the taxpayer.ⁿ³ For original issue discount bonds acquired at a market discount, the stated redemption price is deemed to be equal to the sum of the issue price of the bond plus the aggregate amount of the original issue discount includable in the gross income of all holders for periods before the acquisition by the holder in question.ⁿ⁴ As in the case of original issue discount, market discount is considered to be zero if it is less than one quarter of one percent of the stated redemption price at maturity multiplied by the number of complete years to maturity after the holder acquired the bond.ⁿ⁵

IRC Section 1278(a)(1)(D) makes it clear that a bond acquired at original issue (or acquired with a transferred basis from a person who acquired it at original issue) is not a market discount bond. The rule does not apply if the bond is acquired at original issue at less than its issue price, or if it is issued in a tax-free reorganization in exchange for a market discount bond (unless the market discount bond was issued on or before July 18, 1984, and the new bond has the same term and interest rate as the other bond).

The amount of accrued market discount taken into account on the disposition of a market discount bond is a linear computation that determines the amount that bears the same ratio to market discount on the bond as the number of days that the taxpayer held the bond bears to the number of days after the date the taxpayer acquired the bond up to and including the date of maturity.ⁿ⁶ In lieu of this ratable accrual, the taxpayer can accrue market discount under the constant interest method that is provided for the amortization of original issue discount bonds issued after July 1, 1982.ⁿ⁷ The election is made on a bond-by-bond basis and, once made, is irrevocable.ⁿ⁸

Pursuant to *IRC Section 1276(a)(3)*, any partial principal payment on a market discount bond must be included in

income as ordinary income to the extent the payment does not exceed the accrued market discount on the bond. In such case, the accrued market discount to be taken into account by reason of a disposition of the bond or the receipt of additional partial principal payments, is reduced accordingly.

If a market discount bond is transferred in a nonrecognition transaction, the transferor will be taxed on accrued market discount only to the extent he receives "boot," unless the transaction is an incorporating transfer governed by *IRC Section 351*, in which case the general accrued market discount rules apply.ⁿ⁹ If the transferee's basis is determined by reference to the basis of the bond in the hands of the transferor (transferred basis property), the transferee is treated as having acquired the bond on the date acquired by the transferor for an amount equal to the transferor's basis increased by any original issue discount or market discount included in the gross income of the transferor.ⁿ¹⁰ If the taxpayer transfers a market discount bond in a nonrecognition transaction, and the basis of the property received in exchange is determined by reference to the basis of the transferred property (exchanged basis property), the property received is treated as if it were a market discount bond with any accrued market discount on the transferred bond attaching to the new property.ⁿ¹¹ Thus, on disposition of the property, any gain realized will be ordinary income to the extent of the attached discount.

A taxpayer can elect to include accrued market discount in gross income currently, determining the amount of the accrual either under the linear method or the constant interest method.ⁿ¹² If the election is made, the rule requiring ordinary income treatment upon disposition is inapplicable to bonds acquired by the taxpayer on or after the first day of the taxable year to which the election applies.ⁿ¹³

[6] Partial Dispositions: Stripped Bonds and Bond Coupons.

A "stripped bond" is one originally issued as a coupon bond from which the holder has removed one or more coupons that have not yet become payable.ⁿ¹ A "stripped coupon" is any coupon relating to a stripped bond, and, for purchases after July 1, 1982, need not be evidenced by an actual coupon.ⁿ²

Congress enacted the predecessor of *IRC Section 1286* in 1982, to address the tax issues raised by bond stripping transactions.ⁿ³ Those issues are illustrated by a transaction in which, after detaching the interest coupons from a \$100,000 US Government 20-year coupon bond, the holder sells the corpus for \$8,000. Taking the position that gain or loss in this transaction should be calculated by deducting the seller's basis in the bond (\$100,000) from the amount realized for the bond corpus (\$8,000) would create a \$92,000 loss to the seller. While an offsetting gain would ultimately be recognized by the purchaser of the bond, the deferral period in this case could be as long as 20 years.ⁿ⁴ Congress addressed both the basis allocation issue, requiring the seller in a stripping transaction to allocate basis among the sold and retained components of the bond in accordance with their respective fair market values, and the deferral issue, requiring the purchaser to take the purchase discount into income over the life of the bond as though it were original issue discount rather than deferring income until the bond's sale or redemption.

When a bondholder strips one or more coupons from a bond and, after July 1, 1982, disposes of the bond or any stripped coupons, the seller must include in gross income the sum of (1) any interest accrued on the bond before the date of disposition and not previously accounted for as income, and (2) the accrued market discount on the bond determined as of the time the coupon or bond was disposed of (to the extent the discount had not been included in income previously).ⁿ⁵ This works an increase in the seller's basis which must then be allocated among the items (bond or coupons) retained and the items disposed of according to their relative fair market values. The seller then computes gain or loss on the items disposed of using this adjusted basis.

Any retained item in the hands of the seller (whether a stripped bond or stripped coupon) is deemed to have been purchased by the seller on the date of disposition for an amount equal to the allocated adjusted basis. The importance of this is that, pursuant to *IRC Section 1286(a)*, any stripped coupon in the hands of a purchaser is treated as a bond originally issued on the purchase date with an OID equal to the excess, if any, of the stated redemption price at maturity

(or, in the case of a coupon, the amount payable on the due date of the coupon), over the ratable share of the purchase price of the bond or coupon.ⁿ⁶ Any OID thus resulting is subject to the inclusion rules prescribed by *IRC Section 1272*.

The treatment of any stripped tax-exempt obligation depends on the date of purchase of the obligation. If purchased before June 11, 1987,ⁿ⁷ *IRC Section 1286(d)* (prior to its amendment by the Technical and Miscellaneous Revenue Act of 1988) applies and the amount of OID determined with respect to the stripped bond or coupon is the amount that produces a yield to maturity (as of the purchase date) equal to the lower of (1) the coupon rate of interest on the obligation before the separation of coupons, or (2) the yield to maturity (on the basis of the purchase price) of the stripped obligation or coupon. The amount of OID so determined is taken into account in determining the adjusted basis of the holder under *IRC Section 1288*. The basis of the bond or coupon is increased by interest accrued but not paid before the time the bond is disposed of (and not previously reflected in basis).

For obligations purchased or sold after June 10, 1987, the amount of OID that exceeds the "tax-exempt portion" is treated as OID on a taxable obligation and, therefore, is includable in gross income. The tax-exempt portion of the OID is the amount by which the stated redemption price at maturity (or the amount payable on the due date of a coupon) exceeds an issue price that would produce a yield to maturity as of the purchase date equal to the lower of (1) the coupon rate of interest on the obligation from which the coupons were separated (or, if the taxpayer elects, the original yield to maturity), or (2) the yield to maturity (on the basis of the purchase price) of the stripped obligation or coupon.

*Notice 2010-28*ⁿ⁸ provides interim guidance for holders of qualified tax credit bonds on the tax treatment of coupon stripping transactions, which in general follow the rules prescribed in *IRC § 1286*.ⁿ⁹ A "stripping transaction" is defined as a transaction that results in a separation in ownership between a "credit coupon" (i.e., any right to receive a tax refund with respect to a qualified tax credit bond) for any credit allowance date that has not yet occurred and any right to receive cash (either stated principal or stated interest on the bond) that has not yet become payable, but does not include a transaction in which such a separation reflects a pro rata division of all pre-transaction future rights.ⁿ¹⁰ The purchaser of a credit coupon will not be permitted to claim the associated tax refund unless the qualified tax credit bond which was the subject of the stripping transaction was part of a "strippable issue;" that is, was part of a bond issue meeting all of the following requirements:ⁿ¹¹

1. Designation requirement. The issuer, on or before the date of issue, included a statement in the bond documents that the issue is strippable.
2. Identification requirement. The issuer identified the issue as a strippable issue in the first information return it filed with the IRS under *IRC Section 54A(d)(3)*.
3. Registration requirement. The qualified tax credit bond is issued in registered form. For this purpose, registered form means that all rights to stated principal, stated cash interest, and tax credits under the bond may be transferred only through book entry on the registration books of the issuer or its agent or nominee, which entries are maintained in a manner that makes all the entries available for inspection by the IRS.
4. CUSIP number requirement. A CUSIP number is assigned to the issue, a separate CUSIP number is assigned to all rights to receive tax credits on each credit allowance date,ⁿ¹² and at least one separate CUSIP number is assigned to all rights to receive cash (whether stated principal or stated interest) with respect to the issue.

The stripped credit coupon with respect to which a tax credit is claimed must be either a whole coupon or a proportional share of a whole credit coupon. Any other division of a whole credit coupon, effected through a partnership, trust or other investment arrangement that in substance creates a variable share in the credit coupon, will result in disallowance of any tax credit with respect to that interest.ⁿ¹³ Moreover, to receive a tax credit the stripped coupon must be held by the taxpayer in an account with a broker unless and until the IRS, in published guidance, authorizes the holding of

stripped coupons in other types of accounts.ⁿ¹⁴

The tax consequences of a stripping transaction in qualified tax credit bonds are determined under *IRC Sections 1286(a), (b) and (e)*, in the same manner as a stripping transaction involving taxable interest bonds.ⁿ¹⁵ Accordingly, the seller of a stripped coupon must (a) include in gross income any accrued interest and market discount on the qualified tax credit bond as of the date of the stripping transaction, (b) increase the basis of the bond (including its credit coupons) by the amount taken into gross income, (c) allocate the increased basis among the rights retained by the seller and the rights disposed in the stripping transaction in accordance with the respective fair market values of each component, (d) recognize gain or loss on the credit coupon stripped from the bond, and (e) treat each of the rights retained as having been purchased on the date the stripped coupon is sold for an amount equal to its allocated basis.ⁿ¹⁶ The purchaser of the stripped coupon is deemed, for OID purposes, to have purchased a zero coupon bond with a stated redemption price at maturity equal to the amount payable on the due date of the coupon and an issue price equal to the basis allocated to the credit coupon in the stripping transaction;ⁿ¹⁷ the discount is taken into income in accordance with OID rules.ⁿ¹⁸

Notice 2010-28 adds an additional "aggregation" rule: If, on a single date, a taxpayer purchases (including a "deemed purchase" under *IRC Section 1286*) as part of a single transaction or series of related transactions, more than one component (stated principal, stated cash interest or credit coupons) of a qualified tax credit bond that has been subject to a stripping transaction, then for purposes of the OID and related rules in *IRC Sections 1271 through 1286*, the taxpayer must treat the components so purchased as a single debt instrument (the "aggregated debt instrument") that was newly issued on the purchase date, and none of the payments on the aggregated debt instrument will be deemed to be qualified stated interest. However, if the taxpayer purchases all of the then-outstanding components of a qualified tax credit bond, the resulting aggregated debt instrument is treated as if it had not been subject to a previous stripping transaction and payments on the instrument may be regarded as qualified stated interest.ⁿ¹⁹

The following example illustrates the operation of the stripping transaction rules in *Notice 2010-28*.ⁿ²⁰

Example:

On December 15, 2011, City X issues qualified school construction bonds which carry a credit rate of 10% compounded quarterly and a maturity date of December 15, 2013. Assume these City X qualified tax credit bonds qualify as a "strippable issue" within the meaning of *Notice 2010-28*. S, a cash method calendar year taxpayer, purchases a City X bond with a stated principal amount of \$ 6,000 for \$6,000 cash on December 15, 2011. On the same date S sells one of the \$150 credit coupons, due December 15, 2013, to P, a cash method calendar year taxpayer, for \$123.75, its fair market value on December 15, 2011. After the stripping transaction, S holds the right to receive \$6,000 at maturity as well as the first 7 credit coupons (the "8 retained components"), and P holds only the credit coupon coming due on December 15, 2013.

IRC Section 1286(b)(4) treats S as having purchased the 8 retained components on the date of the stripping transaction, December 15, 2011, and under *Notice 2010-28*'s aggregation rule, the 8 retained components are treated as an aggregated debt instrument that is newly issued on that date. Because no interest had accrued on the City X bond as of the date of the stripping transaction, S does not include accrued interest in income under *IRC Section 1286(b)(1)(A)* and does not increase the basis of the City X bond under *IRC Section 1286(b)(2)*. Pursuant to *IRC Section 1286(b)(3)*, S must allocate its \$6,000 basis in the qualified tax credit bond between the credit coupon S sold to P and S's retained aggregate debt instrument, based on their respective fair market values. Assuming that the fair market value of S's aggregate debt instrument is \$5,877.10 and the fair market value of the December 15, 2013 credit coupon is \$123.75, S's basis in the aggregated debt instrument is \$5,876.27 (\$6,000 basis x [\$5,877.10/\$6,000.85]) and S's basis in the December 15, 2013 credit coupon sold to P is \$123.73 (\$6,000 basis x [\$123.75/\$6,000.85]).

As a result of the foregoing, S realizes gain of \$0.02 on the sale of the credit coupon (\$123.75 sales price less \$123.73 basis allocated to the credit coupon). The aggregated debt instrument created by *Notice 2010-28* 's aggregation rule is deemed newly issued on December 15, 2011 with a stated redemption price at maturity of \$7,050 (\$6,000 + [7 x \$150]) and an issue price equal to the basis allocated to the aggregated debt instrument of \$5,876.27. Under the aggregation rule, no payment on the aggregated debt instrument is qualified stated interest. The aggregated debt instrument therefore has OID of \$1,173.73 (\$7,050-\$5,876.27). Although S generally uses the cash method of accounting, S must include the OID in income as it accrues on a constant yield basis over the term of the aggregated debt instrument in accordance with *IRC Section 1272* and the regulations thereunder.

P is required by *IRC Section 1286(a)* to treat the purchase of the stripped credit coupon as the purchase of a zero coupon bond that is issued on the date of purchase (December 15, 2011). The stripped credit coupon has a stated redemption price at maturity of \$150 and an issue price of \$123.75, resulting in OID of \$26.25 (\$150-\$123.75). Although P generally uses the cash method of accounting, P must include the OID in income as it accrues on a constant yield basis over the term of the credit coupon in accordance with *IRC Section 1272* and the regulations thereunder. P's basis in the stripped credit coupon is increased by the amount of OID included in P's income, so that, by the maturity date of the coupon on December 15, 2013, P's basis in the coupon will equal the \$150 tax credit to which P becomes entitled on that date.

FOOTNOTES:

(n1)Footnote 1. *Fairbanks v US*, 306 US 436 (1939) . See also Chapter 2, § 2.03.

(n2)Footnote 2. *IRC Section 1271(a)(1)*.

(n3)Footnote 3. *IRC § 1271(b)*.

(n4)Footnote 4. *282 US 216 (1931)* .

(n5)Footnote 5. *282 US at 226-227 (1931)* .

(n6)Footnote 6. See § 8.08[4].

(n7)Footnote 7. *IRC §§ 354, 355, 356*. Reorganization exchanges are discussed in Ch 8.

(n8)Footnote 8. See § 8.07[3].

(n9)Footnote 9. See § 8.07[4][a][ii].

(n10)Footnote 1. "Registration required obligation" generally has the same meaning in *IRC § 1287(b)(1)* as in *IRC § 163(f)(2)* (denying an interest deduction to the issuer of any registration required obligation not in registered form. There is one difference: while obligations targeted for sale only to purchasers who are not US persons constitute a fourth exception to the definition of registration required obligations for purposes of the denial of interest deductions, see *IRC § 163(f)(2)(B)*, that exception does not apply for purposes of the denial of capital gains treatment under *IRC § 1287*. See *IRC § 1287(b)(2)*. However, the exception for foreign targeted obligations in *IRC § 163(f)(2)(B)* has been repealed for obligations issued after March 18, 2012, so that the coverage of *IRC §§ 163(f)* and *1287* will be identical after that date. See Ch 19, § 19.05[1][d].

(n11)Footnote 2. See *Treas Reg § 5f.103-1(c)*; Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act," Under Consideration by the Senate (JCX-4-10), Feb 23, 2010, 49. Among other things, if a registration required obligation issued by a state or local government is not "in registered form," interest on the obligation will not be tax exempt. See § 17.02[1][a], *supra*, which discusses the meaning of "in registered form" in that context, but applies for purposes of *IRC § 1287* as well.

(n12)Footnote 3.

(n13)Footnote 1. *Treas Reg § 1.61-7(d)*. The same would be true if the bond was called between interest dates. *Letter Ruling, Feb 7, 1949, P-H 1949 Fed Taxes P 76,191*.

An adjustment to the conversion price to reflect interest accrued on a convertible bond to the date of conversion represents income to the taxpayer. *Letter Ruling, Jan 12, 1956, P-H 1956 Fed Taxes P 76,140*.

A taxpayer exchanged a note having a basis and face value of \$10,000 for a \$10,000 bond worth \$9,424.

Although there was unpaid interest on the note of \$636, no interest income was realized on the exchange since the amount realized was less than the principal amount of the note. The taxpayer realized a loss of \$576 on the transaction, and assumed a basis of \$9,424 for the bond. *Rev Rul 73-328, 1973-2 CB 296*.

(n14)Footnote 2. *L A Thompson Scenic Ry v Commr, 9 BTA 1203 (1928)*, *acq* VII-1 CB 31 (1928); see also *Rev Rul 69-263, 1969-1 CB 197*; *Rev Rul 67-17, 1967-1 CB 179*.

In *MacLaughlin v Harr, 99 F2d 638 (3d Cir 1938)*, interest received after a bank merger was held not to be income when the interest was one of the assets for which the surviving corporation paid a consideration.

The opposite result was reached where there was no purchase of the assets of one bank by the other. *Pontiac Commercial and Savings Bank v Commr, 41 F2d 602 (6th Cir 1930)*.

(n15)Footnote 3. *Sol Op 46, 3 CB 90 (1920)*.

(n16)Footnote 4. This principle was followed in *Moore v Commr, BTA Memo 1940-446*.

(n17)Footnote 5. *Rev Rul 68-575, 1968-2 CB 603*. The Ruling indicates that "most of the listed old rulings are now covered by statute, regulations, or later Revenue Rulings."

(n18)Footnote 6. *Rev Rul 72-224, 1972-1 CB 30*; see also *Palm Beach Trust Co v Commr, 9 TC 1060 (1947)*, *acq* 1948-1 CB 3, *aff'd in part and rev'd in part on other grounds 174 F2d 527 (DC Cir 1949)*, *cert denied, 338 US 825*. The proceeds of a sale of interest coupons may not necessarily be treated as interest. *Lloyd v Commr, 154 F2d 643 (3d Cir 1946)*, *cert denied, 329 US 717* (sale of detached coupons on refunding bonds; proceeds many times greater than amount of interest obligor required to pay in year of sale); *Rev Rul 58-536, 1958-2 CB 21*; *Rev Rul 55-73, 1955-1 CB 236* (sale of coupons representing commissions to brokers).

(n19)Footnote 7. *Rev Rul 73-112, 1973-1 CB 47*. A premium paid to redeem a discount bond at a premium is not "interest" and is taxable. *Rev Rul 72-587, 1972-2 CB 74*.

(n20)Footnote 8. See § 17.01[1][d].

(n21)Footnote 1. *IRC § 1272(a)*. Holders of tax-exempt obligations, United States savings bonds, and "short-term obligations" (any debt instrument which has a fixed maturity date not more than 1 year from date of issue) are not subject to the requirement that OID be accrued ratably throughout the term of a debt instrument, and the OID accrual rule does not apply to most loans between natural persons. *IRC § 1272(a)(2)*.

(n22)Footnote 2. *IRC § 1272(d)(2)*.

(n23)Footnote 3. *IRC § 1271(a)(2)*.

(n24)Footnote 4. *Treas Reg § 1.1271-1(a)(1)*.

(n25)Footnote 5. *Treas Reg § 1.1271-1(a)(1)*.

(n26)Footnote 6. *Treas Reg § 1.1271-1(a)(1)*.

(n27)Footnote 7. See *IRC § 1272(a)(2)(A)*; *Rev Rul 73-112, 1973-1 CB 47*.

(n28)Footnote 8. Suppose, for example, a taxpayer acquires at issuance, for \$50,000, a \$100,000 zero coupon tax-exempt bond maturing in 10 years. If held until maturity, the taxpayer will collect the \$50,000 in OID without payment of any tax. If instead the taxpayer were to sell the bond after holding it for two years, at its then present value of \$59,000, the entire gain of \$9,000 (\$59,000 sales price less \$50,000 basis) would be taxable, albeit at capital gains rates. Assuming the \$9,000 represents OID, an adjustment to basis for accrued OID would prevent that result.

(n29)Footnote 9. *IRC § 1271(a)(3)(C)* and *(D)*. Alternatively, the seller may irrevocably elect to calculate the ratable share of the discount accruing while the seller held the obligation using (i) the seller's yield to maturity based on the seller's cost of acquiring the obligation, and (ii) compounding daily. *IRC § 1271(a)(3)(E)*.

(n30)Footnote 10. *IRC § 1271(a)(3)(B)*.

(n31)Footnote 11. *IRC § 1271(a)(4)(D)*.

(n32)Footnote 12. See § 17.03[2][b], *infra*.

(n33)Footnote 13. *Treas Reg § 1.1275-4(b)(8)(i)*.

(n34)Footnote 14. *Treas Reg § 1.1275-4(b)(8)(ii)*.

(n35)Footnote 15. *Treas Reg § 1.1275-4(b)(8)(iii)*. For this purpose, a contingent payment that is fixed within the six-month period ending on the due date of the payment is treated as a contingent payment even after the payment is fixed. *Treas Reg § 1.1275-4(b)(9)(ii)*.

(n36)Footnote 16. *Treas Reg § 1.1275-4(c)(6)*.

(n37)Footnote 17. *Treas Reg § 1.1275-4(c)(6)(i)*.

(n38)Footnote 18. *Treas Reg § 1.1275-4(c)(6)(ii)*.

(n39)Footnote 1. *IRC § 1276(a)(1)*. A person disposing of a market discount bond in any transaction other than a sale, exchange, or involuntary conversion is treated as realizing an amount equal to the fair market value of the bond. *IRC § 1276(a)(2)*.

(n40)Footnote 2. *IRC § 1276(a)(4)*.

(n41)Footnote 3. *IRC § 1278(a)(1), (2)(A), (3)*.

(n42)Footnote 4. *IRC § 1278(a)(2)(B)*.

(n43)Footnote 5. *IRC § 1278(a)(2)(C)*.

(n44)Footnote 6. *IRC § 1276(b)(1)*.

(n45)Footnote 7. *IRC § 1276(b)(2)(A)*. The bond is treated as having been issued on the date acquired by the taxpayer for an issue price equal to the basis of the taxpayer immediately after its acquisition.

(n46)Footnote 8. *IRC § 1276(b)(2)(C)*.

(n47)Footnote 9. *IRC § 1276(d)*.

(n48)Footnote 10. *IRC § 1276(c)(1)*.

(n49)Footnote 11. *IRC § 1276(c)(2)*.

(n50)Footnote 12. *IRC § 1278(b)(1)*. The basis of the bond in the hands of the taxpayer is increased by the amount includable in gross income. *IRC § 1278(b)(4)*.

The income is treated as interest for all purposes unless (i) the bond is a tax-exempt bond purchased after Apr 1, 1993, or (ii) the bondholder is a nonresident alien or foreign corporation, and the income is not effectively connected with the conduct of a US trade or business.

(n51)Footnote 13. The election which applies to the taxable year for which it is made and all subsequent years can be revoked only with consent. *IRC § 1278(b)(3)*.

The procedure for electing to include market discount in current income or to use a constant interest rate to determine accrued market discount before disposing of bonds under *IRC § 1276(b)* is contained in *Rev Proc 92-67, 1992-2 CB 429*. The provisions of this revenue procedure and of *Rev Proc 92-20, 1992-1 CB 685*, must be followed to properly revoke the election.

(n52)Footnote 1. *IRC § 1286(e)(2)*.

(n53)Footnote 2. *IRC § 1286(e)(3)*. A coupon is defined as any right to receive interest on a bond. *IRC § 1286(e)(5)*.

(n54)Footnote 3. The stripped bond rules were originally added to the Code as *IRC § 1232B* by section 232 of the Tax Equity and Fiscal Responsibility Act of 1982, Pub L 97-248 (TEFRA). Section 1232B became *IRC § 1286* (with minor technical changes) as part of the codification of OID rules in the Deficit Reduction Act of 1984, Pub L 98-369 (DEFRA).

(n55)Footnote 4. See Jt Comm on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (HR 4961, 97th Cong; Pub L 97-248 (1982), p 164.

(n56)Footnote 5. *IRC § 1286(b)*. Mortgage loans become stripped bonds when they are sold if the seller retains a right to receive interest other than as compensation for servicing the mortgages. *Rev Rul 91-46, 1991-2 CB 358*.

(n57)Footnote 6. The ratable shares of the purchase price of bond coupons are determined according to the respective fair market values on the date of purchase. If the OID determined under *IRC § 1286(a)* with respect to the purchase of a stripped bond or stripped coupon is less than the amount computed under *IRC § 1273(a)(3)*, the amount of OID with respect to the purchase is considered to be zero. Temp Treas Reg § 1.1286-1T(a). For this purpose, (1) the term "stated redemption price at maturity," when applied to a stripped bond, has the meaning given to the term by *IRC § 1273(a)(2)* (see § 17.03[1]) and, when applied to a stripped coupon, means the amount payable on the due date of the coupon, and (2) the number of complete years to maturity is the number of full years from the date the stripped bond or stripped coupon is purchased to final maturity.

(n58)Footnote 7. If a person held a tax-exempt obligation or coupon in stripped form on June 10, 1987 for sale in the ordinary course of the person's trade or business, pre-1988 law continues to apply to any sale of the obligation or coupon and to the obligation or coupon while held by the person.

(n59)Footnote 8. *2010-15 IRB 541*.

(n60)Footnote 9. See *IRC § 54A(i)* authorizing the Treasury to issue regulations under which ownership of a qualified tax credit bond may be separated from the right to receive tax credits with respect to such bond (*IRC § 54A(i)(1)*), with tax consequences as prescribed in *IRC § 1286. IRC § 54A(i)(2)*.

(n61)Footnote 10. *Notice 2010-28* , § 3.03(b).

(n62)Footnote 11. *Notice 2010-28* , §§ 3.03(c) and 3.03(d)(1).

(n63)Footnote 12. Thus, a qualified tax credit bond that matures with a single payment of principal two years after issuance requires a CUSIP number for the bond itself, a CUSIP number for each of the quarterly credit allowance dates (a total of 8), and a CUSIP number for the scheduled principal payment at maturity. See *Notice 2010-28* , § 3.03(f) (Example 1).

(n64)Footnote 13. *Notice 2010-28* , § 3.03(d)(2).

(n65)Footnote 14. *Notice 2010-28* , § 3.03(d)(3).

(n66)Footnote 15. *Notice 2010-28* , § 3.03(e). See § 17.04[5] for a discussion of *IRC § 1286* and stripping transactions generally.

(n67)Footnote 16. See *IRC § 1286(b)*.

(n68)Footnote 17. See *IRC § 1286(a)*.

(n69)Footnote 18. See § 17.03[2], *infra*.

(n70)Footnote 19. *Notice 2010-28* , § 3.03(e)(2).

(n71)Footnote 20. See *Notice 2010-28* , § 3.03(f), Example 3.



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Taxation of Securities Transactions

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CHAPTER 17 Transactions in Bonds and Other Debt Instruments

2-17 Taxation of Securities Transactions § 17.05

§ 17.05 Losses From Worthless Obligationsⁿ¹

[1] Obligations in Registered Form or With Interest Coupons.

If a security is a capital asset and was issued before 1983, the loss produced when it becomes worthless is treated as a capital loss sustained on the last day of the taxable year, regardless of the time during the year when worthlessness actually occurred; if the security is not a capital asset, the loss is an ordinary one.ⁿ¹ For this purpose, the term "security" includes "a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form."ⁿ²

It will be noted that the statute uses the term "interest coupons." Does this require that there be more than one? The Court of Claims was presented with this problem in *Allied Chem. Corp. v. United States*,ⁿ³ the obligation in question being a corporate note with a six-month maturity and with a single interest coupon attached. The taxpayer, seeking to achieve a bad debt deduction rather than a capital loss, rested its argument that the note was not a security on the plural form found in the statute. The court disagreed, stating:

"The word 'coupons' embraces many, a few, or only one coupon. The plural was used to embrace all notes with coupons attached, irrespective of how many coupons there might be. There is no indication it was intended to exclude a note with only one coupon."ⁿ⁴

The term "registered form" also needs definition. In the case of a bond, the phrase has been held to mean one registered upon the books of the obligor or of a transfer agent, the purpose being to protect the holder by treating transfers which are not registered as invalid transfers.ⁿ⁵ Thus, if the obligation is evidenced by a numbered certificate issued in the name of the creditor, and is transferable only on the books of the obligor or its agent, it is likely that the obligation will be found to be in registered form.

For obligations issued after December 31, 1982, there can be no loss deduction at all unless the bond is in registered form or is an obligation that issued by a natural person, is not offered to the public, or has a maturity (at issue) of not more than one year.ⁿ⁶ An obligation will be treated as in registered form if the right to principal and interest is transferable only through a book entry consistent with regulations prescribed by the Treasury.ⁿ⁷

One of the most difficult tasks comes in ascertaining the year in which worthlessness occurs, for that is the only year in which the loss will be allowed. This is established by some identifiable event, some one circumstance or set of

circumstances present during the taxable year which shows that the obligation is no longer of value.ⁿ⁸ But therein lies the problem--there is no one circumstance or indicia of worthlessness that is automatically determinative of worthlessness. For example, in one case, worthlessness may occur in the year in which the corporation is adjudicated a bankrupt,ⁿ⁹ while in another, it may occur even earlier, say, when the corporation becomes hopelessly insolvent.ⁿ¹⁰ Perhaps the best way for the taxpayer to ensure that he takes the loss in the proper year is to follow the advice given by Judge Augustus Hand:

"In cases like this the taxpayer is at times in a very difficult position in determining in what year to claim a loss. The only safe practice, we think, is to claim a loss for the earliest year when it may possibly be allowed and to renew the claim in subsequent years if there is any reasonable chance of its being applicable to the income for those years."ⁿ¹¹

Thus, if the taxpayer wants to ensure his loss deduction, he should consider claiming his loss when the debtor is in default in the payment of interest or principal, when a receiver has been appointed, when the obligor's liabilities exceed its assets, when the bonds become unmarketable, when foreclosure of a prior lien is sought, when the debtor is unable to meet its debts as they come due, or when bankruptcy proceedings are filed. Since none of these factors is necessarily determinative of worthlessness, the deduction should be taken in each succeeding year until the proper year of worthlessness is established by a consideration of all of the pertinent evidence.

The foregoing discussion assumes that the taxpayer holding the bond has paid the full purchase price therefor. Does it make a difference if he has not? The answer is yes, if he is a cash basis taxpayer. In such event, his loss in the year of worthlessness is limited to the amount of the purchase price already paid, on the theory that this is the extent of the loss that he has then sustained.ⁿ¹² However, he is entitled to deduct the remainder of the loss when the balance of the price is paid, but that loss will be an ordinary loss and not a capital loss; *IRC Section 165(g)* is inapplicable because the security did not become worthless in the year in which the additional loss was sustained, but in a prior year.

[2] Other Worthless Obligations.

If the obligation held by the taxpayer was issued before 1983 and is not in registered form or lacks interest coupons, or was issued after 1982 and is not a registered-required obligation, the loss is treated as a bad debt, with its allowance as a deduction governed by *IRC Section 166*.ⁿ¹ Pursuant to that provision, losses on debts held by corporations are allowable as deductions against ordinary income.ⁿ² Moreover, the corporation can take a deduction in a year in which the debt becomes partially worthless (if the Commissioner is satisfied that the debt is recoverable only in part),ⁿ³ or it can wait and deduct the entire loss in the year in which the debt becomes wholly worthless.ⁿ⁴

The noncorporate taxpayer is accorded the same treatment only when the debt is a business debt. Otherwise, the deduction is allowed just in the year in which the debt becomes totally worthless, and, then, not as an offset against ordinary income, but as a short-term capital loss.ⁿ⁵

Pursuant to *IRC Section 166(d)(2)*, a debt is a nonbusiness debt when it is not "a debt created or acquired in connection with a trade or business;" or "a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business." Thus, it would seem, that the move from short-term capital loss to ordinary deduction requires nothing more than a showing of the connection between the debt and the taxpayer's trade or business. But this is more easily said than done in light of the Supreme Court's decision in *Whipple v. Commissioner*.ⁿ⁶

The taxpayer in *Whipple* was a promoter, with interests ranging from construction and construction supply to real estate and oil, from food service to soft drink bottling. It was in connection with the latter that the loans in question were made. The taxpayer had acquired a bottling franchise which he transferred to a controlled corporation. In succeeding years, he made sizable cash advances to the corporation in an attempt to keep the business going, but its singular lack of success eventually produced a bad debt for the taxpayer of almost \$57,000. A deduction of this debt as a business bad

debt was challenged by the Commissioner.

The argument in support of an ordinary deduction claimed that a taxpayer who organizes, acquires, finances, and takes an active role in the management of corporations, is considered to be in a business separate and distinct from the business of the corporations. The Supreme Court responded:

"Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation. Even if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debt losses arising from his own business and those actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business."ⁿ⁷

The decision in *Whipple* does not mean that a promoter can never claim a business bad debt deduction for losses incurred in connection with his promoting activities. However, to do so, the promoter must show that he is in the business of promoting--of dealing in enterprises--and not merely in the business of investing.ⁿ⁸

There is little doubt that an ordinary deduction can be secured when the taxpayer can establish that he is in the business of making loans, something that requires more than just isolated or sporadic transactions.ⁿ⁹ But is a deduction permitted when the taxpayer is neither in the business of lending money nor of promoting enterprises? *Whipple* once again supplies the answer, for while the Supreme Court refused to disturb the determination of the lower courts regarding the taxpayer's activities as a promoter, it was concerned with his position as the owner and lessor of the real estate and bottling plant, i.e., with his business of being a landlord. (The Government did not dispute that these activities constituted a trade or business, but argued that the loans were not made as a part of *Whipple's* real estate business either.) For this reason, the Court remanded the cause to determine whether the loss from the worthless debt was proximately related to that business.

Thus, we find that a loss on a loan made to a tenant in order to keep it as a tenant, and thereby to protect the lease, can be a business bad debt; a loan made to a tenant for another purpose cannot.ⁿ¹⁰ In similar fashion, a loan made to a publisher by a writer in order to ensure an outlet for the taxpayer's work and to promote his reputation,ⁿ¹¹ or to a supplier to ensure a continued source of supply of materials or goods, will be treated as a business loan, and the loss as a business bad debt;ⁿ¹² but if the loan is not made to enhance or protect the taxpayer's business, the debt will be a nonbusiness debt.ⁿ¹³

Finally, it is well settled that a loan made to an employer by an employee may be a business loan if required as a condition of continued employment or if otherwise proximately related to the taxpayer's trade or business as an employee.ⁿ¹⁴ Because of the need to find that employment was the primary motivation for the loan,ⁿ¹⁵ it will be virtually impossible for a controlling or dominant stockholder to claim that a loan made by him to the corporation was made to protect his job.ⁿ¹⁶

If the loss results from a payment made by the taxpayer as a guarantor, endorser or indemnitor, and the guaranty arose in the course of the taxpayer's trade or business, the payment is treated as a worthless business debt.ⁿ¹⁷ A noncorporate taxpayer who agrees to act as a guarantor, and does not do so in the course of the taxpayer's trade or business, will be allowed to deduct the loss as a nonbusiness bad debt, but only if the guaranty is entered into in a transaction for profit.ⁿ¹⁸ In neither case can the taxpayer claim a deduction under *IRC Section 162*, *IRC Section 163*, or *IRC Section*

165.n19 Moreover, there must be an enforceable legal duty upon the taxpayer to make the payment, but legal action need not have been brought against the taxpayer.n20

Prior to the Tax Reform Act of 1986, individual taxpayers who incurred losses on deposits in a financial institution were generally limited to deducting the loss as a bad debt under *IRC Section 166*. *IRC Section 165(l)(1)*, added by the 1986 Act, permits a "qualified individual" to treat a reasonably estimated loss on a deposit in a "qualified financial institution" as a casualty loss sustained during the taxable year.

A qualified individual is one who is *not* (i) a 1 percent or more shareholder in the financial institution, (ii) an officer of the institution, or (iii) a person related to an officer or 1 percent or more shareholder.n21 A qualified financial institution is generally a bank, credit union, or similar institution chartered or supervised under federal or state law.

IRC Section 165(l)(5), enacted in 1988, allows a qualified individual who incurs a reasonably estimated loss on a deposit that is not federally insured to claim the loss as an ordinary loss. However, the aggregate amount of loss in any one financial institution to which the ordinary loss election can apply in any taxable year cannot exceed \$20,000 (\$10,000 in the case of married taxpayer filing a separate return); the limitation must be reduced by the amount of any insurance proceeds that can reasonably be expected to be received under state law.

The casualty loss and ordinary loss election are alternative elections. A taxpayer may make only one of the elections with respect to reasonably estimated losses on deposits in any particular institution for any taxable year.

FOOTNOTES:

(n1)Footnote 1. See § 2.07[2][d], *supra*, for the treatment of worthless obligations of an affiliate; see § 2.07[2][b], *supra*, for a discussion of losses incurred by small business investment companies.

(n2)Footnote 1. *IRC § 165(g)(1)*; *Treas Reg § 1.165-5(b)*. The section does not apply to any loss due to the worthlessness of a security reflected in the inventories of a dealer. *Treas Reg § 1.165-5(g)*. Nor does it apply to the worthlessness of a security held by a bank. *IRC § 582(a)*.

If a domestic corporation took a loss under *IRC § 165* with respect to a security that became worthless because of the expropriation, intervention, seizure, or similar taking by a foreign government or property to which the security was related, and the value of the security is restored in whole or in part by reason of a recovery of money or other property in respect of the property to which the security was related, the restored value must be included in gross income for the taxable year in which the restoration occurs. *IRC § 80(a)*. However, no restoration is required unless the loss resulted in a reduction in the taxpayer's tax for any taxable year. *IRC § 80(b)*. The amount included is treated as ordinary income unless the loss produced a capital loss, in which case the restoration is treated as long-term capital gain. *IRC § 80(c)*.

(n3)Footnote 2. *IRC § 165(g)(2)(C)*.

(n4)Footnote 3. 305 F2d 433 (Ct Cl 1962) .

(n5)Footnote 4. 305 F2d 441, 442 (Ct Cl 1962) .

(n6)Footnote 5. *Gerard v Helvering*, 120 F2d 235 (2d Cir 1941) ; *Funk v Commr*, 35 TC 42 (1960) , *acq* 1961-2 CB 4 ; *Est of Martin v Commr*, 7 TC 1081 (1946) . A bond will be registered if it refers to itself as being registered and as being transferable only on the books of the corporate obligor, even though the corporation does not keep a formal register of its obligations. *Oestreicher v Commr*, 20 TC 12 (1953) , *acq* 1953-2 CB 5 .

(n7)Footnote 6. *IRC §§ 165(j)(1), (2)(A), 163(f)(2)(A)*. Regulations may provide that *IRC § 165(j)(1)* will not apply with respect to obligations held in connection with a foreign trade or business or by a broken dealer for sale to customers in the ordinary course of business, the holder complies with such reporting requirements regarding

ownership, transfers and payments as the regulations will require, or the holder promptly surrenders the obligation to the issuer for the issuance of a new obligation in registered form. See § 17.03[2] for the definition of registered form. *IRC § 165(j)(3)*.

(n8)Footnote 7. *IRC §§ 165(j)(2)(B), 163(f)(3)*.

(n9)Footnote 8. The factors which establish the worthlessness of bonds are much the same as those which establish the worthlessness of stock. See generally Worthy, "Stock Losses: Establishing Worthlessness," *NYU 22nd Inst on Fed Tax* 289 (1964).

In *Boehm v Commr*, 326 US 287 (1945), the taxpayer argued that the test to be employed in determining worthlessness was a subjective test. The Supreme Court countered with this statement:

"The standard for determining the year of deduction of a loss is ... a flexible, practical one, varying according to the circumstances of each case. The taxpayer's attitude and conduct are not to be ignored, but to codify them as the decisive factor in every case is to surround the clear language of [Section 165(g)] and the Treasury interpretations with an atmosphere of unreality. ... " 326 US at 293 (1945) .

A primary requisite of establishing worthlessness is to prove that the stock or security had value at the beginning of the taxable year in question. See, eg, *DeMann v Commr*, *TC Memo* 1993-206 .

(n10)Footnote 9. See, eg, *Cammack v US*, 113 F2d 547 (8th Cir 1940) (worthless bad debt). The bad debt Regulations state that bankruptcy is generally an indication of worthlessness of at least part of an unsecured and unpreferred debt. *Treas Reg § 1.166-2(c)(1)*.

(n11)Footnote 10. Eg, *Montgomery v US*, 23 F Supp 130 (Ct Cl 1938), *cert denied* 307 US 632 (bonds worthless although obligor remained in existence). In *Montgomery v US*, 23 F Supp 130 (Ct Cl 1938) *Jarvis v Heiner*, 39 F2d 361 (3d Cir 1930), the corporation was adjudicated a bankrupt in 1921, but was not found to be insolvent until 1922; the latter year was the proper year in which to deduct the loss. See also *Treas Reg § 1.166-2(c)(2)* relating to bad debts and stating that "the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, thereby confirming that the debt is worthless, shall not authorize the shifting of the deduction under section 166 to such later year."

(n12)Footnote 11. *Young v Commr*, 123 F2d 597, 600 (2d Cir 1941) .

(n13)Footnote 12. *Jenkins v Bitgood*, 101 F2d 17 (2d Cir 1939), *cert denied* 307 US 636; *Estate of Spruance v Commr*, 43 BTA 221 (1941), *acq* 1941-1 CB 10, *revd on other grounds* 127 F2d 572 (5th Cir 1942); *Rev Rul* 74-80, 1974-1 CB 117. A loss sustained on bonds purchased with borrowed funds is deductible in the year of worthlessness.

(n14)Footnote 1. The debt must be a bona fide debt. *Treas Reg § 1.166-1(c)*. See, eg, *WF Young, Inc v Commr*, 120 F2d 159 (1st Cir 1941), where the creditor lent the money without expectation of repayment. See also *Stahl v US*, 441 F2d 999 (DC Cir 1970), where a taxpayer lent securities to a securities firm for use as part of its capital account. The securities were to be returned on a given date, subject to the claims of creditors of the firm. The firm sold the securities and then went bankrupt. The taxpayer claimed an ordinary loss under *IRC § 165(c)*; the Commissioner treated the loss as a nonbusiness bad debt. The court held for the taxpayer, viewing the original transaction as a bailment rather than one that created a debtor-creditor relationship.

No bad debt deduction can be taken with respect to an installment note received by a taxpayer who does not elect out of the installment method. Since no portion of the gain is includable in income until a payment is received, there is no basis upon which a bad debt deduction can be predicated. *Lombard v Commr*, *TC Memo* 1994-154 .

A loan that is unenforceable because it bears a usurious interest rate cannot be the source of a bad debt deduction. *Tharp v Commr, TC Memo 1972-10* .

The fact that a creditor-parent takes over the assets of a wholly-owned debtor subsidiary in a statutory merger and continues to operate the subsidiary's business as a branch does not preclude the parent from taking a bad debt deduction. *Ltr Rul 9403010* .

(n15)Footnote 2. *Charles Schneider & Co, v Commr, TC Memo 1973-130* , *affd* 500 F2d 148 (8th Cir 1973) , *cert denied* 420 US 908 .

(n16)Footnote 3. *IRC § 166(a)(2)*.

A deduction for partial worthlessness is allowed only to the extent that the debt is charged off during the taxable year. *IRC § 166(a)(2)*; *Treas Reg § 1.166-3(a)(2)(i)*. If a deduction for partial worthlessness is disallowed in the year of charge-off, it may be allowed in a later year. *Treas Reg § 1.166-3(a)(2)(ii)*.

The Tax Court has held that a corporation is entitled to a deduction for a partially worthless debt even though the corporation's actions contributed to the worthlessness. *ABC Beverage Corp v Commr, TC Memo 2006-195* .

(n17)Footnote 4. *IRC § 166(a)(1)*. The determination of worthlessness requires a consideration of "all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor." *Treas Reg § 1.166-2(a)*. Bankruptcy is generally an indication that at least part of the debt is worthless. *Treas Reg § 1.166-2(c)(1)*.

Legal action to enforce the debt is unnecessary where the surrounding circumstances indicate that the debt is uncollectible and that a judgment would probably be returned unsatisfied. *Treas Reg § 1.166-2(b)*. But merely obtaining a judgment is insufficient if there is evidence to show that the debtor had property on which execution could be had. *Straub Distrib Co v Commr, TC Memo 1971-46* .

(n18)Footnote 5. *IRC § 166(d)(1)*.

The recovery of a bad debt is includable in income as a short-term capital gain. *Deely v Commr, 73 TC 1081 (1980)* .

(n19)Footnote 6. *373 US 193 (1963)* . See generally, O'Neill, "What Constitutes 'Trade of Business' for Bad Debt Purposes: Stockholder, Employee, Promoter; Investment vs. Loan," *30 NYU Inst on Fed Tax* 283 (1972); Knickerbocker, "What Constitutes a Trade or Business for Bad Debt Purposes: 'Stockholder' as a Business," *NYU Inst on Fed Tax* 113 (1965); Note, "Bad Debts: Limitations of the 'Promoter Doctrine,'" *13 Buff L Rev* 635 (1964); Waterman, "Aspects of the Bad Debt--Loss Dichotomy," *18 Tax L Rev* 121 (1962).

(n20)Footnote 7. *373 US at 202* .

(n21)Footnote 8. *Giblin v Commr, 227 F2d 692 (5th Cir 1955)* ; *Newman v Commr, TC Memo 1989-63* ; *Elliott v US, 268 F Supp 521 (D Ore 1967)* ; *Farrar v Commr, TC Memo 1988-385* . The majority of cases find the taxpayer to be an investor, not a promoter. See, eg, *Millsap v Commr, 387 F2d 420 (8th Cir 1968)* ; *US v Clark, 358 F2d 892 (1st Cir 1966)* , *cert denied* 385 US 817 ; *Estate of Campbell v Commr, 343 F2d 462 (2d Cir 1965)* .

(n22)Footnote 9. Compare *Carpenter v Erickson, 255 F Supp 613 (D Ore 1966)* with *Barish v Commr, 31 TC 1280 (1959)* .

(n23)Footnote 10. See eg, *Goldman v Commr, TC Memo 1962-36* , where the purpose behind the loan to a corporation owned by the taxpayer's son was to keep the corporation going, not to keep it as a tenant. A similar result was reached in *Ninberg v Commr, TC Memo 1967-109* where the taxpayer guaranteed a loan made to his own

corporation for the same purpose.

(n24)Footnote 11. *Funk v Commr*, 35 TC 42 (1960) , acq 1961-2 CB 4 . In *Martin v Commr*, 25 TC 94 (1955) , acq 1956-1 CB 4 , a loan, made by an actor to a corporation he formed to make one movie to promote his career, was held to be a business debt. But in *Blauner v Commr*, TC Memo 1967-156 , a debt to a corporation was held to be a nonbusiness bad debt because the taxpayer's career could not be advanced further; he was about to achieve the top executive spot in the corporation.

A loan made to protect a business reputation can be a business loan, *Milbank v Commr*, 51 TC 805 (1969) , acq 1970-1 CB xvi, as can one to protect a credit rating, *Smith v Commr*, 55 TC 260 (1970) . The Fifth Circuit vacated the decision in *Smith* and remanded the case for reconsideration in light of the Supreme Court's decision in *Generes*. On remand, the Tax Court found that loans made to the corporation while it was a functioning entity were motivated by a desire to make the business profitable and, thus, were investment-oriented and nonbusiness. Advances made after the cessation of operations were dominantly motivated by a desire to protect the taxpayer's credit rating and constituted business loans. The later Tax Court opinion is reported at 60 TC 316 (1973) . The Commissioner has acquiesced in the decision. 1973-2 CB 3 .

(n25)Footnote 12. *Dorminey v Commr*, 26 TC 940 (1956) , acq 1957-1 CB 4 . Loans to obtain sales outlets have also been held to be business loans. Eg, *Brenhouse v Commr*, 37 TC 326 (1961) , acq 1962-2 CB 4 ; *Levine v Commr*, 31 TC 1121 (1959) , acq 1959-2 CB 5 ; *Kertes v Commr*, TC Memo 1962-158 .

A business bad debt deduction was allowed in *Estate of Saperstein*, TC Memo 1970-209 , for loans made to a basketball league that the taxpayer had formed to ensure his team access to major playing sites, maintain the team in the national spotlight, and serve as a source of competition.

(n26)Footnote 13. See, eg, *Spillers v Commr*, 407 F2d 530 (5th Cir 1969) .

(n27)Footnote 14. Compare *Trent v Commr*, 291 F2d 669 (2d Cir 1961) and *Rosati v Commr*, TC Memo 1970-343 , both allowing the loss as a business bad debt, with *Stratmore v US*, 420 F2d 461 (3d Cir 1970) , cert denied 398 US 951 , and *Niblock v Commr*, 417 F2d 1185 (7th Cir 1969) , denying a business bad debt deduction where the loans were not motivated by employment.

(n28)Footnote 15. *US v Generes*, 405 US 93 (1972) . Prior to the decision in *Generes*, the Second and Fifth Circuits had used a significant motivation test. *Weddle v Commr*, 325 F2d 849 (2d Cir 1963) ; *US v Generes*, 427 F2d 279 (5th Cir 1970) . The Seventh Circuit employed the primary motivation test. *Niblock v Commr*, 417 F2d 1185 (7th Cir 1969) .

Note, "Characterization of Shareholder-Creditor Bad Debt: United States v Generes Sounds the Knell for Deductions from Ordinary Income," 26 Vand L Rev 105 (1973).

(n29)Footnote 16. *Millsap v Commr*, 387 F2d 420 (8th Cir 1968) ; *Kelly v Patterson*, 331 F2d 753 (5th Cir 1964) . In *Generes*, 427 F2d 279 (5th Cir 1970) the taxpayer was a 44 percent shareholder.

(n30)Footnote 17. *Treas Reg* § 1.166-9(a). No deduction will be allowed for a payment made on a guaranty of a corporate debt if the facts and circumstances indicate that the payment constitutes a contribution to capital by a shareholder. *Treas Reg* § 1.166-9(c).

The *Generes* test applies to payments made pursuant to a guaranty, ie, treated as a business bad debt only if the dominant motive for the guaranty and payment was protection of the taxpayer's business. See, eg, *Smartt v Commr*, TC Memo 1993-65 .

The right of a guarantor to claim a bad debt deduction in the year of payment, regardless of the solvency or financial status of the original debtor, applies only where the guarantor has no right of subrogation against, and no right of reimbursement from, the original debtor. *Treas Reg § 1.166-9(a)*; *Intergraph Corp v Commr*, 106 TC 312 (1996) , *affd in an unpublished opinion* (11th Cir 1997).

A thorough discussion of the taxation of guarantees can be found in Miller, "Federal Income Tax Consequences of Guarantees: A Comprehensive Framework for Analysis," 48 *Tax Lawyer* 103 (1994).

(n31)Footnote 18. *Treas Reg § 1.166-9(b)*.

(n32)Footnote 19. *Treas Reg § 1.166-9(b)*.

A taxpayer sought to deduct his payment as a guarantor as a theft loss under *IRC § 165(e)*. The Tax Court held that the loss could be deducted only as a nonbusiness bad debt. *Parekh v Commr*, *TC Memo 1998-151* .

As long as the borrower's obligation is worthless at the time of payment, it does not matter that it did not become worthless in the same year that payment is made. However, the Tax Court has held that actual payment by a guarantor, even if an accrual method taxpayer, is required before a deduction can be taken under *IRC § 166*. *Black Gold Energy Corp v Commr*, 99 TC 482 (1992) , *affd without published opinion* 33 F3d 62 (10th Cir 1994) .

Where a guarantor substitutes a personal note for that of the primary obligor in satisfaction of the guarantor's guarantee, the substitution does not constitute an outlay that gives rise to a deduction until the note is paid. *Alexander v Commr*, *TC Memo 1995-334* .

(n33)Footnote 20. *Treas Reg § 1.166-9(d)*.

(n34)Footnote 21. A related person includes a sibling (whether by the whole or half blood), spouse, aunt, uncle, nephew, niece, ancestor, or lineal descendant, or any person described in *IRC § 267(b)*.



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Taxation of Securities Transactions

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CHAPTER 17 Transactions in Bonds and Other Debt Instruments

2-17 Taxation of Securities Transactions § 17.06

§ 17.06 Transactions by a Corporation in Its Own Obligations

[1] Purchase or Retirement of Securities--General Rule.

A corporation realizes no gain or loss on the purchase or retirement of its bonds if it pays the same amount for the bonds that it received when they were issued. The redemption at maturity of a bond issued at a premium or at a discount will also not be an occasion for recognizing gain or loss. The premium will have been amortized and included in the corporation's income over the life of the bond;ⁿ¹ the discount will have been deducted on a ratable basis.ⁿ² If the repurchase occurs before the entire premium has been reported as gross income, the corporation will be required to include the excess of the unamortized premium over the repurchase price as income in the year of repurchase.ⁿ³ If the purchase price exceeds the issue price and the previously deducted discount, the excess is available as a deduction.ⁿ⁴

At issue in *National Alfalfa Dehydrating & Milling Co. v. Commissioner*,ⁿ⁵ was whether an amortization deduction was available when a corporation issued \$50 face amount debentures in exchange for \$50 par value preferred stock claimed to have a fair market value of \$33 a share. The Supreme Court held that it was not.

Although the Court appears to have based its decision on a lack of proof as to value, and, thus, as to whether the taxpayer incurred any additional cost in acquiring capital, the Service has argued that *National Alfalfa* establishes an absolute rule that no discount can occur when a corporation issues bonds for its own stock. This view is premised on the fact that the transaction is nothing more than an adjustment of the corporation's capital account. The Service would require that the taxpayer acquire new capital before any discount could arise.ⁿ⁶

The Second Circuit does not apparently interpret *National Alfalfa* as denying an amortization deduction in all cases in which debentures are issued in exchange for old securities.ⁿ⁷ It found that deductible discount can arise when the original consideration received by the company and the face amount of the newly issued securities are not equal. The Fifth Circuit agreed with the Second Circuit's reasoning.ⁿ⁸ The controlling test for the Fifth Circuit is whether the corporation incurred some cost in acquiring the use of capital, not whether additional capital was acquired.ⁿ⁹

[2] Purchase or Retirement of Securities for More Than the Issue Price.

Where a bond is called and redeemed at more than its issue price because of the addition of a call premium, the amount of the premium is deductible as an expense in the year that the bonds are retired.ⁿ¹ If the bonds were not issued at a price equal to their face value, the amount deductible is the excess of the repurchase price, including the call premium,

over the original issue price decreased by the amount of premium returned as income prior to repurchase, or increased by the amount of discount deducted prior thereto.ⁿ²

An exception to the foregoing rule is made in the case of a convertible bond. By virtue of Section 249(a), added by the Tax Reform Act of 1969:

"No deduction shall be allowed to the issuing corporation for any premium paid or incurred upon the repurchase of a bond, debenture, note, or certificate or other evidence of indebtedness which is convertible into the stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation, to the extent the repurchase price exceeds an amount equal to the adjusted issue price plus a normal call premium on bonds or other evidences of indebtedness which are not convertible."ⁿ³

A repurchase premium is the excess of the price paid or incurred to repurchase the obligation over its adjusted issue price.ⁿ⁴ For convertible obligations purchased after March 2, 1998, a call premium specified in dollars under the terms of an obligation is considered to be a normal call premium on a nonconvertible obligation if the call premium applicable when the obligation is repurchased does not exceed an amount equal to the interest (including OID) that otherwise would be deductible for the taxable year of repurchase (determined as if the obligation were not repurchased).ⁿ⁵

[3] Purchase or Retirement of Securities at Less Than the Issue Price.

[a] The Kirby Lumber Rule--Cancellation of Indebtedness Income.ⁿ¹ An issuer realizes income from discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price; the amount of the income is equal to the excess of the adjusted issue price over the repurchase price.ⁿ² An earlier version of this statement met with the approval of the Supreme Court in *United States v. Kirby Lumber Co.*,ⁿ³ a simple case in which the corporation issued its own bonds at par, and then acquired some of them in the open market at less than par.

A few years later, the principle of *Kirby Lumber* was held applicable in a case in which the taxpayer had not originally issued the bonds, but had assumed the obligation of their repayment when it acquired the assets of the issuer.ⁿ⁴ The Supreme Court could find nothing in those facts to distinguish the case from *Kirby Lumber*. But while the debt need not be original with the taxpayer, it apparently must be traceable to an increment in the debtor's assets if the repurchase of the debt at a discount is to produce income for the debtor.ⁿ⁵

[b] Exceptions to the Kirby Lumber Rule.

[i] Cancellation of Indebtedness Intended as a Gift. Can the portion which would normally be included in gross income under the *Kirby Lumber* doctrine be excluded from gross income on the theory that the creditor made a gift of the difference to the corporation? In a 1943 decision, *Helvering v. American Dental Co.*,ⁿ⁶ the Supreme Court answered this affirmatively, the majority opinion ending with these words:

"The fact that the motives leading to the cancellations were those of business or even selfish, if it be true, is not significant. The forgiveness was gratuitous, a release of something to the debtor for nothing, and sufficient to make the cancellation here gifts within the statute."ⁿ⁷

American Dental was not a case which involved the repurchase of bonds at a discount. The claim of gift under those circumstances was not adjudicated by the Supreme Court until 1949, when it considered *Commissioner v. Jacobson*,ⁿ⁸ and held that the taxpayer had realized income on the repurchase. The Court could not find that any bondholder was acting from any interest other than his own. Therefore, it concluded that

It is conceivable, although hardly likely, that a bondholder, in the ordinary course of business and without any express release of his debtor, might have sold part of his claims on the bonds he held at the

full face value of those parts and then have made a gift of the rest of his claims on those bonds to the same debtor 'for nothing.' It is that kind of extraordinary transaction that the respondent asks us, as a matter of law, to read into the simple sales which actually took place and from which he derived financial gains. We are unable to do so on the findings before us.

The situation in each transaction is a factual one. It turns upon whether the transaction is in fact a transfer of something for the best price available or is a transfer or release of only a part of a claim for cash and the balance 'for nothing.' The latter situation is more likely to arise in connection with a release of an open account for rent or for interest, as was found to have occurred in *Helvering v. American Dental Co.*, ... than in the sale of outstanding securities [.]⁹

Jacobson did not overrule *American Dental*. Thus, it is still possible to have the spread between issue price and repurchase price treated as a gift by creditor to debtor. But, as *Jacobson* indicates, the chances of this happening in a business setting are rare, indeed.

[ii] Contributions to Capital. Regulations under *IRC Section 61(a)* provide that a gratuitous forgiveness of a debt owed a shareholder by his corporation is a transaction which amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.¹⁰ However, *IRC Section 108(e)(6)*, added by the Bankruptcy Tax Act of 1980, limits the extent of the contribution to capital to the shareholder's basis in the debt. If the forgiven amount exceeds the shareholder's adjusted basis in the debt, the excess must be accounted for as income from discharge of indebtedness.¹¹

[iii] Issuance of Stock or Other Debt in Exchange for the Canceled Debt.¹² Case law has long held that a corporation did not realize income when the consideration for the acquisition of its bonds was its stock.¹³ The theory on which these cases proceeded viewed the exchange as a substitution of one liability for another, and, thus, as the equivalent of no cancellation at all.

As originally enacted as part of the Bankruptcy Tax Act of 1980, *IRC Section 108* continued this nonrecognition of income rule with two exceptions.¹⁴ The normal debt discharge rules (discussed in the succeeding subsection) applied if only a nominal or token amount of stock was issued for the debt instruments,¹⁵ or if the bonds were held by an unsecured creditor and, as part of a "workout,"¹⁶ the creditor received stock having a value which was less than one half the amount of stock that the creditor would receive if all of the corporation's unsecured creditors had received a pro rata amount of stock in cancellation or satisfaction of the debt.¹⁷

The Tax Reform Act of 1984 removed the nonrecognition of income rule by enacting *IRC Section 108(e)(10)*, under which the debtor corporation is treated as having satisfied the indebtedness with money equal to the fair market value of the stock. This produces income for the corporation to the extent that the principal of the debt exceeds the fair market value of the stock, except in the case of a debtor corporation in a Title 11 bankruptcy proceeding or to the extent the corporation is insolvent.¹⁸ The exceptions do not apply in the case of any debt instrument issued, and stock transferred, after October 9, 1990, in satisfaction of any indebtedness if the stock transferred to the creditor is "nominal or token," or is "disqualified stock"--stock with a stated redemption price that either has a fixed redemption date, is callable by the issuer, or is puttable by the holder.¹⁹

Regulations provide facts and circumstances that are relevant and are to be taken into account in determining whether stock is nominal or token.²⁰ If common and preferred stock are issued for indebtedness, the determination is made separately with respect to each. Moreover, the separate determination whether common stock issued for unsecured indebtedness is nominal or token is made on an aggregate basis with respect to all common stock issued for unsecured debt in the bankruptcy or insolvency workout.²¹ A similar determination is made for preferred stock.²²

The common stock-for-debt exception does not apply to an unsecured indebtedness discharged for common stock if the

individual common stock ratio does not equal at least one-half of the group common stock ratio.ⁿ²³ The individual common stock ratio is the value of common stock issued for an unsecured indebtedness to the amount of the unsecured indebtedness allocated to that common stock. The amount of unsecured indebtedness allocated to the common stock is the adjusted issue price of the indebtedness for which the stock is issued, reduced by the amount of other consideration transferred in the exchange, including (a) the amount of any money; (b) the issue price (determined under *IRC Section 1273* or *1274*) of any new indebtedness; (c) the amount of any indebtedness allocated to preferred stock; and (d) the value of any other property, including any disqualified stock.ⁿ²⁴ The group common stock ratio is determined in the same manner except that it looks to the aggregate values of the common stock and indebtedness.ⁿ²⁵

The determination of the common stock ratio can be illustrated by the following example:

Example:

X Corporation has three outstanding unsecured debts, each with a \$200,000 adjusted issue price. In a bankruptcy proceeding, the first indebtedness is exchanged for cash of \$100,000 and \$40,000 in common stock, the second for \$20,000 in cash, and the third for \$10,000 in common stock. The individual common stock ratio for the first indebtedness is 40 percent, determined by comparing the value of the common stock issued for the indebtedness (\$40,000) to the amount of unsecured indebtedness allocated to the stock (\$200,000 less \$100,000 cash received). There is no individual common stock ratio for the second indebtedness because no stock was received in exchange for the debt. The individual common stock ratio for the third indebtedness is 5 percent (\$10,000 stock, \$200,000 indebtedness).

The group common stock ratio is 10.4 percent, determined by comparing the value of all of the common stock received (\$50,000) with the total amount of unsecured indebtedness allocated to the stock (\$600,000 issue price less \$120,000 cash received). The stock-for-debt exception applies only to the first indebtedness; it is the only one in which the individual common stock ratio equals at least one-half of the group common stock ratio.

The individual preferred stock ratio must be equal to at least one-half of the group preferred stock ratio for the stock-for-debt exception to apply to the receipt of preferred stock.ⁿ²⁶ The individual preferred stock ratio is the value of the preferred stock issued for an unsecured indebtedness to the amount of the indebtedness allocated to the preferred stock. Here, the amount of unsecured indebtedness allocated to the stock is the lesser of the lowest redemption price or lowest liquidation preferenceⁿ²⁷ of the preferred stock (determined at the time of issuance). However, in no event can the allocable indebtedness be less than the fair market value of the preferred stock or greater than the adjusted issue price of the unsecured indebtedness.ⁿ²⁸

The Omnibus Budget Reconciliation Act of 1993 repealed *IRC Section 108(e)(10)* for stock transferred after December 31, 1994, in satisfaction of any indebtedness. However, the repeal did not change the basic rule contained in that provision, namely, that the transferring debtor corporation is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock; the rule is now found in an amended *IRC Section 108(e)(8)* and applies to both recourse and nonrecourse indebtedness.^{n28.1} Moreover, the 1993 change does not apply to any title 11 or similar case (as defined in *IRC Section 368(a)(3)(A)*) filed on or before December 31, 1993.

In those cases for which the stock-for-debt exception remains applicable after 1993, the Service will not treat the issuance of common stock for outstanding unsecured indebtedness in a title 11 case or insolvency workout as nominal or token if the stock to total stock ratio is equal to at least 15 percent.^{n28.2} The stock to total stock ratio is the ratio of (i) the value of all common stock issued for unsecured indebtedness in the title 11 case or insolvency workout to (ii) the value of all stock of the corporation outstanding after the title 11 case or insolvency workout (including preferred stock and disqualified stock).

Suppose, instead, that the consideration for the acquisition consists of new obligations of the corporation rather than its stock. Before the enactment of *IRC Section 1275(a)(4)* in 1984, the result turned on the amount of the new debt. If the face amount of the new bonds was equal to or greater than the issue price of the acquired obligations, all that was deemed to have occurred was a change in the instrument evidencing the liability, with the result that income was not then realized by the corporation.ⁿ²⁹ However, when the principal amount of the new debt was less than the old, the transaction was deemed to have produced income for the corporation on the ground that income would have been created had the corporation sold the new obligations for cash and then used the proceeds to retire the older obligations.ⁿ³⁰

IRC Section 108(e)(11) was added to the Code as part of the Omnibus Budget Reconciliation Act of 1990 and provides that, for the purpose of determining the amount of cancellation of indebtedness income derived in a debt-for-debt transaction, the debtor is treated as having satisfied the indebtedness with an amount of money equal to the issue price of the new debt instrument.ⁿ³¹ The provision was renumbered in 1993 and is now *IRC Section 108(e)(10)*. For this purpose the issue price of the new obligation is determined under the general rule applicable to debt instruments issued for property, discussed in § 17.02[4][c][i].

The 1990 legislation repealed *IRC § 1275(a)(4)*, but left unanswered the proper treatment of a debt-for-debt transaction occurring after enactment of the Tax Reform Act of 1984 and before the addition of what is now *IRC Section 108(e)(10)*. *IRC Section 1275(a)(4)* seemed to suggest that there should have been no cancellation of indebtedness income where the issue price of new debt received in a reorganization was less than that of the old, for it provided that, in such a case, "the issue price of the debt instrument so issued shall be treated as equal to the adjusted issue price of the old debt instrument." The answer may not be so simple.

Suppose that an outstanding debt with a face amount of \$1,000 and a value of \$800 was exchanged for a debt with a principal amount of \$850 and a value of \$800. A literal application of *IRC Section 1275(a)(4)* would have yielded no cancellation of indebtedness income, but would have created amortizable bond premium of \$150 issuer (the difference in the face amounts of the old and new debt) and market discount for the holder of the new debt of \$50 (the difference between \$850 and \$800); the market discount would be includable in the holder's income at maturity.ⁿ³²

The Service apparently took the position that cancellation of indebtedness income should have arisen whenever the fair market value of the new debt was less than the adjusted issue price of the debt for which it was exchanged.ⁿ³³ This was achieved, as in pre-*IRC Section 1275(a)(4)* days, by a comparison of the face amounts of the old and new debt. *IRC Section 1275(a)(4)* then would have been applied according to its terms, but with an adjustment made for the amount of cancellation of indebtedness income. Thus, in the previous example, the exchange would have created \$150 of cancellation of indebtedness income, which would have reduced the \$1,000 issue price determined under *IRC Section 1275(a)(4)* to \$850. There would not have been any amortizable bond premium, but the holder would still have had to report \$50 of market discount at maturity.

[iv] Statutory Exclusion of Cancellation of Indebtedness Income: *IRC Section 108*.^{n33.1} *IRC Section 108(a)(1)* permits a corporation to exclude income realized from the discharge of an indebtedness on which it is liable, if the discharge occurs in a bankruptcy case,ⁿ³⁴ outside of bankruptcy while the debtor is insolvent,ⁿ³⁵ or the indebtedness discharged is either qualified farm indebtedness or, in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.ⁿ³⁶ An ordering process gives precedence to a discharge in bankruptcy over an insolvency or qualified farm indebtedness discharge, while an insolvency discharge is given precedence over the discharge of qualified farm indebtedness or qualified real property business indebtedness.ⁿ³⁷ This ensures a uniformity of treatment (e.g., all bankrupt debtors governed by the same rules regardless of the type of debt discharged) while preserving the "fresh start" approach underlying bankruptcy policy.ⁿ³⁸

The exclusion from gross income in a bankruptcy case is automatic. However, the amount of discharged debt excluded

from gross income must be applied to reduce the debtor's tax attributes in the following order:

- (1) Any net operating loss for the discharge year and any net operating loss carryover to such year.
- (2) Carryovers to or from the year of discharge of the amount allowable as the general business credit. No portion of a carryover attributable to the employee stock ownership credit is taken into account.
- (3) The amount of the minimum tax credit available under *IRC Section 53(b)* as of the beginning of the taxable year immediately following the taxable year of the discharge.
- (4) Any net capital loss for the year of discharge and any net capital loss carryover to the year.
- (5) The basis of the taxpayer's property.
- (6) Any passive activity loss or credit carryover of the taxpayer under *IRC Section 469(b)* for the taxable year of the discharge.
- (7) Any carryover to or from the taxable year of discharge of the foreign tax credit.ⁿ³⁹

The reduction is on a dollar for dollar basis, except in the case of the credit and passive loss carryovers, where the reduction is 33 1/3 cents for each dollar excluded, and is made after the determination of the taxpayer's income tax for the year of discharge.ⁿ⁴⁰ The reduction in the amount of net operating loss or capital loss or carryovers of such losses is made first in the loss for the discharge year and then in the carryovers in the order of the taxable year from which each carryover arose.ⁿ⁴¹ The reduction in the credit carryovers is made in the order in which the carryovers are taken into account in determining the tax for the year of discharge.ⁿ⁴²

In lieu of the reductions described above, the corporation can elect to apply any portion of the excluded amount to the reduction under *IRC Section 1017* in the basis of the taxpayer's depreciable property (including, if the taxpayer so elects, real property held for sale to customers in the ordinary course of a trade or business).ⁿ⁴³ However, the elected amount cannot exceed the aggregate adjusted bases of the depreciable property held by the taxpayer at the beginning of the taxable year following the year of discharge, for that is the time specified for the making of the reduction in basis.ⁿ⁴⁴ The order of reduction is set forth in regulations.ⁿ⁴⁵

The tax treatment of an insolvency debt discharge depends upon the solvency of the debtor at the time of discharge. If the debtor is insolvent, the rules applicable in the case of bankruptcy discharge apply, but only to the extent of the insolvency (the extent to which liabilities exceed the fair market value of assets immediately before the discharge).ⁿ⁴⁶ A solvent taxpayer must report the discharged amount in income.ⁿ⁴⁷

The amount excluded under a qualified farm indebtedness discharge cannot exceed the sum of the adjusted tax attributes of the taxpayer and the aggregate adjusted bases of qualified property (property used or held for use in a trade or business or for the production of income) held by the taxpayer as of the beginning of the taxable year following the year in which discharge occurs.ⁿ⁴⁸ For this purpose, the term "adjusted tax attributes" means the sum of the attributes described above, other than the basis of the taxpayer's property, determined by taking into account \$3 for each \$1 of general business credit or foreign tax credit carryover.ⁿ⁴⁹ The adjusted basis of any qualified property and the amount of adjusted tax attributes are determined after any reduction resulting from an insolvency discharge.ⁿ⁵⁰

The exclusion of an amount of discharged qualified farm indebtedness requires the same reductions in tax attributes as the bankruptcy and insolvency discharges. Any amount applied to reduce basis can only reduce the basis of qualified property held by the taxpayer and must be applied in the following order: first, depreciable property; next, land used or held for use in the trade or business of farming; and finally, other qualified property.ⁿ⁵¹

Generally, the amount excluded under a qualified real property business indebtedness cannot exceed the excess (if any) of (i) the outstanding principal amount of such indebtedness immediately before discharge, over (ii) the fair market value of the real property securing the indebtedness at the time of discharge, reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by the property at that time.ⁿ⁵² However, an overall limitation prevents the amount excluded from exceeding the aggregate adjusted bases of depreciable real property held by the taxpayer immediately before the discharge (other than depreciable real property acquired by the taxpayer in contemplation of the discharge).ⁿ⁵³ The amount excluded from gross income is applied to reduce the basis of the depreciable real property of the taxpayer.ⁿ⁵⁴

In the case of a partnership, *IRC Sections 108(a), 108(b), 108(c), and 108(g)*, are applied at the partner level.ⁿ⁵⁵ However, for an S corporation, those provisions are applied at the corporate level.ⁿ⁵⁶

Gain on a subsequent disposition of any reduced basis property will be subject to the recapture rules of *IRC Section 1245* (for depreciable personal property), or *IRC Section 1250* (in the case of depreciable realty). This is accomplished by treating the reduction as a deduction for depreciation, and by treating any property not usually subject to depreciation (inventory real property which the debtor elects to treat as depreciable property) as *Section 1245* property.ⁿ⁵⁷ This is designed "to ensure that ordinary income treatment eventually will be given to the full amount of basis reduction. ..."ⁿ⁵⁸

Although the debt discharge transaction will normally involve just debtor and creditor, the Code takes into account the acquisition of an indebtedness by a party related to the debtor-corporation and provides that such acquisition is to be deemed an acquisition by the debtor to the extent required by *IRC Sections 61(a)(12)* and *108*.ⁿ⁵⁹ For this purpose, the term related party includes a member of a controlled group of corporations of which the debtor is a member, or trade or business under common control with the debtor, a partnership controlled by the debtor or a partner in such a partnership, an individual owning, directly or indirectly, more than 50 percent in value of the outstanding stock, and another corporation if more than 50 percent of the outstanding stock of it and the debtor-corporation are owned, directly or indirectly by the same individual.ⁿ⁶⁰

Suppose that a related party acquires the debtor's indebtedness from an unrelated party in exchange for a new indebtedness of the related party. If the old debt could be acquired at a discount, and the new debt issued at a price equal to the acquisition price, the combination of *IRC Section 108(e)(4)* and *IRC Section 108(e)(11)* would effectively eliminate any cancellation of indebtedness income for the debtor. The regulations foreclose that possibility by providing that the amount of income realized by the debtor must be measured by reference to the holder's cost of acquiring the indebtedness, provided the holder acquires the debt "by purchase" on or less than six months before the acquisition date.ⁿ⁶¹ A purchase occurs if the indebtedness in the hands of the holder is not substituted basis property within the meaning of *IRC Section 7701(a)(42)* (eg, if the holder has a cost basis under *IRC Section 1012* or a fair market value basis under *IRC Section 301(d)*). Where the holder's basis is not established by purchase within the six-month period, the measuring standard becomes the fair market value of the debt.

Income is also realized by a debtor when debt is acquired in anticipation of becoming a related party. These indirect acquisitions occur if (1) the holder acquired the debt less than six months before becoming related to the debtor, (2) on the date the holder becomes related to the debtor, indebtedness of the debtor represents more than 25 percent of the fair market value of the total gross assets of the holder or more than 25 percent of the fair market value of the total gross assets of the holder group, or (3) the holder acquired the debt six months or more before the date the holder became related to the debtor, but less than 24 months before that date.ⁿ⁶²

Section 1231(a) of the American Recovery and Reinvestment Act of 2009ⁿ⁶³ added *IRC Section 108(i)* to provide, on a temporary basis, a new category of specially treated discharge of indebtedness income which, though not excluded from income under *IRC Section 108(a)*, may be deferred for a significant period at the election of the taxpayer without

reducing tax attributes or the basis of depreciable property.ⁿ⁶⁴ An election to defer may only be made with respect to discharge of indebtedness income realized in connection with the "reacquisition" of an "applicable debt instrument" during the calendar years 2009 or 2010, and requires that the income deferred be taken into account ratably over a five-year period commencing, for calendar year taxpayers, with the year 2014.ⁿ⁶⁵ A separate election must be made for each applicable debt instrument reacquired during the year which gives rise to discharge of indebtedness income the taxpayer wishes to defer, and the election must be included with the taxpayer's return for the taxable year in which the reacquisition occurs.ⁿ⁶⁶ Once made, the election is irrevocable ⁿ⁶⁷ and supersedes any exclusions for the deferred discharge of indebtedness income that might otherwise be applicable under *IRC Sections 108(a)(1)(A), (B), (C) or (D)*.ⁿ⁶⁸

A "reacquisition" includes any acquisition of an applicable debt instrument by the debtor (issuer) or a "related person" (within the meaning of *IRC Section 108(e)(4)*), whether the acquisition is made for cash, debt (including modification of a debt instrument),ⁿ⁶⁹ corporate stock, or a partnership interest, and also includes a contribution of a debt instrument to the capital of a corporation and the complete forgiveness of indebtedness by the holder of an applicable debt instrument.ⁿ⁷⁰ An "applicable debt instrument" is broadly defined to mean "a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness issued by a C corporation or any other person in connection with the conduct of a trade or business by such person."ⁿ⁷¹

If an applicable debt instrument is reacquired by issuing a debt instrument in exchange, and there is original issue discount (OID) with respect to the debt instrument so issued, OID accruing in taxable years prior to the commencement of the five-year income recognition period (but not in excess of the amount of discharge of indebtedness income deferred) must also be deferred and the aggregate amount of accrued OID deducted ratably over the five-year income recognition period.ⁿ⁷²

The deferral of discharge of indebtedness income (and related OID deductions, if any) terminates, and any remaining deferred income and deductions must be recognized, in any taxable year in which the electing taxpayer liquidates or sells substantially all of its assets, ceases business, or dies.ⁿ⁷³

IRC Section 108(i) may be elected by any taxpayer, including an individual or a pass-thru entity such as an S corporation or a partnership.ⁿ⁷⁴ The procedures for making a Section 108(i) election are set forth in *Rev Proc 2009-37*.ⁿ⁷⁵

In the case of a partnership, a special rule requires that any deferred discharge of indebtedness income be allocated to the partners immediately before the discharge and allocated to the distributive shares of each partner under *IRC Section 704* as though the income had been recognized.ⁿ⁷⁶ Any decrease in partnership liabilities as a result of the discharge is not taken into account for purposes of *IRC Section 752* to the extent it would cause the partner to recognize gain under *IRC Section 731*; instead, partnership liabilities are deemed to be decreased at the time and to the extent discharge of indebtedness income is recognized under *IRC Section 108(i)*.ⁿ⁷⁷

[4] Returns Relating to Cancellation of Indebtedness by Certain Entities.

Any applicable entity that discharges at least \$600 of the total indebtedness of any person during any calendar year must file an information return on Form 1099-C with the Internal Revenue Service.ⁿ¹ For this purpose, a discharge of indebtedness is deemed to have occurred if, and only if, there has occurred one of the identifiable events described below, whether or not an actual discharge of indebtedness has occurred on or before the date on which the identifiable event has occurred.ⁿ² The return must include the following information:

- (1) the name, address and taxpayer identification number of each person for whom there was an identifiable event during the year;

- (2) the date on which the identifiable event occurred;
- (3) the amount of indebtedness discharged;
- (4) an indication whether the identifiable event was a discharge of indebtedness in a bankruptcy, if known; and
- (5) any other information required by Form 1099-C or its instructions, or current revenue procedures.ⁿ³

For this purpose, an indebtedness is any amount owed to an applicable financial entity, including stated principal, fees, stated interest, penalties, administrative costs, and fines.ⁿ⁴ The amount of indebtedness discharged may represent all, or only a part, of the total amount owed to the applicable financial entity.

An applicable entity is an executive, judicial, or legislative agency, or an applicable financial entity.ⁿ⁵

An applicable financial entity is defined as (i) a bank or trust company chartered under the laws of the United States or of any state, (ii) a mutual savings bank, cooperative bank, domestic building and loan association, or other savings institution chartered and supervised as a savings and loan or similar association under federal or state law, (iii) a credit union, (iv) the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, the National Credit Union, and any other federal executive agency and successor of the foregoing, (v) any other corporation that is a direct or indirect subsidiary of a bank, building and loan association, savings and loan association, or credit union, if, by virtue of being affiliated with such entity, the subsidiary is subject to supervision and examination by a federal or state agency that regulates such entities, and (vi) any organization in which the lending of money is a significant trade or business.ⁿ⁶

Proposed regulations provide that the lending of money is a significant trade or business if money is lent on a regular and continuing basis.ⁿ⁷ There are three safe harbors under which organizations will not be considered to have a significant trade or business of lending money. The first safe harbor applies to an organization that was not required to report under *IRC Section 6050P* in the previous calendar year if its gross income from lending money in the most recent test year (the most recent taxable year ending before July 1 of the previous calendar year) is less than both 15 percent of the organization's gross income and \$5 million.ⁿ⁸ The second applies to an organization that was required to report under *IRC Section 6050P* for the previous calendar year if, for each of the three most recent test years, its gross income from lending money is less than both 10 percent of the organization's gross income and \$3 million.ⁿ⁹ The third applies to certain newly formed organizations. Except for an entity that is formed or availed of for the principal purpose of holding loans acquired by an applicable entity, an organization that does not have a test year is considered not to have a significant trade or business of lending money even if the organization lends money on a regular and continuing basis.ⁿ¹⁰

In addition to the safe harbors, the proposed regulations provide a general exception to information reporting for entities whose principal trade or business is the sale of nonfinancial goods or the provision of nonfinancial services. Such businesses are not considered to have a significant trade or business of lending money with respect to lending or credit extended as part of the purchase by customers of those goods and services.ⁿ¹¹

As mentioned above, indebtedness is discharged, for purposes of the reporting requirement, on the date of the occurrence of a specified identifiable event.ⁿ¹² The identifiable events are:ⁿ¹³

- (1) a discharge in bankruptcy under title 11 of the United States Code (bankruptcy);
- (2) a cancellation or extinguishment of an indebtedness that renders a debt unenforceable in a receivership, foreclosure, or similar proceeding in a federal or state court (other than a discharge in bankruptcy);

- (3) a cancellation or extinguishment of an indebtedness upon the expiration of the statute of limitations for collection of an indebtednessⁿ¹⁴ or upon the expiration of a statutory period for filing a claim or commencing a deficiency judgment proceeding;
- (4) a cancellation or extinguishment of an indebtedness pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor's right to pursue collection of the indebtedness;
- (5) a cancellation or extinguishment of an indebtedness that renders a debt unenforceable pursuant to a probate or similar proceeding;
- (6) a discharge of indebtedness pursuant to an agreement between an applicable financial entity and a debtor to discharge indebtedness at less than full consideration;
- (7) a discharge of indebtedness pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt;ⁿ¹⁵ or
- (8) the expiration of the nonpayment test period, if it occurs after December 31, 1997.ⁿ¹⁶

A number of situations are excepted from the reporting requirement. First, reporting is required in the case of a discharge in bankruptcy only if the creditor knows from information included in the reporting entity's books and records pertaining to the indebtedness that the debt was incurred for business or investment purposes.ⁿ¹⁷ Second, the discharge of an amount of indebtedness that is interest need not be reported.ⁿ¹⁸ Third, in the case of a lending transaction, no reporting is required if the discharge is of an amount other than stated principal.ⁿ¹⁹ Fourth, no reporting is required in the case of a deemed discharge under *IRC Section 108(e)(4)* (relating to the acquisition of an indebtedness by a person related to the debtor), unless the disposition of the indebtedness by the creditor was made with a view to avoiding the reporting requirements.ⁿ²⁰ Fifth, the release of a co-obligor is not required to be reported if the remaining debtors continue to be liable for the full amount of the unpaid indebtedness.ⁿ²¹ Lastly, because a guarantor is not a debtor for purposes of the reporting requirement, there is no need to report with respect to a guarantor, whether or not there has been a default and demand for payment made upon the guarantor.ⁿ²²

In the case of a multi-debtor indebtedness of \$10,000 or more incurred on or after January 1, 1995, a reporting entity is subject to reporting requirements for each debtor discharged from the indebtedness.ⁿ²³ If a multi-debtor indebtedness is incurred prior to January 1, 1995, or thereafter in an amount less than \$10,000, reporting is required only with respect to the primary (or first-named) debtor. In addition, only one return of information is required if the reporting entity knows, or has reason to know that co-obligors were husband and wife living at the same address when an indebtedness was incurred, and does not know or have reason to know that such circumstances have changed at the date of discharge of the indebtedness.

If indebtedness is owned (or treated as owned for federal income tax purposes) by more than one creditor, each creditor that is an applicable entity must comply with the reporting requirements with respect to any discharge of indebtedness of \$600 or more allocable to that creditor.ⁿ²⁴ A creditor will be considered to have complied with the reporting requirement if a lead bank, fund administrator, or other designee of the creditor complies on its behalf in a reasonable manner, such as by filing a single return reporting the aggregate amount of indebtedness discharged, or by filing a return with respect to the portion of the discharged indebtedness allocable to the creditor. Any reasonable method may be used to determine the portion of the discharged indebtedness allocable to each creditor.

Every applicable entity required to make such a return must also furnish the person whose debt was discharged a written statement showing the name and address of the entity required to make the return, and the information required to be

shown on the return with respect to that person.ⁿ²⁵ The statement must be furnished to the person no later than January 31 of the year following the calendar year of discharge. Any applicable entity required to file a return must also retain a copy of the return, or have the ability to reconstruct the data required to be included on the return, for at least four years from the date the return is required to be filed.ⁿ²⁶

IRC Sections 6721 and 6722 impose penalties for failure to file the information returns required under *IRC Section 6050P*.ⁿ²⁷ No penalty is imposed on an applicable entity required to make the prescribed return if it is shown that the failure is due to reasonable cause and not to willful neglect.ⁿ²⁸

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.61-12(c)(2)*.

(n2)Footnote 2. *Treas Reg § 1.163-3(a)(1)*. For the computation of discount (or premium) on serial bonds, see *Rev Rul 70-353, 1970-2 CB 39*. If the bonds were issued by a corporation prior to March 1, 1913, the premium represented income in the year of issue.

If bonds that were issued at a discount are converted into stock, any unamortized bond discount loses its character as such and may not be deducted as interest. *Rev Rul 72-348, 1972-2 CB 97*.

(n3)Footnote 3. *Treas Reg § 1.61-12(c)(3)*.

(n4)Footnote 4. *Treas Reg § 1.163-3(c)(1)*.

(n5)Footnote 5. *417 US 134 (1974)*.

(n6)Footnote 6. The Service apparently seized upon a portion of a statement in the Court's opinion that "when viewed from the corporation's perspective, ... there has been no new capital acquired and no additional cost incurred in retaining the old capital." *Id at 152*.

(n7)Footnote 7. *Cities Service Co v US, 522 F2d 1281 (2d Cir 1974)*, cert denied *423 US 827*.

(n8)Footnote 8. *Gulf, Mobile & Ohio RR v Commr, 579 F2d 892 (5th Cir 1978)*.

(n9)Footnote 9. Discount deductions were denied in *National Can Corp v US, 687 F2d 1107 (7th Cir 1982)*, and *Honeywell Inc v Commr, 87 TC 624 (1986)*, because the difference in fair market values of the stock and debentures on the date of exchange was attributable to a conversion feature of the bonds.

Taxpayer's subsidiary issued debentures convertible into the common stock of the taxpayer. At a later date, the subsidiary called the debentures for redemption, thereby prompting most of the debenture holders to convert their debentures into the taxpayer's common stock. The debentures were then redeemed by the subsidiary for cash in an amount equal to the principal of the debentures with accrued interest. The taxpayer claimed a capital loss measured by the amount by which the fair market value of the taxpayer's stock exceeded the principal of the exchanged debentures. The Tax Court in *Reynolds Metals Co v Commr, 105 TC 304 (1995)*, *affd 114 F3d 1177 (4th Cir 1997)*, held that the taxpayer was not entitled to the loss deduction. In the court's opinion, there were two elements involved in the issuance of the taxpayer's stock: (1) the acquisition of the debentures and the right to obtain reimbursement from the subsidiary; and (2) the discharge of the conversion obligation under the indenture under which the debentures were issued. On this basis, the excess of the fair market value of the issued shares over the principal amount of the debentures would be attributable to the conversion feature and the balance to the debentures. The taxpayer's basis in the debentures would be limited to their principal amount, yielding no gain or loss on their redemption. The portion attributable to the conversion feature would be considered a capital contribution by the taxpayer to the subsidiary.

(n10)Footnote 1. *Treas Reg § 1.163-3(c)(1)*. A corporation does not need to net bond premium and bond discount

arising from redemptions and repurchases in the same year. The premium may be deductible under *IRC* § 163; the gain on repurchase may be excludable under *IRC* § 108. *Rev Rul* 70-368, 1970-2 CB 39. The effect of an exclusion under *IRC* § 108 is discussed in § 17.05[3][b][iv].

(n11)Footnote 2. *Treas Reg* § 1.163-3(c)(1).

(n12)Footnote 3. The various aspects of *IRC* § 249 are discussed in *Clark Equip Co v US*, 912 F2d 113 (6th Cir 1990). The court in *Clark Equipment* held that a conversion was a repurchase for purposes of *IRC* § 249.

The adjusted issue price is the issue price as defined in *IRC* §§ 1271(b) and 1274 (see § 17.02[4][c][i]), increased by any discount deducted before repurchase or decreased by any premium previously amortized. *IRC* § 249(b)(1). A normal call premium on a convertible obligation is "an amount equal to a normal call premium on a nonconvertible obligation which is comparable to the convertible obligation." *Treas Reg* § 1.249-1(d)(1). A call premium specified in dollars will be considered normal if it does not exceed one year's interest increased by the amount of discount deductible under *IRC* § 163 or decreased by the amount of bond premium includable under *IRC* § 61. *Treas Reg* § 1.249-1(d)(2). The one year's interest safe harbor does not apply unless there is a call right in the obligation. *Ltr Rul* 9526004.

Control for the purposes of *IRC* § 249(a) means the ownership of at least 80 percent of the voting stock and 80 percent of the total number of shares of all other classes of stock in a corporation. *IRC* §§ 249(b)(2), 368(c).

Prior to the passage of *IRC* § 249, the Service had contended that the excess premium was not deductible, *Rev Rul* 67-409, 1967-2 CB 62; the courts did not agree. *Southwest Grease & Oil Co v US*, 435 F2d 675 (10th Cir 1971); *Roberts & Porter, Inc v Commr*, 307 F2d 745 (7th Cir 1962); *Head Ski Co v US*, 323 F Supp 1383 (D Md 1971) *affd per curiam* 454 F2d 732 (4th Cir 1972); *Universal Tractor-Equipment Corp v US*, 19 AFTR2d 1337 (ED Va 1967). The Service has announced that, in cases which do not come within the ambit of *IRC* § 249, amounts expended by taxpayers on the call of convertible obligations will be deductible, provided the taxpayers can show facts substantially similar to those in *Roberts & Porter*, *Head Ski*, and *Southwest Grease & Oil*, *Rev Rul* 74-210, 1974-1 CB 48, revoking *Rev Rul* 67-409.

Roberts & Porter and *Head Ski* were distinguished in *Richmond, Fredricksburg & Potomac RR v Commr*, 62 TC 174 (1974), *affd* 528 F2d 917 (4th Cir 1975), and no deduction was allowed for a premium paid in redemption of guaranteed stock which, unlike convertible bonds, gave holders a present right to share in earnings.

As part of a plan in a voluntary Chapter 11 bankruptcy proceeding, a corporation issued stock to a class of creditors that included convertible debenture holders. The value of the stock exceeded the amount of the debt. In TAM 200143001, the Service stated that the premium paid to the debenture holders was deductible as interest provided the premium was not attributable to the conversion feature in the debentures.

(n13)Footnote 4. *Treas Reg* § 1.249-1(c).

(n14)Footnote 5. *Treas Reg* § 1.249-1(d)(2).

(n15)Footnote 1. See also Chs 1 and 2. An excellent article is Eustice, "Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion," 14 *Tax L Rev* 225 (1959).

(n16)Footnote 2. *Treas Reg* § 1.61-12(c)(2)(ii). A corporation repurchased bonds that had been issued in exchange for preferred stock in a tax-free recapitalization. The repurchase price was greater than the amount received by the corporation on the issuance of the stock but less than the face value of the bonds. Since the repurchase price was greater than the issue price, the corporation did not realize any cancellation of indebtedness income. *US Steel Corp v US*, 848 F2d 1232 (Fed Cir 1988).

(n17)Footnote 3. 284 US 1 (1931) .

The Kirby Lumber rule was applied in *Gillin v US*, 423 F2d 309 (Ct Cl 1970) , where a loan of Canadian funds immediately converted into US dollars was repaid with Canadian funds purchased with a lesser amount of US dollars.

(n18)Footnote 4. *Helvering v American Chicle Co*, 291 US 426 (1934) .

(n19)Footnote 5. *Commr v Rail Joint Co*, 61 F2d 751 (2d Cir 1932) ; *Fashion Park, Inc v Commr*, 21 TC 600 (1954) , nonacq 1955-1 CB 7 ; see also *Bradford v Commr*, 233 F2d 935 (6th Cir 1956) . The failure of the courts to apply Kirby Lumber in these cases is criticized in Del Cotto, "Debt Discharge Income: Kirby Lumber Co Revisited Under the 'Transitional Equity' Rule of Hillsboro," 38 Buffalo L Rev 777 (1990).

(n20)Footnote 6. 318 US 322 (1943) .

(n21)Footnote 7. 318 US at 331 (1943) .

(n22)Footnote 8. 336 US 28 (1949) .

(n23)Footnote 9. 336 US at 51 (1949) .

(n24)Footnote 10. *Treas Reg § 1.61-12(a)*. Prior to 1980, there was a conflict of authority as to whether a forgiveness of interest was also a contribution to capital. Compare *Commr v Auto-Strop Safety Razor Co*, 74 F2d 226 (2d Cir 1934) and *George Hall Corp v Commr*, 2 TC 146 (1943) , non-acq 1972-1 CB 3 , with *Helvering v Jane Holding Corp*, 109 F2d 933 (8th Cir 1940) , cert denied 310 US 653 .

Rev Rul 76-316, 1976-2 CB 22 , limited the amount of the contribution to capital to the principal portion of the debt.

(n25)Footnote 11. See § 17.05[3][b][iv] for a discussion of the treatment of discharge of indebtedness income.

(n26)Footnote 12. The following discussion of discharge of indebtedness income resulting from the exchange of a debt instrument for stock or other debt, as well as the preceding discussion of forgiveness of debt as a contribution to capital (see § 17.05[3][b][ii] above), should be read in the light of new *IRC § 108(i)*, added by the American Recovery and Reinvestment Act of 2009, which temporarily provides an election to defer the reporting of income arising from such transactions if the discharge takes place in 2009 or 2010. *IRC § 108(i)* is discussed in § 17.05[3][b][iv].

(n27)Footnote 13. *Commr v Capento Sec Corp*, 140 F2d 382 (1st Cir 1944) , affg 47 BTA 691 (1942) ; *Liquid Carbonic Corp v Commr*, 34 BTA 1191 (1936) ; but see *Claridge Apartments Co v Commr*, 138 F2d 962 (7th Cir 1943) , revd on other grounds 323 US 141 (1944) .

No deduction was allowed for interest set aside but never paid on bonds that were converted into stock. Since the conversion rate was constant whether or not there was interest owing, the conversion was the equivalent of a discharge of the obligation to pay interest. *Columbia Gas System, Inc v US*, 334 F Supp 1279 (SDNY 1971) , affd 473 F2d 1244 (2d Cir 1973) . A similar result was reached in *Tandy Corp v US*, 626 F2d 1186 (5th Cir 1980) , where accrued interest and premium on bonds converted to stock were canceled.

(n28)Footnote 14. The 1980 legislation treated the stock received by the creditor as § 1245 property and considered any amount allowed the creditor as a bad debt deduction or as an ordinary loss on the exchange, reduced by any gain realized on the exchange, as a deduction for depreciation subject to recapture as ordinary income under *IRC § 1245*. *IRC § 108(e)(7)(A)*.

(n29)Footnote 15. The stock issued for debt in *Ltr Rul 8837001* amounted to about 15 percent of the total consideration and about 10 percent of the debt canceled in the exchange. This was held not to be a nominal or token

amount of stock.

(n30)Footnote 16. A "workout" is a transaction or series of transactions involving a significant restructuring of the debt of a corporation in financial difficulty.

(n31)Footnote 17. *IRC § 108(e)(8)*, as in effect prior to the Omnibus Budget Reconciliation Act of 1993.

(n32)Footnote 18. A corporation under the jurisdiction of a court in a Title 11 case issued preferred stock with a redemption price and liquidating preference of \$300,000 to a creditor owed \$500,000. Held, the stock-for-debt exception applied only to the extent of the redemption price and liquidating preference. *Rev Rul 90-87, 1990-2 CB 32*.

(n33)Footnote 19. The disqualified stock rule does not apply to any stock transferred, in satisfaction of any indebtedness if the transfer (a) is in a title 11 or similar case filed on or before Oct 9, 1990, (b) is pursuant to a written binding contract in effect on Oct 9, 1990, and at all times thereafter before the transfer, (c) is pursuant to a tender offer or exchange offer described in documents filed with the Securities and Exchange Commission on or before Oct 9, 1990, or (d) is pursuant to a transaction that was described in a written public announcement before Oct 9, 1990, and was the subject of both a prior filing and a subsequent pre-Jan 1, 1991 filing with the Securities and Exchange Commission.

Stock that is disqualified stock is not considered to be stock in determining whether stock issued for indebtedness is nominal of token.

(n34)Footnote 20. *Treas Reg § 1.108-1(b)*.

(n35)Footnote 21. *Treas Reg § 1.108-1(b)*. Common stock is all stock other than preferred stock and disqualified stock. *Treas Reg § 1.108-1(d)(1)*.

(n36)Footnote 22. *Treas Reg § 1.108-1(b)*. Preferred stock is any stock (other than disqualified stock) that has a limited or fixed redemption price or liquidation preference, and, upon issuance, does not have a right to participate in corporate growth in any material way. A right to participate in corporate growth is not established by the fact that the redemption price or liquidation preference exceeds the fair market value of the preferred stock. *Treas Reg § 1.108-1(d)(4)*.

(n37)Footnote 23. *Treas Reg § 1.108-1(c)(1)(i)*.

(n38)Footnote 24. *Treas Reg § 1.108-1(c)(1)(ii)*.

(n39)Footnote 25. *Treas Reg § 1.108-1(c)(1)(iii)*.

(n40)Footnote 26. *Treas Reg § 1.108-1(c)(2)(i)*.

(n41)Footnote 27. A liquidation preference exists if the stock's right to share in liquidation proceeds is limited and preferred. *Treas Reg § 1.108-1(d)(3)*.

(n42)Footnote 28. *Treas Reg § 1.108-1(c)(2)(ii)*.

(n43)Footnote 28.1. If a debtor partnership transfers a capital or profits interest in the partnership in satisfaction of an indebtedness, the partnership is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the interest. In addition, any discharge of indebtedness income recognized by the partnership is included in the distributive share of taxpayers who were the partners in the partnership immediately before the discharge.

The question presented in TAM 9830002 was whether *IRC § 108(e)(6)* or *108(e)(8)* applied to a situation in which a debtor contemporaneously issued stock to each of three creditors in cancellation of its separate debts to them, where the

creditors were (1) the corporation that theretofore owned all of the debtor's stock, (2) the corporation that owned all of the debtor's parent's stock, and (3) the corporation that, in turn, owned all of that second corporation's stock. Held, *IRC § 108(e)(8)* applied because the debtor issued stock in return for the cancellation of each of the debts; the cancellation was not a contribution to the capital of the debtor.

(n44)Footnote 28.2. *Rev Proc 94-26, 1994-1 CB 612* , effective with respect to any issuance of stock for indebtedness: (1) pursuant to a plan confirmed by the court in a title 11 case after May 17, 1994; or (2) if there is no title 11 case, pursuant to an insolvency workout in which all issuances of stock for indebtedness occur after May 17, 1994. In both instances, the case had to be filed on or before Dec 31, 1993.

(n45)Footnote 29. *Cf Great Western Power Co v Commr, 297 US 543 (1936)* .

(n46)Footnote 30. *Commr v Stanley Co, 185 F2d 979 (2d Cir 1951)* ; *Commr v Coastwise Transp Corp, 71 F2d 104 (1st Cir 1934)* , *cert denied 293 US 595* . However in *Pennsylvania Elec Co v US, 135 F Supp 416 (Ct Cl 1955)* , the court treated the excess of the value of the new bonds over the issue price of the old as a capital contribution by a creditor parent to a debtor subsidiary.

(n47)Footnote 31. The transitional rules affecting transactions involving disqualified stock, discussed above, apply with equal force to debt-for-debt exchanges.

(n48)Footnote 32. Query, whether amortizable bond premium can arise without an actual outlay of cash. See *Treas Reg § 1.61-14(c)*.

(n49)Footnote 33. For a discussion of the Service's position, see Sheppard, "Debt-For-Debt Exchanges," *48 Tax Notes* 954 (1990).

(n50)Footnote 33.1. See American Bar Association Section of Taxation, "Report of the Section 108 Real Estate and Partnership Task Force," *46 Tax Lawyer* 209 (1992). See also Burke, "Partnership Debt-Equity Exchanges: Kirby Lumber and Subchapter K," *47 Tax Lawyer* 13 (1993).

(n51)Footnote 34. The Code actually employs the term "title 11 case," defined as "a case under title 11 of the US Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court." *IRC § 108(d)(2)*. The mere fact that a bankruptcy court assumes jurisdiction over a corporation and the trustee undertakes to manage the corporation's affairs in bankruptcy does not constitute discharge of indebtedness income under *IRC § 108(a)*; there must be a specific order or approval of the bankruptcy plan. *Friedman v Commr, TC Memo 1998-196* .

(n52)Footnote 35. The insolvency exception applies only to the extent the income is produced by a cancellation of indebtedness. For example, if an insolvent taxpayer conveys property with a basis of \$8,000 and a fair market value of \$11,000 to a creditor in payment of a \$12,000 debt, the \$3,000 difference between basis and value will be gain that is realized and recognized as derived from a disposition of property; the remaining \$1,000 will be cancellation of indebtedness income subject to the rules of *IRC § 108(a)(1)*. *Rev Rul 90-16, 1990-1 CB 12* . Apparently, the Service will limit the application of *Rev Rul 90-16* to instances in which the debt involved is recourse debt. If nonrecourse, *IRC § 108(a)(1)* will not apply even if the debt exceeds the fair market value of the property. *Ltr Rul 9302001* .

A bifurcated analysis of the tax consequences was found to be warranted in *Frazier v Commr, 111 TC 243 (1998)* . The facts of the case were unusual. The lender's bid (the only bid) at the foreclosure sale was higher than the actual fair market value of the property at the time. The Tax Court used the fair market value as the amount realized on the sale, giving rise to a realized loss on the property portion of the transaction. The taxpayers realized cancellation of indebtedness income that they could exclude because they were insolvent. Of interest is the fact that the Service argued that *Rev Rul 90-16* should not be applied.

The taxpayers in *Gehl v Commr*, 102 TC 784 (1994), *affd in an unpublished disposition* (8th Cir 1995), transferred appreciated property to a creditor in partial satisfaction of a debt; the remainder of the debt was forgiven. The taxpayers were insolvent both before and after the transfer. The excess of the fair market value of the property over its basis was held to be gain from dealings in property and properly includable in income pursuant to *IRC § 61(a)(3)*, and did not constitute cancellation of indebtedness income. The Service conceded that the forgiven portion of the debt was cancellation of indebtedness income that could be excluded from income by reason of the insolvency of the taxpayers.

A similar result was reached in *Moore v Commr*, *TC Memo 1994-446*, where the a partnership interest was transferred in exchange for cash, a note, and the assumption of the taxpayer's obligations on the partnership's debt.

A transfer of property in exchange for a mortgage discharge produced capital gain rather than cancellation of indebtedness income in *Correra v Commr*, *TC Memo 1997-356*. The Fifth Circuit reached the same result in 2925 *Briarpark Ltd v Commr*, 163 F3d 313 (5th Cir 1999), on the ground that *IRC § 61(a)(3)*, not *IRC § 61(a)(12)*, should apply when the transaction relieves the taxpayer-owner of (1) the obligation to repay the debt, and (2) title to the property.

(n53)Footnote 36. A debt is treated as qualified farm indebtedness if (i) the indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming, and (ii) at least 50 percent of the taxpayer's gross receipts for the three taxable years preceding the year of discharge is attributable to the trade or business of farming. *IRC § 108(g)(2)*.

Qualified real property business indebtedness is indebtedness (other than qualified farm indebtedness) that (a) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by that property; (b) was incurred or assumed before Jan 1, 1993, or is qualified acquisition indebtedness; and (c) with respect to which the taxpayer makes an election (on the taxpayer's return for the year of discharge) to treat the indebtedness as qualified real property business indebtedness. *IRC §§ 108(c)(3), 108(d)(9)*. The required election can be revoked only with the consent of the Service. The election is made on a completed Form 982 attached to a timely-filed (including extensions) federal income tax return for the taxable year in which the taxpayer has excludable discharge of indebtedness income. *Treas Reg § 1.108(c)-1(b)*.

Indebtedness is qualified acquisition indebtedness if it was incurred or assumed to acquire, construct, reconstruct, or substantially improve business real property. *IRC § 108(c)(4)*. A refinancing of the indebtedness can be qualified real property business indebtedness, but only to the extent it does not exceed the amount of the indebtedness being refinanced.

The "in connection with" requirement for qualified real property business indebtedness is satisfied if the debt is secured by real property used in a trade or business at the time the debt is incurred. *TAM 200014007*.

The discharge, whether of qualified farm indebtedness or qualified real property business indebtedness, must be by a qualified person--generally a person actively and regularly engaged in the business of lending money and any federal, state, or local government or agency or instrumentality thereof. *IRC §§ 46(c)(8)(D)(iv), 108(g)(1)*.

(n54)Footnote 37. *IRC § 108(a)(2)*.

(n55)Footnote 38. S Rep No 1035, 96th Cong, 2d Sess 10 (1980).

(n56)Footnote 39. *IRC § 108(b)(1), (2)*. If a taxpayer realizes cancellation of indebtedness income that is excluded from gross income under *IRC § 108(a)* either during or after a taxable year in which the taxpayer is the distributor or transferor of assets in a transaction described in *IRC § 381(a)*, any tax attributes to which the acquiring corporation succeeds, including the basis of property acquired by the acquiring corporation in the transaction, must reflect the reductions required by *IRC § 108(b)*. For this purpose, all attributes listed in *IRC § 108(b)(2)* immediately prior to the

transaction described in *IRC § 381(a)*, but after the determination of tax for the year of distribution or transfer of assets, including basis of property, will be available for reduction under *IRC § 108(b)(2)*. However, the basis of stock or securities of the acquiring corporation, if any, received by the taxpayer in exchange for the transferred assets will not be available for reduction under *IRC § 108(b)(2)*. *Treas Reg § 1.108-7(c)*.

An S corporation, with excluded discharge of indebtedness income, reduces the listed tax attributes after items of income, loss, deduction, or credit have been passed through to its shareholders. Moreover, if the corporation had a net operating loss for a year in which it was a C corporation, there is no reduction in any net operating loss carried forward from that year; *IRC § 1371(b)(1)* prevents the carryforward. *TAM 9541001*.

(n57)Footnote 40. *IRC § 108(b)(3), (4)(A)*.

(n58)Footnote 41. *IRC § 108(b)(4)(B)*.

(n59)Footnote 42. *IRC § 108(b)(4)(C)*.

(n60)Footnote 43. *IRC §§ 108(b)(1), (b)(5)(A), 1017(b)(3)(E)(i)*.

The elections must be made on Form 982 attached to the taxpayer's return for the year in which discharge occurs, or such other time as the regulations permit. Once made, they can be revoked only with consent. *IRC §§ 108(d)(9), 1017(b)(3)(E)(ii)*.

If the taxpayer establishes to the satisfaction of the Service reasonable cause for failure to file the election with the original return, the taxpayer may file the election with an amended return or claim for refund. *Temp Treas Reg § 7a.1(d)(1)*.

Stock held by a parent will be treated as depreciable property if the parent and subsidiary file a consolidated return for the discharge year and the subsidiary agrees to reduce its basis in its depreciable property or inventory real property. *IRC § 1017(b)(3)(D)*.

(n61)Footnote 44. *IRC §§ 108(b)(5)(B), 1017(a)*. If a taxpayer realizes cancellation of indebtedness income that is excluded from gross income under *IRC § 108(a)* either during or after a taxable year in which the taxpayer is the distributor or transferor of assets in a transaction described in *IRC § 381(a)*, the basis of property acquired by the acquiring corporation in the transaction, must reflect the reductions required by *IRC § 1017*. For this purpose, the basis of property of the distributor or transferor corporation immediately prior to the transaction described in *IRC § 381(a)*, but after determination of tax for the year of distribution or transfer of assets, will be available for reduction under *IRC § 108(b)(2)*. However, the basis of stock or securities of the acquiring corporation, if any, received by the taxpayer in exchange for the transferred assets will not be available for reduction under *IRC § 108(b)(2)*. *Treas Reg § 1.1017-1(b)(4)*.

(n62)Footnote 45. *Treas Reg § 1.1017-1*.

(n63)Footnote 46. *IRC § 108(d)(3)*. A reduction in the principal amount of nonrecourse debt that exceeds the fair market value of the property securing the debt results in discharge of indebtedness income. *Rev Rul 91-31, 1991-1 CB 19*. However, the amount by which the nonrecourse debt is undersecured is taken into account in determining whether, and to what extent, a taxpayer is insolvent, but only to the extent that the excess nonrecourse debt is discharged. *Rev Rul 92-53, 1992-2 CB 48*.

The Ninth Circuit has held that a taxpayer claiming to be insolvent must prove by a preponderance of the evidence that he or she will be called upon to pay an obligation claimed to be a liability, and that the total amount of liabilities so proved exceed the fair market value of the taxpayer's assets. *Merkel v Commr, 192 F3d 844 (9th Cir 1999)*.

According to the Service, assets that are exempt from the claims of creditors under state law must be taken into account in determining whether a taxpayer is insolvent. *Ltr Rul 199935002* ; *Ltr Rul 199932013* . The Tax Court agrees. *Carlson v Commr*, 116 TC 87 (2001) .

(n64)Footnote 47. *IRC § 108(e)(5)* permits a debt reduction to be treated as a purchase price adjustment if (i) the debt of a purchaser of property is reduced, and (ii) the discharge would otherwise result in includable cancellation of indebtedness income. If the creditor is not the seller, any debt reduction produces income unless the discharge results from an infirmity that can be traced back to the original sale. *Rev Rul 92-99, 1992-2 CB 48* . The Service will not challenge a bankrupt or insolvent partnership's treatment of a reduction of an indebtedness as a purchase price adjustment if the transaction would have qualified as such absent the insolvency or bankruptcy. *Rev Proc 92-92, 1992-2 CB 505* .

The reductions to tax attributes mentioned earlier apply to amounts excluded from gross income under *IRC § 108(a)*. Although a reduction in basis is logical when the cancellation of indebtedness is excluded from income under *IRC § 108(e)(5)*, there is nothing in the Code that explicitly mandates the adjustment

Ltr Ruls 9338049 and *9338029* both involved the formation of a transitory subsidiary corporation to redeem the parent corporation's stock from a shareholder with funds borrowed from a bank. In each case, the subsidiary then merged into the parent, which then sought a reduction in the amount of the bank loan. The Service ruled that the transitory corporation would be ignored and the reduction in the debt would be treated as a purchase price reduction under *IRC § 108(e)(5)*.

Cancellation of indebtedness income is characterized as passive income for purposes of the passive activity loss rules of *IRC § 469* to the extent the proceeds of the discharged debt were used in a passive activity when the discharge occurred. *Rev Rul 92-92, 1992-2 CB 103* .

(n65)Footnote 48. *IRC § 108(g)(3)(A), (C)*.

(n66)Footnote 49. *IRC § 108(g)(3)(B)*.

(n67)Footnote 50. *IRC § 108(g)(3)(D)*.

(n68)Footnote 51. *IRC § 1017(b)(4)*.

(n69)Footnote 52. *IRC § 108(c)(2)(A)*. See generally, Taggart, "Revenue Reconciliation Act of 1993--Real Estate Indebtedness," 23 *Real Est L J* 48 (1994).

The outstanding principal amount means the principal amount of indebtedness together with all additional amounts owed that, immediately before the discharge, are equivalent to principal, in that interest on such amounts would accrue and compound in the future, except that outstanding principal amount cannot include amounts that would be deductible if paid and will be adjusted to account for unamortized premium and discount with respect to the indebtedness discharged. *IRC § 108(e)(2), (3)*; *Treas Reg § 1.108-6(a)*.

(n70)Footnote 53. *IRC § 108(c)(2)(B)*.

(n71)Footnote 54. *IRC §§ 108(c)(1)(A), 1017(a), 1017(b)(3)(F)*.

(n72)Footnote 55. *IRC § 108(d)(6)*. A partnership must consent to reduce its partners' shares of the partnership's depreciable property if requested by (1) partners who directly or indirectly own an aggregate of more than 80 percent of the partnership's capital and profits interests, or (2) five or fewer partners who own directly or indirectly an aggregate of more than 50 percent of the partnership's capital and profits interests. *Treas Reg § 1.1017-1(g)(2)(ii)(C)*.

The legislative history underlying the exclusion of income arising from the cancellation of qualified real property business indebtedness provides that, in the case of discharge of indebtedness of a partnership, the determination of whether the debt is qualified real property business indebtedness is made at the partnership level. HR Rep No 111, 103d Cong, 1st Sess 622-625 (1993).

A cancellation of partnership indebtedness that cannot be excluded from a partner's income is a deemed distribution of money under *IRC § 752(b)*. The deemed distribution occurs on the last day of the partnership's taxable year. *Rev Rul 94-4, 1994-1 CB 195 ; Rev Rul 92-97, 1992-2 CB 124 .*

The election to exclude the discharge of qualified real property business indebtedness income is made by the partners, on a partner by partner basis. See, eg, *Ltr Rul 9840026 .*

In *Babin v Commr, 23 F3d 1032 (6th Cir 1994)* , *cert denied 115 S Ct 421* , a case predating the enactment of *IRC § 108*, an insolvent partner received no distribution of income based on a forgiveness of the partnership's indebtedness, and, thus, was not entitled to increase the adjusted basis of his partnership interest.

(n73)Footnote 56. *IRC § 108(d)(7)(A)*. For discharges of indebtedness after Oct 11, 2001, the discharge of indebtedness income cannot be taken into account under *IRC § 1366(a)* in order to increase the basis of an S corporation shareholder's stock. See *§ 15.03[1]*. For purposes of the reduction in the net operating loss for the taxable year of discharge and any net operating loss carryover to that taxable year, any loss or deduction that is disallowed for the taxable year of discharge under *IRC § 1366(d)(1)* (loss in excess of shareholder's basis in stock and debt) is treated as a net operating loss for that taxable year. *IRC § 108(d)(7)(B)*. The preceding sentence does not apply to any excluded income resulting from the discharge of qualified real property business indebtedness.

(n74)Footnote 57. *IRC § 1017(d)(1)*. The computation of the amount of straight-line depreciation taken into account under *IRC § 1250(b)* is made as if there had been no reduction under *IRC § 1017*. *IRC § 1017(d)(2)*.

(n75)Footnote 58. S Rep No 1035, 96th Cong, 2d Sess 10, 16 (1980).

(n76)Footnote 59. *IRC § 108(e)(4)(A)*; *Treas Reg § 1.108-2(a), (f)*. Under *Treas Reg § 1.108-2(g)*, if the debtor realizes income from the discharge of indebtedness resulting from the acquisition by the related party, the debt is treated as a new debt issued by the debtor to the related party on the acquisition date. See, eg, *Rev Rul 2004-79, 2004-2 CB 106 .*

(n77)Footnote 60. *IRC § 108(e)(4)(A), (C), 267(b)(2), (3)*.

(n78)Footnote 61. *Treas Reg § 1.108-2(f)*. The rules do not apply to a direct or indirect acquisition of indebtedness with a stated maturity date on or before the date that is one year after the date of acquisition, provided the debt is retired on or before its maturity date. The rules also do not apply to a securities dealer who acquires the indebtedness in the ordinary course of business and disposes of it within a period consistent with the holding of the indebtedness for sale to customers in the ordinary course of business. *Treas Reg § 1.108-2(e)*.

See also *Rev Rul 91-47, 1991-2 CB 16* , where a person unrelated to the debtor formed a corporation to acquire the debt and shortly thereafter sold the new corporation's stock to the debtor. According to the Service, such a transaction produces a cancellation of indebtedness income for the debtor.

(n79)Footnote 62. *Treas Reg § 1.108-2(b)*. The acquisition of corporate debt by a beneficiary of a decedent creditor's estate or by a beneficiary of a revocable trust that became irrevocable upon the creditor's death in the situation where (1) the beneficiary is related to the corporate debtor, (2) the decedent creditor was also related to the corporate debtor, but (3) the estate or trust is not related to the corporate debtor, is not a direct acquisition within the meaning of

Treas Reg § 1.108-2(b). *Rev Proc 2000-33*, 2000-2 CB 257 .

(n80)Footnote 63. Pub L No 111-5.

(n81)Footnote 64. See *IRC § 108(i)*.

(n82)Footnote 65. For fiscal year taxpayers, the income recognition period begins in the fifth taxable year following the taxable year in which the reacquisition occurs if it occurs in 2009, or the fourth taxable year following the taxable year of reacquisition if the reacquisition occurs in 2010. *IRC § 108(i)(1)(A)* and *(B)*.

(n83)Footnote 66. The election must clearly identify the instrument with respect to which the election is being made, the amount of discharge of indebtedness income being deferred, and such other information as the Secretary may prescribe. *IRC § 108(i)(5)(B)(i)*. The Secretary also has authority to require reporting of information with respect to the election in subsequent taxable years. *IRC § 108(i)(7)(B)*

(n84)Footnote 67. *IRC § 108(i)(5)(B)(ii)*.

(n85)Footnote 68. *IRC § 108(i)(5)(C)*. These exclusions, as discussed above, are for discharge of indebtedness income (A) that occurs in a title 11 case, (B) that occurs while the debtor is insolvent, (C) that is qualified farm indebtedness, or (D) that is qualified real property business indebtedness.

(n86)Footnote 69. See *Treas Reg § 1.1001-3*.

(n87)Footnote 70. *IRC § 108(i)(4)*.

(n88)Footnote 71. *IRC § 108(i)(3)*. The statute basically adopts the definition of debt instrument found in *IRC § 1275(a)(1)*. See *Treas Reg § 1.1275-1(d)* ("[D]ebt instrument means any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law (including, for example, a certificate of deposit or a loan).")

(n89)Footnote 72. *IRC § 108(i)(2)*. The OID deferral rule can also apply where the debtor reacquires its debt for cash. If the taxpayer issues a debt instrument and uses the proceeds of the issuance "directly or indirectly" to reacquire an outstanding debt, the newly issued debt instrument is treated as if it were issued in satisfaction of the retired debt instrument (debt-for-debt exchange) and any OID on the newly issued debt becomes subject to the OID deferral rule. (If only a portion of the proceeds of the new debt instrument is applied to retire existing indebtedness on which discharge of indebtedness income is realized and deferred, the OID deferral rule will apply to a ratable portion of the new debt instrument's OID (eg, if half of the proceeds are used to acquire the outstanding debt, a deduction for half the new instrument's OID will be deferred under the rule). *IRC § 108(i)(2)(B)*; HR Conf Rep 111-16, 111th Cong, 1st Sess (Feb 12, 2009), at 565.

(n90)Footnote 73. *IRC § 108(i)(5)(D)(i)*. The Treasury has the authority to prescribe, by regulation, rule or other guidance, additional events that will cause the "acceleration of deferred items" (as the termination of deferral is described in the statute) in "similar circumstances" to those described in *IRC § 108(i)(5)(D)*. *IRC § 108(i)(7)*. One area in which Treasury is expected to provide guidance is whether income recognition should be accelerated when the taxpayer sells its business in a tax-free reorganization, and whether in these circumstances the deferred items could be carried over under *IRC § 381*. See 2009 TNT 46-2 (March 12, 2009).

The House Conference Report on *IRC § 108(i)* states that in a Title 11 case, deferred items are accelerated (i.e., deferral is terminated) only where the taxpayer liquidates, sells substantially all its assets, or ceases to do business, but are not accelerated where a taxpayer "reorganizes and emerges from the title 11 case." Where deferral is terminated in a title 11 case, "any deferred items are taken into income as of the day before the petition is filed." HR Conf Rep 111-16 at 565.

(n91)Footnote 74. The election is made at the entity level by the S corporation, partnership or other pass-thru entity. *IRC § 108(5)(A)(iii)*.

(n92)Footnote 75. *2009-36 IRB 309*. In general, an *IRC § 108(i)* election is made by attaching a statement with the information required by *Rev Proc 2009-37* to the taxpayer's (or pass-thru entity's) timely filed (including extensions) federal income tax return for the taxable year in which the reacquisition of the applicable debt instrument occurs. (§ 4.01(1)(a)). *Rev Proc 2009-37* also grants an automatic extension of 12 months in which to file the *IRC § 108(i)* election. (§ 4.01(2)). The election may defer all or only a portion of the discharge of indebtedness income arising from the reacquisition of an applicable debt instrument, and if only a portion is deferred under *IRC § 108(i)*, the taxpayer may elect to exclude the remainder from income under *IRC § 108(a)(1)(A), (B), (C) or (D)*. (§ 4.04(1)). Separate elections are required for each reacquisition of an applicable debt instrument, but a taxpayer may treat two or more applicable debt instruments that are part of the same issue and reacquired during the same taxable year as one applicable debt instrument for purposes of making an election. (§ 4.03) The taxpayer is not required to combine reacquisitions of applicable debt instruments of the same issue within the same taxable year in a single election, however, and may choose instead, for example, to elect deferral of all discharge of indebtedness income with respect to one reacquisition while deferring none or only a portion of the discharge of indebtedness income from another reacquisition, even if the applicable debt instruments are of the same issue and the reacquisitions are made in the same taxable year. (§ 4.04(2)). Finally, the taxpayer may file a protective *IRC § 108(i)* election that will be triggered if the taxpayer's assumption that the reacquisition of an applicable debt instrument did not give rise to discharge of indebtedness income is challenged by the IRS. (§ 4.11).

Rev Proc 2009-37 also requires that taxpayers who make an *IRC § 108(i)* election attach an annual information statement to their returns for every subsequent year until the deferred income is fully reported. (§ 5.01). The information required includes a statement with respect to each applicable debt instrument as to the amount of tax-deferred income and deferred original issue discount (OID) deductions (if any) taken into account in the current year, the amounts remaining to be taken into account in future years, and whether such income and OID have been taken into account as the result of an acceleration event as described in *IRC § 108(i)(5)(D)* has taken place. (§ 5.02).

(n93)Footnote 76. *IRC § 108(i)(6)*. The Secretary has authority to prescribe additional rules for the application of *IRC § 108(i)* to partnerships, S corporations and other pass-thru entities, including rules regarding allocation of deferred OID deductions. *IRC § 108(i)(7)(C)*.

(n94)Footnote 77. *IRC § 108(i)(6)*. In the case of any partner, shareholder or other owner of an interest in a pass-thru entity, in addition to the events which terminate deferral at the entity level as described in *IRC § 108(i)(5)(D)(i)*, *supra*, deferral also terminates with respect to any partner, shareholder or other owner of an interest in a pass-thru entity when the interest is sold, exchanged or redeemed. *IRC § 108(i)(5)(D)(ii)*.

(n95)Footnote 1. *IRC § 6050P(a), (b); Treas Reg § 1.6050P-1(a)(1)*. Generally, the Form 1099-C must be filed with the IRS office designated in the instructions for Form 1099-C on or before February 28 of the year following the calendar year in which the identifiable event occurs. *Treas Reg § 1.6050P-1(a)(4)(i)*. However, indebtedness discharged in bankruptcy must be reported for the later of the calendar year in which the amount of discharged indebtedness first becomes ascertainable, or the calendar year in which the identifiable event occurs. *Treas Reg § 1.6050P-1(a)(4)(ii)*.

Multiple discharges of indebtedness of less than \$600 are not required to be aggregated unless the separate discharges are pursuant to a plan. *Treas Reg § 1.6050P-1(a)(2)*. However, discharged indebtedness must be reported whether or not the debtor is subject to tax on the discharged debt under *IRC § 61 or 108* or otherwise by applicable law. *Treas Reg § 6050P-1(a)(3)*.

The Service will not issue rulings as to whether amounts reduced pursuant to the terms of a debt instrument are reportable under *IRC § 6050P* until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations, or otherwise. *Rev Proc 2010-3, 2010-1 CB 110, 120*, (§ 5.16).

(n96)Footnote 2. *Treas Reg § 1.6050P-1(a)(1)*.

(n97)Footnote 3. *IRC § 6050P(a)*; *Treas Reg § 1.6050P-1(a)(1)*.

(n98)Footnote 4. *Treas Reg § 1.6050P-1(c)*.

(n99)Footnote 5. *IRC § 6050P(c)(1)*. The term "executive, judicial, or legislative agency" is defined as a department, agency, court, court administrative office, or instrumentality in the executive, judicial, or legislative branch of Government, including government corporations. *31 USC § 3701(a)(4)*.

(n100)Footnote 6. *IRC § 6050P(c)(2)*. Any return required to be made by a governmental agency (whether as an applicable entity or applicable financial entity) is made by the officer or employee appropriately designated for that purpose. *IRC § 6050P(c)(3)*.

(n101)Footnote 7. *Prop Treas Reg § 1.6050P-2(a)*. Lending money includes acquiring an indebtedness, and gross income from such an acquired indebtedness is treated as gross income from lending money, without regard to whether the indebtedness was originated by either an applicable entity or a related party. *Prop Treas Reg § 1.6050P-2(e)*.

(n102)Footnote 8. *Prop Treas Reg § 1.6050P-2(b)(1)*. Gross income from lending money includes income from interest, fees, penalties, merchant discount, interchange and gains arising from the sale of an indebtedness. *Prop Treas Reg § 1.6050P-2(d)*.

(n103)Footnote 9. *Prop Treas Reg § 1.6050P-2(b)(2)*.

(n104)Footnote 10. *Prop Treas Reg § 1.6050P-2(b)(3)*. If an entity (the transferee entity) is formed or availed of by an applicable entity for the purpose of holding indebtedness acquired or originated by the applicable entity, then the transferee entity has a significant trade or business of lending money. *Prop Treas Reg § 1.6050P-1(e)(2)(v)*.

(n105)Footnote 11. *Prop Treas Reg § 1.6050P-2(c)*.

(n106)Footnote 12. *Treas Reg § 1.6050P-1(b)(1)*. If a discharge of indebtedness occurs before the date on which an identifiable event occurs, the discharge may, at the creditor's discretion, be reported. *Treas Reg § 1.6050P-1(b)(3)*.

(n107)Footnote 13. *Treas Reg § 1.6050P-1(b)(2)(i)*.

(n108)Footnote 14. In the case of an expiration of the statute of limitations for collection of an indebtedness, an identifiable event occurs only if, and at such time as, a debtor's affirmative statute of limitations defense is upheld in a final judgment or decision of a judicial proceeding, and the period for appealing the judgment or decision has expired. *Treas Reg § 1.6050P-1(b)(2)(ii)*.

(n109)Footnote 15. A creditor's defined policy includes both a written policy of the creditor and the creditor's established business practice. *Treas Reg § 1.6050P-1(b)(2)(iii)*.

(n110)Footnote 16. *Treas Reg § 1.6050P-1(b)(2)(iv)*. There is a rebuttable presumption that this type of identifiable event has occurred during the calendar year if a creditor has not received a payment on an indebtedness at any time during a period of 36 months increased by the number of calendar months during all or part of which the creditor was precluded from engaging in collection activity by a stay in bankruptcy or similar bar under state or local law. The presumption may be rebutted by the creditor if the creditor (or a third-party collection agency on behalf of the creditor) has engaged in significant bona fide collection activity (more than merely nominal or ministerial collection action, such as an automated mailing) at any time during the 12-month period ending at the close of the calendar year, or if facts and circumstances existing as of January 31 of the calendar year following expiration of the 36-month period indicate that the indebtedness has not been discharged. Facts and circumstances indicating that an indebtedness has not been discharged include the existence of a lien relating to the indebtedness against the debtor (to the extent of the value

of the security), or the sale or packaging for sale of the indebtedness by the creditor. In *PLR 200802012*, the Internal Revenue Service acknowledged a situation where the reporting rules of *IRC § 6050P* would not apply. In that private ruling, the writing off of amounts owed to the taxpayer was not considered an "identifiable event" that required reporting, because it arose from a settlement required by statute rather than by voluntary agreement.

(n111)Footnote 17. *Treas Reg § 1.6050P-1(d)(1)(i)*. Indebtedness is considered incurred for business purposes if it is incurred in connection with the conduct of any trade or business other than the trade or business of performing services as an employee. Indebtedness is considered incurred for investment purposes if it is incurred to purchase property held for investment, as defined in *IRC § 163(d)(5)*.

(n112)Footnote 18. *Treas Reg § 1.6050P-1(d)(2)*.

(n113)Footnote 19. *Treas Reg § 1.6050P-1(d)(3)*. A lending transaction is any transaction in which a lender loans money to, or makes advances on behalf of, a borrower (including revolving credits and lines of credit).

(n114)Footnote 20. *Treas Reg § 1.6050P-1(d)(5)*.

(n115)Footnote 21. *Treas Reg § 1.6050P-1(d)(6)*.

(n116)Footnote 22. *Treas Reg § 1.6050P-1(d)(7)*.

(n117)Footnote 23. *Treas Reg § 1.6050P-1(e)(1)(i)*. If multiple debtors are jointly and severally liable on an indebtedness, the amount of discharged indebtedness required to be reported with respect to each debtor is the total amount of indebtedness discharged. For this purpose, multiple debtors are presumed to be jointly and severally liable on an indebtedness in the absence of clear and convincing evidence to the contrary. *Treas Reg § 1.6050P-1(e)(1)(ii)*.

(n118)Footnote 24. *Treas Reg § 1.6050P-1(e)(2)(i)*. Indebtedness owned by a partnership is treated as owned by the partners. *Treas Reg § 1.6050P-1(e)(2)(ii)*.

If multiple creditors are considered to hold interests in an indebtedness, and an entity is required to report a discharge of indebtedness because it is an entity formed or availed of by an applicable entity for the principal purpose of holding indebtedness acquired or originated by the applicable entity, then the multiple creditors are not required to report the discharge of indebtedness. *Prop Treas Reg § 1.6050P-1(e)(2)(v)*.

(n119)Footnote 25. *IRC § 6050P(d)*.

(n120)Footnote 26. *Treas Reg § 1.6050P-1(e)(7)*.

(n121)Footnote 27. The Service has announced that it will not impose penalties on lenders for failing to comply with the reporting requirements for discharges of indebtedness occurring before Jan 1, 2001. *Notice 2000-22, 2000-1 CB 902*.

(n122)Footnote 28. *IRC §§ 6724(a), 6724(d)(1)(B)(viii)*.



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CHAPTER 18 The Taxpayer as a Dealer in Securities

2-18 Taxation of Securities Transactions 18.syn

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CHAPTER 18 The Taxpayer as a Dealer in Securities

2-18 Taxation of Securities Transactions § 18.01

§ 18.01 Introduction

A person can engage in securities transactions either as an investor or trader, or as a dealer in securities. The policy considerations affecting the tax consequences of securities transactions are obviously not the same when the taxpayer enters the transaction as a dealer rather than as an investor. For one thing, when held for resale by a dealer, securities become the dealer's inventory or stock in trade, and are thus removed from the status of capital assets. The dealer's expenses can no longer be viewed merely as capital expenditures recoverable through the medium of basis; they constitute a cost of doing business, and, therefore, call for different treatment. The way in which the tax treatment of a dealer differs from that of an investor or trader is the subject of this chapter.



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CHAPTER 18 The Taxpayer as a Dealer in Securities

2-18 Taxation of Securities Transactions § 18.02

§ 18.02 "Dealer in Securities" Defined

The Regulations define a dealer in securities as:

"[A] merchant of securities whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom."¹

The definition points up the salient difference between a dealer and a trader in securities--the presence of a merchandising function. The dealer purchases securities as stock in trade, with the expectation of turning a profit, not because of a rise in the market value of the securities, but because the dealer can secure a market of buyers who will purchase the securities at a price greater than cost.^{1.1} The trader performs no merchandising function, but rather buys and sells for investment or speculation, seeking a profit through a change in value during the interval between purchase and sale. Not even that degree of activity sufficient to cloak the buying and selling of securities with the mantle of a trade or business can transform the trader into a dealer.² That can only happen when the trader becomes a merchant in securities.

The merchant analogy has led the Supreme Court and others to decree dealer status for stock exchange specialists, at least with respect to the securities in which they specialize.³ This conclusion rests on the fact that the stocks carried by specialists "are their real stock in trade necessary for making a market and required for sale to customers [other members of the stock exchange] in connection with the performances of that function."⁴ Similarly, a bank maintaining a separate securities department can be a dealer, at least in part, even though other departments of the bank hold securities for investment.⁵

Conversely, the absence of merchant-like activities makes a stock exchange member,⁶ or brokerage firm partner,⁷ trading for her own account a trader and not a dealer. And even a specialist can qualify as an investor, a status that is more easily achieved when the securities involved are not those in which she specializes, but one that may be secured even with respect to the securities in which she does specialize.⁸

No hard and fast test for determining dealer status can be devised; each case must be decided on its own facts.⁹ However, the foregoing cases serve as a guide to the fact situations that have led courts to conclude that a person is or is

not a dealer.

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.471-5*; see also *Kemon v Commr*, 16 TC 1026 (1951) .

(n2)Footnote 1.1. A person can be a dealer if the income derived results from acting as a "middleman." See the discussion in *Ltr Rul 9345003* (dealer sold securities to customers, received compensation for acting as a middleman, and had a unique source of supply for the securities that it sold).

(n3)Footnote 2. *Treas Reg § 1.471-5*. A trader who is not a dealer must treat losses as capital losses. See, eg, *Van Suetendal v Commr*, 1944 Tax Ct Memo LEXIS 108 , *affd* 152 F2d 654 (2d Cir 1945) ; *Chen v Commr*, TC Memo 2004-132 ; *Frankel v Commr*, TC Memo 1989-39 .

(n4)Footnote 3. *Helvering v Fried*, 299 US 175 (1936) ; *Vaughan v Commr*, 85 F2d 497 (2d Cir 1936) , *cert denied* 299 US 606 ; *Rev Rul 60-321*, 1960-2 CB 166 . Being a specialist, and thus a dealer with respect to some securities, does not make one a dealer with respect to all securities. *Currie v Commr*, 53 TC 185 (1969) , *acq* 1970-1 CB 15 .

(n5)Footnote 4. *Vaughan v Commr*, 85 F2d 497 (2d Cir 1936) , *cert denied* 299 US 606, at 499 .

(n6)Footnote 5. *Denman v Squire*, 18 F Supp 287 (ND Ohio 1936) , *aff'd*, 111 F2d 921 (6th Cir 1940) ; *Harriman Natl Bank v Commr*, 43 F2d 950 (2d Cir 1930) ; *Rev Rul 70-563*, 1970-2 CB 108 .

(n7)Footnote 6. *Brown v US*, 426 F2d 355 (Ct Cl 1970) ; *Seeley v Helvering*, 77 F2d 323 (2d Cir 1935) ; *Wilson v Commr*, BTA Memo 1943-85.

(n8)Footnote 7. *Townley v Commr*, BTA Memo 1934-578.

(n9)Footnote 8. *Currie v Commr*, 53 TC 185 (1969) , *acq*, 1970-1 CB 15 . *Rev Rul 71-30*, 1971-1 CB 226 .

(n10)Footnote 9. *Kemon v Commr*, 16 TC 1026 (1951) ; Herzberg, "Dealer or Investor?" 37 *Taxes* 155 (1959).



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CHAPTER 18 The Taxpayer as a Dealer in Securities

2-18 Taxation of Securities Transactions § 18.03

§ 18.03 Sales of Securities by Dealers

By definition, the sale of any security forming part of a dealer's inventory will produce gain or loss that is ordinary in nature.ⁿ¹ The amount of gain or loss will depend on the method of inventory valuation employed by the dealer--cost, cost or market whichever is lower, or market value.ⁿ²

[1] Sales of Investment Securities.

Suppose a dealer holds certain securities for investment account, and not for resale to customers. Does dealer status taint the capital asset quality which normally attaches to investment securities, or is capital treatment available?

The answer must be couched in conditional terms. Gain realized by a dealer on the sale or exchange of a security will take on ordinary income characteristics unless (1) before the close of the day on which it is acquired (or such earlier date as regulations will prescribe), the security is clearly identified in the dealer's records as a security held for investment, and (2) the security is not, at any time after the close of such day (or such earlier date), held primarily for sale to customers in the ordinary course of the dealer's trade or business.ⁿ¹ If the security is acquired pursuant to the exercise of an option, the security will be deemed held for investment only if, before the close of the day the option is acquired, the option is identified as being held for investment.ⁿ² Any loss sustained by a dealer on the sale or exchange of a security will be a capital loss, if the security was ever identified as an investment security.ⁿ³ Thus, while a change in status from investment security to inventory security will affect the character of realized gain, it will in no way change the character of realized loss.ⁿ⁴

A security is clearly identified as being held for investment "when there is an accounting separation of the security from other securities ..."ⁿ⁵ An accounting separation is achieved "by making appropriate entries in the dealer's books of account to distinguish the security from inventories and to designate it as an investment."ⁿ⁶ In addition, some further identification, such as the certificate number of the particular security, should accompany the appropriate entry.ⁿ⁷

The separation between investment securities and inventory must be reflected not only in the dealer's books and records, but also in his method of disposing of investment securities. Too many contacts between investment account and inventory account may lead to the inference that the taxpayer acquired the "investment securities" with the intent of funneling the securities through his normal avenues of sale, and not for investment.ⁿ⁸

[2] Short Sales.

The general short sale rule considers the gain or loss from a short sale as gain or loss from the sale or exchange of a capital asset, to the extent that the property used to cover the short sale is a capital asset.ⁿ¹ It would seem, therefore, that a dealer could insure the realization of gain on investment securities held for less than one year, and in so doing, convert short-term gain into long-term gain, merely by entering into a short sale of inventory securities and then closing the short sale with the investment securities after they have been held for more than one year. However, if a short sale is made by a dealer in securities at a time when substantially identical securities have been held in the dealer's investment account for less than one year, the special holding period provision of *IRC Section 1233(b)(2)* will apply and make long-term gain unavailable,ⁿ² unless the short sale is closed within 20 days from the date of sale.ⁿ³ Here, as in the case of the ordinary investor, the acquisition of a "put," an option to sell, is deemed a short sale, and the exercise or lapse of the option considered the closing of the short sale.ⁿ⁴

[3] Wash Sales.

Insofar as an individual is concerned, the wash sale rules affect losses incurred in a transaction entered into for profit, as well as losses incurred in the taxpayer's trade or business, unless the taxpayer is a dealer in stock or securities and the loss is sustained in a transaction made in the ordinary course of that business.ⁿ¹ Thus, an individual dealer in securities will not be concerned with *IRC Section 1091*, unless the transaction involves securities held for investment.

A corporate dealer in securities is protected from *IRC Section 1091* application if it is a dealer in stock or securities and the loss is incurred in the ordinary course of its business as a dealer.ⁿ²

[4] Sales of "Puts" and "Calls".

The definition of security contained in *IRC Section 1236(c)* includes the right to purchase a security. Thus, any gain or loss realized by a dealer on the sale or exchange of a "call," or purchase option, would be subject to the same rules as a sale of the underlying security. So, if the option were clearly identified as being held for investment, and the identification were made within the permissible period, any gain realized on the sale of the option would be capital gain.

It should be noted that an option to sell is not included in the *IRC Section 1236(c)* definition. This should not defeat the ability of a dealer to treat the "put" as an investment security and thereby obtain capital treatment. Since the underlying security fits the statutory definition, and, therefore, can be considered a capital asset if held for investment, the option should in all probability be infused with capital characteristics, and any gain or loss realized on its disposition treated as capital gain or loss under *IRC Section 1234(a)*.

FOOTNOTES:

(n1)Footnote 1. *IRC §§ 1221(a)(1), 1222.*

IRC § 1221(a)(6), discussed in § 2.04[1], excludes from capital asset status any commodities derivative financial instrument held by a commodities derivatives dealer, unless it is established to the satisfaction of the Service that the instrument has no connection to the activities of the dealer as a dealer, and the instrument is clearly identified in the dealer's records as having no such connection before the close of the day on which it was acquired, originated, or entered into (or such other time as regulations prescribe).

(n2)Footnote 2. *Treas Reg § 1.471-5.* A dealer may also use the LIFO method. *Rev Rul 60-321, 1960-2 CB 166 .*

Dealers holding Treasury securities and other United States securities in inventory in accordance with the regulations can transfer such securities to a book-entry system maintained by a Federal Reserve Bank without becoming subject to the rules regarding identification of securities, found in *Treas Reg § 1.1012-1(c)(7)*. *Rev Rul 71-15, 1971-1 CB 149 .* The term "other United States securities" is defined as "a transferable bond, note, certificate of indebtedness, bill,

debenture, or similar obligation which is subject to the provisions of 31 CFR Part 306 or other comparable Federal regulations and which is issued by (1) any department or agency of the Government of the United States, or (2) the Federal National Mortgage Association, the Federal Home Loan Bank, the Federal Land Banks, the Federal Intermediate Credit Banks, the Banks of Cooperatives, or the Tennessee Valley Authority."

Since the dealer holds an inventory of securities, the accrual method of accounting must be employed. *Treas Reg* § 1.446-1(c)(2)(i); *Rev Rul* 74-280, 1974-1 CB 121 .

(n3)Footnote 1. *IRC* § 1236(a). For the purposes of the section, a "security" is defined as "any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing. *IRC* § 1236(c).

A registered floor specialist who acquires the stock in which he is registered as part of his duties on a national securities exchange has until the close of the seventh business day following acquisition to identify the stock as being held for investment and to remove the stock from inventory. *IRC* § 1236(d).

See *Rev Rul* 79-80, 1949-1 CB 86 , for instances in which *IRC* § 1236 may apply to securities acquired by a dealer because of order errors and securities differences.

Identification of a security as held for investment under *IRC* § 1236(a) will not serve to identify the security as held for investment, or as not for sale, for purposes of the mark-to-market accounting rules prescribed for dealers in securities by *IRC* § 475. *Rev Rul* 93-76, 1993-2 CB 235 , as modified and clarified by *Rev Rul* 94-7, 1994-1 CB 151 . See § 18.05 for a discussion of the mark-to-market rules.

(n4)Footnote 2. *IRC* § 1236(e).

(n5)Footnote 3. *IRC* § 1236(b).

(n6)Footnote 4. *Treas Reg* § 1.1236-1(b). A transfer from an investment account to a margin account of securities held as collateral by a dealer who did not relinquish control or title did not change the status of the securities. *Rev Rul* 73-403, 1973-2 CB 308 .

(n7)Footnote 5. *Treas Reg* § 1.1236-1(d)(1). The failure to identify stock purchased for investment does not turn the stock into inventory stock. The stock retains its character as investment stock; the failure to identify merely removes the dealer's right to capital treatment with respect to such stock. *Stephens, Inc v US*, 321 F Supp 1159 (ED Ark 1970) . The Eighth Circuit agreed with the district court on this point, but found that the taxpayer was not a dealer. 464 F2d 53 (8th Cir 1972) , cert denied, 409 US 1118 .

The Service will not rule whether specialty stock allocated to an investment account by a registered specialist on a national securities exchange is a capital asset. *Rev Proc* 2007-3, 2007-1 IRB 108 .

(n8)Footnote 6. *Treas Reg* § 1236-1(d)(1). At least one case has held that the use of serial numbers for shares is not necessary, if there is an adequate showing of the number of shares transferred to the investment account and a suitable legend placed on the stock certificates. *Ellis, Holyoke & Co v Commr*, TC Memo 1970-10 .

(n9)Footnote 7. Other means of further identification are set forth in *Rev Rul* 64-160, 1964-1 CB (Part 1) 306 , modifying *Rev Rul* 59-332, 1959-2 CB 190 ; and *Rev Rul* 67-419, 1967-2 CB 265 . *Rev Rul* 64-160 has been modified to allow the criteria set forth therein for identifying stock held for investment to apply to any security, as defined in *IRC* § 1236(c). *Rev Rul* 76-489, 1976-2 CB 250 .

Identification of a particular book-entry security in a dealer's books of account by reference to the lot number that the

dealer has assigned to the lot at the time of purchase of the security is a method of identification that satisfies the requirements of *Treas Reg § 1.1236-1(d)(1)*. *Rev Rul 73-37, 1973-1 CB 374*, amplifying *Rev Rul 71-15, 1971-1 CB 149*, and *Rev Rul 71-21, 1971-1 CB 221*. See also *Rev Rul 73-31, 1973-1 CB 216*.

(n10)Footnote 8. See, eg, *Tellier v Commr, TC Memo 1963-212*, *aff'd on this issue, 342 F2d 690 (2d Cir 1965)*, *aff'd on other grounds 383 US 687 (1966)*.

(n11)Footnote 1. *IRC § 1233(a)*. Short sales are the subject of Ch 10.

(n12)Footnote 2. See § 10.02[2].

(n13)Footnote 3. *IRC § 1233(e)(4)(A)*.

(n14)Footnote 4. *IRC §§ 1233(e)(4)(B), 1233(b)*.

(n15)Footnote 1. Wash sales are discussed in § 2.07[3].

(n16)Footnote 2. *IRC § 1091(a)*.



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2-18 Taxation of Securities Transactions § 18.04

§ 18.04 Expenses of Dealers in Securities

Expenditures incurred by a dealer in securities for such items as rent, salaries, and professional services are deductible as ordinary and necessary business expenses under *IRC Section 162*. This holds true not only for those activities which constitute the taxpayer a dealer, but, as well, for any activities of an investment nature which qualify as a trade or business. In addition, expenses incurred in connection with investment activities which are too minimal to be deemed a trade or business may if the dealer is an individual, be deducted under *IRC Section 212*, as an expense incurred in connection with the production of income. Thus, insofar as normal trade or business expenses are concerned, the dealer and trader are treated alike.ⁿ¹ The balance of this section will focus on instances in which a dealer is treated differently from a trader or investor.

[1] Expenses Incurred in Purchasing or Selling Securities

Commissions paid in the acquisition of securities are nondeductible, whether the taxpayer be dealer or investor.ⁿ¹ The situation changes when the commissions are paid in connection with the sale of a security. Such commissions still do not provide a deduction from ordinary income for a taxpayer who is not a securities dealer; they are merely an offset against the selling price, and, thus, reduce the amount of gain realized, or increase the amount of loss realized, on the transaction.ⁿ² The dealer is placed in a preferred position; the commissions can be treated as an ordinary and necessary business expense.ⁿ³ It should be noted that a deduction is available to a dealer only when acting as such. A dealer who steps outside that role, is relegated to the same position as a trader or investor.

An additional selling expense is incurred whenever a state or local governmental unit imposes a stock transfer tax. Prior to 1964, such taxes were deductible as taxes under *IRC Section 164*. Since then, deduction is permitted only to the extent that the transfer tax is either an ordinary and necessary business expense, deduction of which is permitted by *IRC Section 162*, or an investment expense made deductible by *IRC Section 212*.ⁿ⁴

[2] Expenses Relating to Tax-Exempt Income

A dealer, just as any other taxpayer, is not permitted a deduction for any expenses allocable to tax-exempt income *other than interest*.ⁿ¹ Similar disallowance attends any interest expense or indebtedness incurred or continued to purchase or carry tax-exempt interest obligations.ⁿ² However, except for interest expense, a deduction is disallowed to a dealer for any expense allocable to tax-exempt interest, provided the expense is incurred in connection with the dealer's trade or business and is deductible under *IRC Section 162*.ⁿ³

[3] Amortization of Bond Premium

The average taxpayer, acquiring a bond at a premium, has the option to amortize the premium in the manner set forth in *IRC Section 171*.ⁿ¹ However, the section has no application to dealers in securities, except insofar as they hold securities for investment.ⁿ² But since the yearly decrease in value of the bond will most likely approximate the amount of annual premium amortization, a parallel result can be achieved if the dealer values inventory securities at the lower of cost or market, as is permitted.ⁿ³ The decline in inventory value furnishes the dealer with the equivalent deduction.ⁿ⁴

[a] Tax-Exempt Interest Securities. A dealer in securities, holding tax-exempt municipal bonds purchased at a premium as part of inventory of securities, must adjust the basis in the securities to reflect bond premium amortization. The manner in which the adjustment is accomplished turns on the method of inventory valuation employed by the dealer.

If the gross income of the dealer is computed by the use of inventories, and inventories are valued on any basis other than cost, the required adjustment is a yearly reduction in the dealer's "cost of securities sold"ⁿ⁵ by an amount equal to the amount of amortizable bond premium that an investor would be entitled to deduct were such deduction not disallowed by *IRC Section 171(a)(2)*.ⁿ⁶ The rule just announced has no application if the obligation is sold or disposed of within thirty days of acquisition,ⁿ⁷ or if the obligation bears as its earliest maturity or call date, a date more than five years from the date of acquisition.ⁿ⁸ In the first case, no reduction in cost of securities sold is required at all. In the second, no adjustment with respect to the obligation is required if the taxpayer still holds the obligation at the end of the taxable year.ⁿ⁹ Instead, when the taxpayer sells or otherwise disposes of the obligation, the cost of securities sold for the taxable year of disposition must be reduced by an amount equal to the total amortizable bond premium attributable to the taxpayer's period of ownership.ⁿ¹⁰ However, even then, no adjustment need be made if the obligation is sold at a gain, or otherwise disposed of at a time when its value exceeds its adjusted basis.ⁿ¹¹

Example:

X, a dealer in securities, and a calendar year taxpayer, values inventories on a basis other than cost. On January 1, 1988, the dealer purchases three municipal bonds. Each bond has a face value of \$1,000 and was purchased for \$1,120. Bond 1 matures on December 31, 1990. Bonds 2 and 3 mature on December 31, 1997. Bonds 1 and 2 are sold on December 31, 1989 for \$1,050 each. Bond 3 is sold on December 31, 1990 for \$1,150. The adjustment to cost of securities sold are:

Bond	Adjustment		
	1988	1989	1990
1	\$40	\$40	
2	None	\$24	
3	None	None	None

Annual adjustment of one-third of the premium is required with respect to Bond 1, since its maturity date falls within three years from the date acquired. No reduction in cost of securities sold is required in 1988 with respect to Bonds 2 and 3. Each bears a maturity date more than five years from the date of acquisition; each was still held by the taxpayer at the end of the year. The sale of Bond 2 at a loss triggers a 1989 reduction in cost of securities sold attributable to the period of X's ownership of the bond. No adjustment is required when Bond 3 is sold. It had, as its earliest maturity date, a date more than five years after the date it was acquired; and it was sold at a gain.

If the taxpayer computes income without the use of inventories, or by the use of inventories valued at cost, he makes no adjustment to cost of securities sold. However, he is required to make a year-of-sale adjustment to the adjusted basis of any obligation sold or disposed of during the taxable year. The reduction in basis is equal to the amount of amortization

which would have been required for the period the bond was held were the premium amortizable.ⁿ¹² Again, there is no adjustment if the bond is disposed of within thirty days of acquisition, or if the earliest maturity or call date of the bond is a date more than five years from the date of acquisition and the bond is sold at a gain.

FOOTNOTES:

(n1)Footnote 1. However, if there will be a difference if the activities cannot be deemed a trade or business and the route to deduction is *IRC § 212*. In such case, the deductions constitute miscellaneous itemized deductions subject to the 2 percent floor of *IRC § 67*.

(n2)Footnote 1. *Treas Reg § 1.263(a)-2(e)*.

(n3)Footnote 2. *Treas Reg § 1.263(a)-2(e)*. *Spreckels v Helvering*, 315 US 626 (1942) . *Prop Treas Reg 1.263(a)-1(d)(1)*, (2).

(n4)Footnote 3. *Treas Reg § 1.263(a)-2(e)*.

Commissions paid to brokers by a distributor of mutual fund shares were held to be currently deductible in *Ltr Rul 9345003* . The ruling contains a detailed discussion of the factors that make one a dealer in securities. They include:

- (1) whether the person sells to customers;
- (2) the form of the person's compensation; and
- (3) the person's relationship to its supply of securities.

See also, *Prop Treas Reg 1.263(a)-1(d)(1)*.

(n5)Footnote 4. *Rev Rul 65-313*, 1965-2 CB 47 .

(n6)Footnote 1. *IRC § 265(a)(1)*.

(n7)Footnote 2. *IRC § 265(a)(2)*.

(n8)Footnote 3. *IRC § 265(a)(1)*. Disallowance of expenses allocable to interest is provided only when the expense is otherwise deductible under *IRC § 212*.

(n9)Footnote 1. See § 17.02[5].

(n10)Footnote 2. *Treas Reg § 1.171-4(c)*.

(n11)Footnote 3. *Treas Reg § 1.471-5*.

(n12)Footnote 4. *Treas Reg § 1.165-4(c)*.

(n13)Footnote 5. The term "cost of securities sold" means the amount ascertained by subtracting the value of the ending inventory of a taxable year from the sum of (1) the value of opening inventory, and (2) the cost of securities purchased during the year. *IRC § 75(b)(2)*.

(n14)Footnote 6. *IRC § 75(a)(1)*. An investor or trader is not permitted a deduction for amortizable bond premium if the interest on the bond is excludable from gross income. *IRC § 171(a)(2)*.

(n15)Footnote 7. *IRC § 75(b)(1)(A)(i)*. The thirty-day period need not be within a single taxable year. *Treas Reg §*

1.75-1(a)(2).

In *Brown v United States*, 426 F2d 355 (Ct Cl 1970) , the taxpayers, claiming to be dealers, sold municipal bonds within thirty days of purchase, seeking thereby to gain an advantage through the accrual of tax-free interest and a loss deduction to the extent of the unamortized premium. The taxpayers failed to achieve this goal because they were found to be acting as investors, not as dealers. Therefore, they were required to reduce the basis of the bonds by the amount of the amortizable bond premium that could not be claimed as a deduction under *IRC § 171(a)(2)*. See § 17.03[6].

(n16)Footnote 8. *IRC § 75(a); IRC § 75(b)(1)(A)(ii)*.

(n17)Footnote 9. *IRC § 75(a)*.

(n18)Footnote 10. *IRC § 75(a)*.

(n19)Footnote 11. *IRC § 75(b)(1)(B)*. In determining whether a disposition results in a gain, any amount attributable to interest is disregarded, as is any adjustment to basis for amortization of bond premium. *Treas Reg § 1.75-1(b)(2)(ii)*.

(n20)Footnote 12. *IRC § 75(a)(2)*.



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Taxation of Securities Transactions

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CHAPTER 18 The Taxpayer as a Dealer in Securities

2-18 Taxation of Securities Transactions § 18.05

§ 18.05 Mark-to-Market Accounting Method for Dealers in Securities

IRC Section 475, effective for taxable years ending on or after December 31, 1993, requires dealers in securities to utilize a mark-to-market accounting system in valuing securities held for sale to customers. Two rules apply. Any security forming part of the inventory of the dealer is included in inventory at its fair market value.ⁿ¹ In the case of any security that is not inventory and is held at the close of the taxable year, the dealer must recognize gain or loss as if the security were sold for its fair market value on the last business day of the taxable year and report the gain or loss on the dealer's return for that year.ⁿ²

For purposes of the mark-to-market rules, a dealer in securities is a taxpayer who (1) regularly purchases securities from, or sells securities to, customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.ⁿ³ A security is any (a) share of stock in a corporation; (b) partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; (c) note, bond, debenture, or other evidence of indebtedness;ⁿ⁴ (d) interest rate, currency, or equity notional principal contract;ⁿ⁵ (e) evidence of an interest in, or a derivative financial instrument in, any of the foregoing, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency (but not a contract to which *IRC Section 1256(a)* applies); and (f) any position not described in (a)-(e), but which is a hedge with respect to such a security and is clearly identified as such in the dealer's records before the close of the day on which it was acquired or entered into.ⁿ⁶

IRC Section 475 does not apply to any security held for investment, any hedge of a security held for investment, or any hedge of a position, right to income, or any liability that is not a security in the hands of the taxpayer.ⁿ⁷ It likewise does not apply to any note, bond, debenture, or other evidence of indebtedness that is acquired or originated by a dealer in the ordinary course of the dealer's trade or business and is not held for sale, or to any obligation to acquire such a security if the obligation is entered into in the ordinary course of the trade or business.ⁿ⁸ A security is held for investment or not held for sale if it is not held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.ⁿ⁹

The exceptions will not apply to any security unless it is clearly identified in the dealer's records as an excepted security before the close of the day on which it was acquired, originated, or entered into.ⁿ¹⁰ The following items held by a dealer are per se held for investment and are deemed to be properly identified as such:

(1) Stock in a corporation, or in a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, to which the taxpayer has a relationship described in *IRC Section 267(b)(2), (3), (10), (11), or (12)*, or in *IRC Section 707(b)(1)(A) or (B)*; or

(2) A contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract.ⁿ¹¹

If a security has not been timely identified under *IRC Section 475(b)(2)* and, after the last day on which such an identification would have been timely, the per se rule begins to apply to the security, then the dealer must recognize gain or loss on the security as if it was sold for its fair market value as of the close of business on the last day before the per se rule begins to apply to the security.ⁿ¹² If a security ceases to be an excepted security after being identified as such, *IRC Section 475* will apply to any changes in value of the security occurring after the cessation.ⁿ¹³

The mark-to-market rules apply to any security that is improperly identified as being held for investment, and to any position that the dealer fails to identify as a hedge of a security. However, any loss resulting from application of the *IRC Section 475* prior to disposition of the security or position is recognized only to the extent of gain previously recognized under the mark-to-market rules with respect to the security or position.ⁿ¹⁴

Gain or loss resulting from the application of the mark-to-market rules is normally treated as ordinary income or loss.ⁿ¹⁵ However, this will not be the case for any gain or loss allocable to a period during which the security is one excepted from the definition of security for purposes of *IRC Section 475*, is held by the taxpayer other than as a dealer in securities, or is improperly identified.ⁿ¹⁶

IRC Sections 263A (uniform capitalization rules) and *263(g)* (requiring capitalization of interest and carrying charges in the case of straddles) do not apply to any security subject to the mark-to-market rules.ⁿ¹⁷ Moreover, a security marked to market under *IRC Section 475* is not subject to the wash sale rules of *IRC Section 1091*; the security is not deemed to be sold and reacquired.ⁿ¹⁸

Any taxpayer required to change its accounting method to comply with *IRC Section 475* is treated as having initiated the change and as having the change consented to by the Service. The net amount of any adjustments required by *IRC Section 481* because of the change is taken into account ratably over the five-taxable year period beginning with the first taxable year ending on or after December 31, 1993.ⁿ¹⁹ If any portion of the adjustment called for by *IRC Section 481(a)* is attributable to the use of the last-in, first-out method of accounting with respect to any qualified security for five consecutive taxable years, the portion is taken into account over a 15-year period.ⁿ²⁰ A qualified security for this purpose is one acquired by a floor specialist in connection with the specialist's duties as a specialist on an exchange, but only if the security is one in which the specialist is registered with the exchange.ⁿ²¹ The 15-year rule also applies to a taxpayer who is a market maker in connection with the taxpayer's duties as a market maker. In this case, the security must be included on the National Association of Security Dealers Automated Quotation (NASDAQ) system, the taxpayer must be registered as a market maker in such security with the National Association of Security Dealers, and as of the last day of the taxable year preceding the taxpayer's first taxable year ending on or after December 31, 1993, the taxpayer (or a predecessor) must have been actively engaged as a market maker in the security for the two-year period ending on that date (or, if shorter, the period beginning 61 days after the security was listed on the NASDAQ system and ending on that date).ⁿ²²

As a general rule, a loss incurred by a member of a consolidated group on stock of the group's common parent is disallowed; gain is eliminated in certain transactions.ⁿ²³ However, a subsidiary that is a dealer in its parent's stock or positions recognizes both gain and loss on the stock to the extent taken into account under of *IRC Section 475(a)* (or *IRC Section 1256(a)* for dealer equity options).ⁿ²⁴ To be eligible, the subsidiary must regularly trade in the parent's stock (of the same class) in the ordinary course of its business as a dealer. The exception does not apply if the subsidiary or any other member of the group has structured or engaged in any transaction while a member (or in anticipation of

becoming a member), during the taxable year or in any year within the preceding five taxable years that is open for assessment under *IRC Section 6501*, with a principal purpose of avoiding gain or creating loss on the parent's stock subject to *IRC Section 475(a)*.

IRC Section 475(e)(1), enacted as part of the Taxpayer Relief Act of 1997, permits a dealer or trader in commodities to elect the mark-to-market accounting of *IRC Section 475* for commodities held by the dealer.ⁿ²⁵ For this purpose, a commodity is defined as any commodity that is actively traded; any option, forward contract, short position, notional principal contract or derivative instrument that references such a commodity, and any other evidence of an interest in such a commodity, as well as any position that hedges the described items and is clearly identified in the taxpayer's records before the close of the day it was acquired or entered into (or such other time as regulations may prescribe).ⁿ²⁶

Traders in securities are also permitted to elect mark-to-market accounting for all securities held in connection with the taxpayer's trade or business as a trader; the election can be made without the consent of the Service, but cannot be revoked without consent.ⁿ²⁷ Even if the election is made, the mark-to-market rules do not apply to any security that is not held in connection with the trader's trade or business and is adequately identified as such before the day on which it was acquired, originated, or entered into (or such other time that regulations may prescribe).ⁿ²⁸ Any security subject to the mark-to-market rules that was acquired in the normal course of the taxpayer's activities as a trader in securities is not taken into account for purposes of the constructive sale rules of *IRC Section 1259*.ⁿ²⁹

The House version of the bill that became the Taxpayer Relief Act of 1997 contained an express statement that gain or loss recognized by an electing trader would be taxed as ordinary gain or loss. The final version omitted that statement, but does state that "rules similar to the rules of subsections (b)(4) and (d) shall apply to securities held by a person in any trade or business with respect to which an election... is in effect."ⁿ³⁰ *IRC Section 475(d)(3)* states a general rule that gain or loss with respect to a security subject to the mark-to-market rules is to be treated as ordinary income or loss. Presumably, this is the indication that Congress meant to provide ordinary treatment for securities marked to market by a trader. However, gain or loss that is treated as ordinary gain or loss because of the election is treated as capital gain or loss for purposes of the tax on net earnings from self-employment, and is treated as passive income for purposes of determining the amount of a publicly traded partnership's passive income.ⁿ³¹

IRC Section 475(g) mandates the issuance of regulations to carry out the purposes of *IRC Section 475*. The legislative history of *IRC Section 475* indicates that those regulations may permit the use of valuation methodologies that reduce the administrative burden of compliance on the taxpayer but clearly reflect income for federal income tax purposes.ⁿ³² The result is a safe harbor that is based on the principle that, if a mark-to-market method used for financial reporting is sufficiently consistent with the requirement of *IRC Section 475* and if the financial statement employing that method has certain indicia of reliability, then the values used on that financial statement may be used for purposes of the mark-to-market rules.ⁿ³³

The financial statement must be the taxpayer's primary financial statement for the taxable year prepared in accordance with United States generally accepted accounting principles and (i) is a financial statement that is required to be filed with the Securities Exchange Commission, (ii) is a financial statement required to be filed with a federal agency other than the Internal Revenue Service, or (iii) is a certified audited financial statement used for a non-tax purpose.ⁿ³⁴

FOOTNOTES:

(n1)Footnote 1. *IRC § 475(a)(1)*. For further discussion of the effect of this provision on the valuation and taxation of inventories of securities dealers, see L. Schneider, *Federal Income Taxation of Inventories § 8.01[4]* (Matthew Bender).

(n2)Footnote 2. *IRC § 475(a)(2)*. Gain or loss realized on a later disposition of the security is adjusted to take into account any gain or loss taken into account under the mark-to-market rules.

The mark-to-market rule of *IRC* § 475(a)(2), including the valuation requirement subsumed therein, is a method of accounting subject to the clear reflection standard of *IRC* § 446(b). *Bank One Corp v Commr*, 120 TC 174 (2003) .

(n3)Footnote 3. *IRC* § 475(c)(1). If the principal activity of a taxpayer is selling nonfinancial goods or providing nonfinancial services, the fact that the taxpayer extends credit to the purchasers of its nonfinancial goods or services does not make the taxpayer a dealer in securities, even if the taxpayer sells the acquired evidences of indebtedness. *Treas Reg* § 1.475(c)-1(b). A taxpayer that regularly purchases securities from customers in the ordinary course of a trade or business is not ordinarily a dealer in securities if the taxpayer does not sell more than a negligible portion of the purchased securities. *Treas Reg* § 1.475(c)-1(c).

A taxpayer's transactions with related persons may be transactions with customers for purposes of *IRC* § 475. For example, if a taxpayer, in the ordinary course of the taxpayer's trade or business, regularly holds itself out to related persons as willing and able to enter into either side of a position in securities, the taxpayer is a dealer in securities for purposes of *IRC* § 475, even if it engages in no other transactions with customers. The foregoing rule does not apply to members of a consolidated group unless the group makes the intragroup customer election. The election is made by filing a statement signed by the common parent and attached to the timely filed federal income tax return for the consolidated group for that taxable year. The election applies to that year and to all subsequent years, and can be revoked only with the permission of the Commissioner. *Treas Reg* § 1.475(c)-1(a)(3). *Rev Proc* 97-43, 1997-2 CB 494 , sets forth the procedure for a taxpayer requesting consent to change its method of accounting to comply with the election.

A taxpayer whose sole business consists of trading in securities (does not purchase from, or sell to, customers in the ordinary course of a trade or business) is not a dealer in securities. *Rev Rul* 93-76, 1993-2 CB 235 , as modified and clarified by *Rev Rul* 94-7, 1994-1 CB 151 , and as clarified, modified, and partially obsoleted, and superseded by *Rev Rul* 97-39, 1997-2 CB 62 , reprinted as Appendix I, *infra* .

The regulations extend the definition of dealer in securities to a taxpayer that, in the ordinary course of the taxpayer's trade or business, regularly holds itself out as willing and able to enter into, assume, offset, assign, or otherwise terminate a position in securities with customers. *Treas Reg* § 1.475(c)-1(a)(2)(i).

(n4)Footnote 4. This category of security does not include any nonfinancial customer paper, namely, (i) a note, bond, debenture, or other evidence of indebtedness; (ii) that arises out of the sale of nonfinancial goods and services by a person whose principal activity is the selling or providing of nonfinancial goods and services; and (iii) that is held by that person or a related person (within the meaning of *IRC* § 267(b) or *IRC* § 707(b)) at all times since issue. *IRC* § 475(c)(4).

(n5)Footnote 5. An equity notional contract does not include any other notional contract, such as a notional principal contract based on the price of oil, wheat, or other commodity. HR Rep No 213, 103d Cong, 1st Sess 130 (1993).

(n6)Footnote 6. *IRC* § 475(c)(2). The classification of a security under financial accounting principles is not dispositive of treatment of the security for federal income tax purposes. *Rev Rul* 93-76, 1993-2 CB 235 , as modified and clarified by *Rev Rul* 94-7, 1994-1 CB 151 , reprinted as Appendix I, *infra* . The following items held by a dealer in securities are not securities for purposes of the mark-to-market rules: (1) a security, if *IRC* § 1032 prevents the taxpayer from recognizing gain or loss with respect to that security; (2) a debt instrument issued by the taxpayer (including a synthetic debt instrument, within the meaning of *Treas Reg* § 1.1275-6(b)(4), that the taxpayer is treated as having issued); or (3) a REMIC residual interest, or an interest or arrangement that is determined by the Commissioner to have substantially the same economic effect, if the interest is acquired after Jan 4, 1995. *Treas Reg* § 1.475(c)-2(a). A negative REMIC residual interest, or an interest or arrangement having substantially the same economic effect acquired before Jan 4, 1995, is also not a security. *Treas Reg* § 1.475(c)-2(c).

A hedge is any position that manages the dealer's risk of interest rate or price changes or currency fluctuations, including any position that is reasonably expected to become a hedge within 60 days after the acquisition of the position. *IRC § 475(c)(3)*. For transactions entered into before Dec 17, 1999, a hedge was a position that reduced the dealer's risk.

Congress anticipates that the identification rules with respect to hedges will be applied in such a manner as to minimize the imposition of additional accounting burdens on securities dealers. HR Rep No 213, 103d Cong, 1st Sess 130 (1993).

The mark-to-market rules do not apply to any foreign currency transaction that is part of a Section 988 hedging transaction. *IRC § 988(d)(1)*.

(n7)Footnote 7. *IRC § 475(b)(1)(A), (C)*. Except as otherwise determined by the Commissioner in a revenue ruling, revenue procedure, or letter ruling, the investment security exception does not apply to any interest rate, currency, or equity notional principal contract, or to any evidence of an interest in, or a derivative financial instrument in a security. *IRC § 475(b)(4)*; *Treas Reg § 1.475(b)-1(c)(1)*. The described notional principal contracts and derivative securities can be treated as investment securities in the hands of a dealer if the taxpayer establishes unambiguously that the contract or securities were not acquired in the taxpayer's capacity as a dealer in such securities. *Treas Reg § 1.475(b)-1(e)(2)*.

(n8)Footnote 8. *IRC § 475(b)(1)(B)*.

(n9)Footnote 9. *Treas Reg § 1.475(b)-1(a)*.

(n10)Footnote 10. *IRC § 475(b)(2)*. If, as of the close of the last taxable year ending before Dec 31, 1993, a security was identified under *IRC § 1236* as a security held for investment, the security is treated as adequately identified as held for investment for purposes of *IRC § 475*. Temp *Treas Reg § 1.475(b)-2T(a)(1)*. However, except for this transitional rule, identification of a security as held for investment under *IRC § 1236* will not serve to identify the security as held for investment or as not for sale for the mark-to-market rules, unless there is a specific reference to *IRC § 475*. *Rev Rul 93-76, 1993-2 CB 235*, as modified and clarified by *Rev Rul 94-7, 1994-1 CB 151* and as clarified, modified, and partially obsoleted, and superseded by *Rev Rul 97-39, 1997-2 CB 62*, reprinted as Appendix I, *infra*.

In determining the timeliness of an identification under *IRC § 475(b)(2)*, the date that a dealer acquires a security is not affected by whether the dealer has a substituted basis in the security. *Treas Reg § 1.475(b)-2(b)*.

Congress anticipates that Treasury Regulations will permit a financial institution that is treated as a securities dealer and that originates evidences of indebtedness in the ordinary course of business to identify those evidences of indebtedness as held out for investment based on the accounting practices of the institution, but not later than 30 days after the date the evidence of indebtedness is originated. HR Rep No 213, 103d Cong, 1st Sess 133-134 (1993); *Rev Rul 93-76, 1993-2 CB 235*, as modified and clarified by *Rev Rul 94-7, 1994-1 CB 151*, and as clarified, modified, and partially obsoleted, and superseded by *Rev Rul 97-39, 1997-2 CB 62*, reprinted as Appendix I, *infra*. Congress also anticipates that, where appropriate, the regulations will provide similar identification rules for evidences of indebtedness that are acquired by a financial institution.

(n11)Footnote 11. *Treas Reg §§ 1.475(b)-1(b)(1), (2)*. The relationships are determined taking into account the attribution rules of *IRC §§ 267(c)* and *707(b)(3)*. *Treas Reg § 1.475(b)-1(b)(2)(ii)*.

The per se rule does not apply to a security if (i) the security is actively traded on an established financial market; (ii) less than 15 percent of all of the outstanding shares or interests of the same class are held by the taxpayer and parties in one of the described relationships to the taxpayer; and (3) if the security was acquired from a person having one of the specified relationships to the taxpayer, then, after the time the security was acquired, at least one full business day has passed, and there has been significant trading involving unrelated persons. *Treas Reg § 1.475(b)-1(b)(3)*.

(n12)Footnote 12. *Treas Reg* § 1.475(b)-1(4)(i)(B).

(n13)Footnote 13. *IRC* § 475(b)(3).

(n14)Footnote 14. *IRC* § 475(d)(2).

(n15)Footnote 15. The rule applies as well to any hedges that are subject to the mark-to-market provisions. HR Rep No 213, 103d Cong, 1st Sess 135 (1993).

(n16)Footnote 16. *IRC* § 475(d)(3). Gain or loss resulting from the disposition of a security that would have been subject to the second mark-to-market rule will also be treated as ordinary income or loss. However, if a security is never held in connection with the taxpayer's activities as a dealer in securities, *IRC* § 475(d)(3) does not affect the character of the gain or loss from the security, even if the taxpayer fails to identify the security under *IRC* § 475(b)(2). *Treas Reg* § 1.475(d)-1(a).

If a dealer acquires a security with a substituted basis, (i) *IRC* § 475(a) applies only to changes in value of the security occurring after the acquisition; and (ii) any built-in gain or loss with respect to the security (based on the difference between the fair market value of the security on the date the dealer acquired it and its basis to the dealer on that date) is taken into account, and has the character that would apply to the built-in gain or loss if *IRC* § 475(a) did not apply to the security. *Treas Reg* § 1.475(a)-3.

(n17)Footnote 17. Congress believes that the fair market value of a security should include costs that the dealer would otherwise capitalize. HR Rep No 213, 103d Cong, 1st Sess 131 (1993).

(n18)Footnote 18. *IRC* § 475(d)(1).

(n19)Footnote 19. Omnibus Budget Reconciliation Act of 1993, § 13223(c)(2). To compute the net Section 481(a) adjustment, the taxpayer needs to determine which of the securities it held at the close of the taxable year immediately preceding the year of change are marked to market at the beginning of the year of change. Any security not treated as identified as being covered by an exception to the mark-to-market rules must be marked to market as of the beginning of the year of change and must be taken into account in computing the amount of the net Section 481 adjustment. *Rev Rul* 93-76, 1993-2 CB 235, as modified and clarified by *Rev Rul* 94-7, 1994-1 CB 151, and as clarified, modified, and partially obsoleted, and superseded by *Rev Rul* 97-39, 1997-2 CB 62, reprinted as Appendix I, *infra*.

(n20)Footnote 20. Omnibus Budget Reconciliation Act of 1993, § 13223(c)(3).

(n21)Footnote 21. A floor specialist is a person who is (i) a member of a national securities exchange; (ii) is registered as a specialist with the exchange; and (iii) meets the requirements for specialists established by the SEC. *IRC* § 1236(d).

(n22)Footnote 22. Omnibus Budget Reconciliation Act of 1993, § 13223(c)(3)(B).

(n23)Footnote 23. *Treas Reg* § 1.1502-13(f)(6)(i), (ii).

(n24)Footnote 24. *Treas Reg* § 1.1502-13(f)(6)(iii).

(n25)Footnote 25. The election can be made without the consent of the Service. Once made, it applies to the taxable year in which it is made and all subsequent taxable years unless revoked with the consent of the Service. *IRC* § 475(e)(3).

To make the election under *IRC* § 475(e), dealers and traders must attach a statement to the original tax return for the year immediately preceding the election year or to an extension request for that return. The statement, which must be

filed by the original return's due date, must describe (1) the election being made, and (2) the first tax year for which the election is effective. If an eligible dealer or trader elects the mark-to-market method and the dealer or trader's accounting method is inconsistent with *IRC § 475*, the accounting method must be changed to comply with the election. *Rev Proc 99-17, 1999-1 CB 503*.

(n26)Footnote 26. *IRC § 475(e)(2)*.

(n27)Footnote 27. *IRC § 475(f)(1)(A), (3)*. A trader in commodities can also elect the mark-to-market rules with respect to commodities held in connection with the taxpayer's activities as a trader in commodities. *IRC § 475(f)(2)*. The election can be made separately for each trade or business.

Rev Proc 99-17, 1999-1 CB 503, governs an election under *IRC § 475(f)* as well. However, the required statement must also include the trade or business for which the election is made. The statement must be filed not later than the due date (without regard to extensions) of the original federal income tax return for the taxable year immediately preceding the election year, and the statement must be attached either to that return or, if applicable, to a request for an extension of time to file that return. *Rev Proc 99-17* provides the exclusive means of making the election. Thus, in *Ltr Rul 200423015*, the failure to follow the prescribed requirements precluded use of the mark-to-market method of accounting by a trader.

An electing trader must recognize gain or loss on any security held in connection with the trade or business as if the security were sold for its fair market value on the last business day of the taxable year; the gain or loss is taken into account for that year. Proper adjustment must be made in the amount of any gain or loss subsequently realized for the gain or loss taken into account under the mark-to-market rules.

(n28)Footnote 28. *IRC § 475(f)(1)(B)*. If a security that was identified as having no connection with the taxpayer's trade or business later ceases to be such, the mark-to market rules apply to any changes in value of the security occurring after the cessation.

(n29)Footnote 29. *IRC § 475(f)(1)(C)*. The constructive sale rules of *IRC § 1259* are discussed in §§ 9A.06[2] and 10.02[2].

(n30)Footnote 30. *IRC § 475(f)(1)(D)*.

(n31)Footnote 31. *IRC § 475(f)(1)(D)*.

(n32)Footnote 32. HR Rep No 1211, 103rd Cong, 1st Sess 616 (1993).

(n33)Footnote 33. *Treas Reg § 1.475(a)-4*. Any security within the meaning of *IRC § 475(c)(2)* is an eligible position for purposes of the safe harbor for dealers and traders in securities. Any commodity as defined in *IRC § 475(e)(2)* is an eligible position for purposes of the safe harbor for dealers and traders in commodities. *Rev Proc 2007-41, 2007-1 CB 1492*.

(n34)Footnote 34. *Treas Reg § 1.475(g)-4(h)(1)(2)*. If a taxpayer files more than one such statement, the primary statement is the one first described in the text



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CHAPTER 19 Expenses of Investors and Traders

2-19 Taxation of Securities Transactions 19.syn

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CHAPTER 19 Expenses of Investors and Traders

2-19 Taxation of Securities Transactions § 19.01

§ 19.01 Introduction

Each person who engages in securities transactions incurs some expenses in addition to the purchase price. In the case of the casual, infrequent investor, the extra cost may be limited to purchase and selling commissions paid to brokers; in the case of the trader, the expenses may encompass every conceivable cost of carrying on a trade or business.

Some expenditures, notably those incurred on the purchase of securities, can never be claimed as a deduction. Instead, they are treated as capital expenditures and added to the basis of the acquired property. Other amounts paid give rise to a deduction for both the frequent trader and the sometime investor. Still others may be deductible by the trader, but not the investor; this occurs when deductibility is restricted to expenses incurred in carrying on a trade or business. Finally, there are some potentially deductible expenses that are rendered nondeductible by a specific provision of the Code evidencing a legislative policy against allowance, eg, *IRC Section 265(a)(2)* barring any deduction for interest paid on funds borrowed to purchase or carry tax-exempt securities.



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CHAPTER 19 Expenses of Investors and Traders

2-19 Taxation of Securities Transactions § 19.02

§ 19.02 Distinguishing the Trader and Investor

The discussion in the immediately preceding chapter distinguished the dealer in securities from the trader or investor. In brief, the dealer is a merchant in securities who regularly engages in the purchase of securities and their resale to customers, and who does not expect to profit from an increase in the value of the securities between purchase and resale, but rather from a price differential or mark-up which represents compensation for his labor and services.ⁿ¹

The trader also regularly engages in the purchase and resale of securities. Indeed, the frequency of his activities may be sufficient to constitute a trade or business.ⁿ² But the trader performs no merchandising function; he buys and sells securities for his own account, seeking "such circumstances as a rise in value or an advantageous purchase to enable [him] to sell at a price in excess of cost."ⁿ³

The investor is often thought of as a person who limits his investment activities to occasional transactions for his own account.^{n3.1} But frequency of investment activity cannot furnish the only basis for distinguishing between trade and investor, for there are persons who must be classified as investors even though their investments and transactions are as extensive as those of persons considered to be traders. In such case, the distinction must be based on the nature of the investment which each makes. The trader is more often identified with speculative securities and quick turnover; the investor is more concerned with traditional yield values and with the realization of a profit through appreciation over a longer period.

A further distinction between trader and investor lies in the provisions which govern the deductibility of expenses incurred in connection with their investment activities. A trader, if engaged in a trade or business, will secure his deductions under *IRC Section 162*. If his activities do not rise to the status of a trade or business, the applicable provision is *IRC Section 212*. An investor must always find the authorization of his deduction in *IRC Section 212*, since "managing one's own investments in securities is not the carrying on of a trade or business, irrespective of the extent of the investments or the amount of time required to perform the managerial functions."ⁿ⁴ Although, with rare exception, this will have little effect on the expenses which can be deducted, it may make a difference in the taxpayer's taxable income. Expenses allowed under *IRC Section 162* reduce gross income to arrive at adjusted gross income;ⁿ⁵ this is true of *IRC Section 212* expenses only if they are attributable to property held for the production of rents or royalties.ⁿ⁶ Thus, the trader whose activities constitute a trade or business can deduct his investment expenses and still take the standard deduction in lieu of itemizing personal deductions;ⁿ⁷ an investor must choose between the standard deduction and itemizing, and if the investor itemizes, the 2-percent floor on itemized deductions dictated by *IRC Section 67* will

come into play. In addition, the ability to carry back and carry forward excess deductions depends upon the presence of a trade or business.ⁿ⁸ The computation of an individual's net operating loss for a given year limits deductions which are not attributable to a trade or business to the amount of nonbusiness gross income.ⁿ⁹

FOOTNOTES:

(n1)Footnote 1. *Treas Reg § 1.471-5*; see Ch 18.

(n2)Footnote 2. *Treas Reg § 1.471-5*; *Kales v Commr*, 101 F2d 35 (6th Cir 1939) ; *Alverson v Commr*, 35 BTA 482 (1937) .

(n3)Footnote 3. *Kemon v Commr*, 16 TC 1026, 1033 (1951) . See also *Marrin v Commr*, 147 F3d 147 (2d Cir 1998) .

(n4)Footnote 3.1. See *Clearmeadow Investments, LLC v US*, 87 Fed Cl 509, 526-527 (2009) ("a taxpayer who is directly involved in activity which is frequent, continuous and regular is a trader, while those whose activity is more isolated and passive are investors." (citations omitted)). The court noted that, "in drawing this line, courts generally have refused to attribute to the taxpayer, as indicative of trade or business status, trading activity performed by third parties or other forms of non-active, indirect involvement." *Id*.

(n5)Footnote 4. *Wilson v US*, 376 F2d 280, 293 (Ct Cl 1967) ; see also *Higgins v Commr*, 312 US 212 (1941) .

(n6)Footnote 5. *IRC § 62(a)(1)*.

(n7)Footnote 6. *IRC § 62(a)(4)*.

(n8)Footnote 7. *IRC § 63(b)*. The trader is allowed to deduct all of the interest expense incurred in carrying on the trade or business; the investor's deduction is limited by *IRC § 163(d)*. See, eg, *Estate of Yaeger v Commr*, TC Memo 1988-264 , *aff'd*, 889 F2d 29 (2d Cir 1989) . The investment interest deduction limitation is discussed in § 19.05[1][b], *infra*.

(n9)Footnote 8. *Purvis v Commr*, TC Memo 1974-164 , *aff'd per curiam* 530 F2d 1332 (9th Cir) (no loss carryover; taxpayer not a trader).

(n10)Footnote 9. *IRC § 172(c), (d)(4)*.



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CHAPTER 19 Expenses of Investors and Traders

2-19 Taxation of Securities Transactions § 19.03

§ 19.03 Expenses Incurred in the Purchase of Securities

"It has long been recognized, as a general matter, that costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures. The most familiar example of such treatment is the capitalization of brokerage fees for the sale or purchase of securities, as explicitly provided by long standing Treasury regulation, *Treas. Reg. 1.263(a)-2(e)*, and as approved by this Court in *Helvering v. Winmill*, 305 U.S. 79 (1938) , and *Spreckels v. Commissioner*, 315 U.S. 626 (1942) ."n1

A deduction for purchase commissions will be denied even though the taxpayer incurs them as a regular and recurring expense in his business of buying and selling securities.n2 Indeed, the requirement that commissions paid on the acquisition of securities be added to the cost of the securities extends even to purchases made by dealers in securities, and to purchases by a corporation.n3

How does one resolve the issue of deduction versus capitalization when it comes to other expenses as to which the Regulations are silent? The best approach seems to be the one announced by the Supreme Court in *Woodward v. Commissioner*,n4 and *United States v. Hilton Hotel Corp.*,n5 decided on the same day. In both cases, litigation expenses incurred in appraisal proceedings for the purchase of minority shares were held nondeductible and properly treated as part of the cost of the acquired stock. According to the Court, the relevant inquiry is "whether the origin of the claim litigated is in the process of acquisition itself."n6 There is no reason to confine the "origin" test to expenses incurred in litigation; it should be applied whenever it becomes necessary to distinguish between deductible expense and capital expenditure in the purchase of securities. To illustrate, purchase commissions would be considered capital items, even if not governed by a particular provision of the regulations, since the taxpayer would not have incurred the expense but for the purchase of the securities. Therefore, it must be said that the expense originated "in the process of acquisition itself."n7

It may be difficult, at times, to determine whether the expenditure was incurred in the acquisition process. For example, if the expenditures relate to an action brought against a corporate executive or broker-dealer under Section 10(b) of the Securities Exchange Act, the crucial determinant is the ground upon which the suit is based. If it is against the executive as a purchaser of stock, or against the broker-dealer on a claim that arose in the investment process, the expenditure will not be currently deductible.n8

FOOTNOTES:

(n1)Footnote 1. *Woodward v Commr*, 397 US 572, 575 (1970) .

(n2)Footnote 2. *Helvering v Winmill*, 305 US 79 (1938) .

(n3)Footnote 3. *Rev Rul 69-561*, 1969-2 CB 25 .

(n4)Footnote 4. 397 US 572 (1970) .

(n5)Footnote 5. 397 US 580 (1970) . The *Woodward* and *Hilton Hotels* cases are discussed in Note, "The Characterization of Legal Fees as Deductible Expenses or Capital Expenditures--A Need for Clarification in the Law," 21 *Syr L Rev* 926 (1970).

(n6)Footnote 6. *Woodward v Commr*, 397 US at 577 .

(n7)Footnote 7. *Ellis Banking Corp v Commr*, TC Memo 1981-123 , *aff'd on this ground* 688 F2d 1376 (11th Cir 1982) , *cert denied* 463 US 1207 ; *Nagy v Commr*, TC Memo 1978-318 ; *Rev Rul 73-580*, 1973-2 CB 86 .

(n8)Footnote 8. *Locke v Commr*, 568 F2d 663 (9th Cir 1978) ; *Wagner v Commr*, 78 TC 910 (1982) ; *Bradford v Commr*, 70 TC 584 (1978) ; *Rev Rul 80-119*, 1980-1 CB 40 .

Premiums paid to shareholders by a corporation acquiring its own stock in order to avoid the expected adverse consequences of an involuntary takeover were held not to be deductible in *Stokely-Van Camp, Inc v US*, 974 F2d 1319 (Fed Cir 1992) . Similarly, "greenmail" payments made in connection with the purchase of common stock were held to be nondeductible in *Wrangler Apparel Corp v US*, 931 F Supp 420 (MD NC 1996) .



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§ 19.04 Expenses Incurred in the Sale of Securities

As we saw in the preceding section, commissions paid on the purchase of securities are treated alike by dealers, traders and investors; they must be capitalized and added to the basis of the acquired property. Equality of treatment does not prevail when it comes to brokerage fees incurred in the sale of securities, for while a dealer is permitted to deduct selling commissions as an ordinary and necessary expense of doing business,ⁿ¹ an investor or trader (even one whose activities can be characterized as a trade or business) can use such commissions, as well as most other selling expenses, only as an offset against the selling price to reduce the amount of gain or increase the amount of loss realized from the transaction.ⁿ²

The distinction in treatment rests on practical considerations:

"The dealer usually buys in large quantities, his sales are numerous and in relatively small amounts, his commissions are often computed and paid on a volume of sales instead of on individual transactions, and where he uses inventories he necessarily departs widely from the principles of accounting for the profit on each individual purchase and sale."ⁿ³

But, as the Supreme Court observed:

"[F]or the casual buyer and seller of securities, or even the large scale trader on his own account, ... the practical obstacles to treating sales commissions as offsets against selling price do not exist."ⁿ⁴

On the other hand, state transfer taxes imposed on the sale of securities, and not deductible as taxes under *IRC Section 164*, can be deducted by dealers, traders and investors either as an expense of carrying on a trade or business (*IRC Section 162*) or as an expense incurred in the production of income (*IRC Section 212*).ⁿ⁵ This differs from the position taken with respect to the now repealed federal excise tax on stock transfers, the Government holding such taxes deductible by dealers but not by traders or investors.ⁿ⁶ However, in *Hirshon v. United States*,ⁿ⁷ the Court of Claims reached a contrary result, finding such taxes to be deductible in full, as ordinary and necessary business expenses, by a trader in securities. It should be noted, though, that some years later, the Tax Court did not see fit to extend the *Hirshon* rationale and allow a nonbusiness taxpayer to deduct such taxes as an expense incurred in the production of income.ⁿ⁸

An attempt to treat state income taxes attributable entirely to gains realized on the sale of stock as an expense of sale, deductible in computing gain for federal income tax purposes, met with failure in *Taylor v. Commissioner*.ⁿ⁹ Although

state income taxes are allowed as a deduction under *IRC Section 164*, a deduction under a predecessor section would have been wholly worthless to the taxpayer; he had no income apart from the gains against which to apply the deduction.ⁿ¹⁰ Denial of the deduction rested, in part, on the theory that

"When gain is realized in a capital transaction, the assessment of income taxes may be inevitable, in a sense, but resulting income taxes are highly contingent. Other unrelated transactions resulting in capital losses can reduce, or obliterate, the contingent liability."ⁿ¹¹

FOOTNOTES:

(n1)Footnote 1. *GCM 15430*, XIV-2 CB 59 (1935). *GCM 15430* was declared obsolete by *Rev Rul 69-31*, 1969-1 CB 307. The position taken therein is still good law. *Prop Treas Reg 1.263(a)-1(d)(1)*.

(n2)Footnote 2. *Spreckels v Commr*, 315 US 626 (1942) ; *Treas Reg § 1.263(a)-2(e)*.

Prior to 1976, where the seller was an estate, the selling expense could be used as an offset against the gross amount in computing capital gain or loss, and as a deduction for estate tax purchases under *IRC § 2053*. See, eg, *Commerce Trust Co v US*, 438 F2d 111 (8th Cir 1971) ; *Clapp v US*, 26 AFTR2d 70-5537 (CD Cal 1970) ; *Est of Dorn v Commr*, 54 TC 1651 (1970) , acq, 1971-2 CB 2 ; *Bray v Commr*, 46 TC 577 (1966) , acq 1971-2 CB 2 , aff'd 396 F2d 452 (6th Cir 1968) ; *Rev Rul 71-173*, 1971-1 CB 204 . *IRC § 642(g)* was amended in 1976 to prevent such a result. See *Prop Treas Reg 1.263(a)-1(d)(1)*, (2).

The taxpayer in *McKeague v US*, 57 AFTR2d 86-1258 (Fed Cir 1986) , deducted litigation expenses incurred in an action by an officer-shareholder regarding his employment by the corporation and the sale price of his stock to the other shareholders. The Claims Court allowed the deduction. The Federal Circuit remanded the matter to the lower court to consider whether the suit had a dual origin--to preserve his investment in the stock and to protect his employment--and, if so, to determine how the expenses should be allocated between the capital and ordinary income components of the claim.

Dye v US, 121 F3d 1399 (10th Cir 1997) , also required an allocation of litigation expenses between the portion of the recovery that produced ordinary income, yielding an ordinary deduction, and the portion that was capital in nature, resulting in a capital loss.

Payments to investment bankers in connection with an unsuccessful effort to defeat a hostile tender offer were partly attributable to an evaluation of the taxpayer's stock, and partly related to a defense of its business and corporate policy. The portion related to the evaluation of the stock was a capital expenditure; the balance was deductible as a business expense. *AE Staley Mfg Co & Subs v Commr*, 119 F3d 482 (7th Cir 1997) .

(n3)Footnote 3. *GCM 15430*, XIV-2 CB 59, 61 (1935).

(n4)Footnote 4. *Spreckels v Commr*, 315 US at 630 (1942) .

(n5)Footnote 5. *IRC § 164(a)*; see also *Rev Rul 65-313*, 1965-2 CB 47 . Prior to 1964, the taxes were deductible as taxes under *IRC § 164*.

Transfer taxes paid in connection with a gift of securities would be nondeductible because not incurred in the production of income.

(n6)Footnote 6. The Service position was first announced in *IT 3806*, 1946-2 CB 41, declared obsolete by *Rev Rul 69-43*, 1969-1 CB 310 . The position was reaffirmed in *Rev Rul 55-756*, 1955-2 CB 536 , which also was declared obsolete by *Rev Rul 72-619*, 1972-2 CB 650 .

(n7)Footnote 7. *116 F Supp 135 (Ct Cl 1953)* . The Service announced that it would not follow *Hirshon*. Rev Rul 55-756, 1955-2 CB 536 .

(n8)Footnote 8. *Maytag v Commr*, 32 TC 270 (1959) .

(n9)Footnote 9. *298 F2d 198 (4th Cir 1962)* .

(n10)Footnote 10. The gains would have been subject to the flat 25 percent alternative tax rate then in effect.

(n11)Footnote 11. *Taylor v Commr*, 298 F2d 198, 203 (4th Cir 1962) .



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§ 19.05 Expenses Incurred in Carrying or Managing Securities

[1] Interestⁿ¹

[a] In General. *IRC Section 163* sets forth a general rule that "there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."ⁿ² But suppose the interest was paid as part of a scheme having no economic purpose and designed solely to provide the taxpayer, generally a high-bracket taxpayer, with a tax deduction. This was the situation in *Knetsch v. United States*ⁿ³ where the taxpayer purchased ten single-premium annuity bonds, each in the face amount of \$400,000 and bearing interest at 2 1/2 percent, compounded annually, by giving his check for \$4,000 and signing nonrecourse annuity loan notes for the balance. The notes were secured by the bonds and carried an interest rate of 3 1/2 percent. The taxpayer prepaid the first year's interest, \$140,000, on the day that he signed the note. Five days later he borrowed \$99,000 of the amount by which the cash or loan value of the bonds at the end of the first contract year would have exceeded his original indebtedness; he again prepaid the interest. For the two years involved in the proceeding, the taxpayer's borrowings against the loan value of the bonds amounted to some \$203,000, while his claimed interest deduction exceeded \$294,000. The Supreme Court disallowed the deduction, noting that the taxpayer's continued borrowings would have converted a "guaranteed" cash value at maturity of more than \$8,300,000 into a relative pittance of \$1,000, and concluding, therefore, that

"Knetsch's transaction with the insurance company did 'not appreciably affect his beneficial interest except to reduce his tax. ...' For it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction. What he was ostensibly 'lent' back was in reality only the rebate of a substantial part of the so-called 'interest' payments. The \$91,570 difference retained by the company was its fee for providing the facade of 'loans' whereby the petitioners sought to reduce their 1953 and 1954 taxes in the total sum of \$233,297.68. There may well be single-premium annuity arrangements with nontax substance which create an 'indebtedness' for the purposes of ... § 163(a) of the 1954 Code. But this one is a sham."ⁿ⁴

The deduction in *Knetsch* was denied because the sham character of the transaction negated the existence of any "indebtedness." But an interest deduction may be unavailable even when the loan transaction is genuine, as it was in *Goldstein v. Commissioner*.ⁿ⁵ There the taxpayer borrowed almost \$1 million at 4 percent interest in order to purchase low-yield Treasury notes, the sole purpose behind the transaction being to secure a large interest deduction to offset income from the taxpayer's sweepstakes winnings. The Second Circuit found deductibility barred by the underlying notion of *IRC Section 163*--to permit a deduction when a taxpayer decides to engage in a purposive activity financed

with borrowed funds rather than with his own funds. Thus, the court was of the opinion, that "when it enacted Section 163(a) Congress could not have intended to permit a taxpayer to reduce his taxes by means of an interest deduction that arose from a transaction that had no substance, utility or purpose beyond the tax deduction."ⁿ⁶

IRC Section 163 allows the deduction for interest "paid or accrued within the taxable year." For taxpayers employing the accrual method of accounting, interest accrues ratably over the period of the loan and is allowable as a deduction ratably over the period, irrespective of when paid.ⁿ⁷ An exception to this general rule occurs when the interest is payable by an accrual method taxpayer to a related cash basis taxpayer and the amount of interest is not includable in income for the taxable year of the accrual. In such case, the deduction is allowable in the year in which the amount is includable in the gross income of the person to whom the payment is made.^{n7.1}

A cash basis taxpayer is allowed to deduct expenses only when they are paid.ⁿ⁸ It follows logically that such a taxpayer should be allowed to deduct all of the interest paid during the taxable year. However, *IRC Section 461(g)* requires interest attributable to periods after the close of the taxable year in which paid to be charged to capital account and treated as paid in the period to which attributable.ⁿ⁹

A special rule, designed to match the deduction for amortization of original issue discount (OID) with the inclusion of accrued discount in the holder's income, applies in the case of any debt instrument issued after July 1, 1982, other than by a natural person. Under *IRC Section 163(e)(1)*, the amount of the OID allowable as a deduction in any taxable year is equal to the aggregate daily portions of the OID for days during the taxable year.ⁿ¹⁰ If the instrument is held by a related foreign person, the deduction is not allowed until the OID is paid.ⁿ¹¹

A second rule governing the deduction of interest applies when a debt instrument with OID is held by a related foreign person that is a controlled foreign corporation or passive foreign investment company. In such case, a deduction will be allowable to the issuer with respect to the OID for any taxable year before the taxable year in which paid only to the extent the OID is includable in the prior taxable year in the gross income of a United States person who owns stock in the corporation.^{n11.1}

Except to the extent disallowed by a provision such as *IRC Section 249* (limitation on the deduction of bond premium on repurchase),ⁿ¹² if a debt instrument is repurchased by the issuer for a price in excess of its adjusted issue price, the excess (repurchase premium) is deductible as interest for the year in which the repurchase occurs.ⁿ¹³ If the issuer repurchases a debt instrument in a debt-for-debt exchange, the repurchase price is the issue price of the newly issued debt instrument (reduced by any unstated interest within the meaning of *IRC Section 483*).ⁿ¹⁴ However, if the issue price of the newly issued debt instrument is determined under either *IRC Section 1273(b)(4)* or *IRC Section 1274*, any repurchase premium is not deductible in the year of the repurchase, but is amortized over the term of the newly issued debt instrument in the same manner as if it were OID.ⁿ¹⁵

In a qualified reopening of an issue of debt instruments, if a holder pays more or less than the adjusted issue price of the original debt instruments to acquire an additional debt instrument, the issuer treats the difference as an adjustment to the issuer's interest expense for the original and additional debt instruments.^{n15.1} The adjustment is taken into account over the term of the instrument using constant yield principles.

If the holder pays more than the adjusted issue price of the original debt instrument, then with respect to the issuer but not the holder, the difference increases the aggregate adjusted issue prices of both the original and additional debt instruments in the issue.^{n15.2} If the holder pays less than the adjusted issue price of the original debt instrument, then with respect to the issuer but not the holder, the difference reduces the aggregate adjusted issue prices of all debt instruments in the issue.^{n15.3}

As of the reopening date, the issuer must redetermine the yield of the debt instruments in the issue for purposes of applying the constant yield method to determine the issuer's accruals of interest expense over the remaining term of the

debt instruments in the issue.^{n15.4} This redetermined yield is based on the aggregate adjusted issue prices of the debt instruments in the issue and the remaining payment schedule of the debt payments in the issue. If the aggregate adjusted issue prices of the debt instruments in the issue are less than the aggregate stated redemption price at maturity of the instruments (determined as of the reopening date) by a *de minimis* amount, the issuer can either treat all stated interest as qualified stated interest, or choose to deduct the OID at maturity, on a straight-line basis over the term of the debt instrument or in proportion to stated interest payments.ⁿ¹⁶

The Tax Reform Act of 1986 introduced *IRC Section 163(h)* and the disallowance of any deduction for personal interest, that is, interest other than (1) interest properly allocable to a trade or business (other than the trade or business of performing services as an employee),ⁿ¹⁷ (2) investment interest,^{n17.1} (3) interest taken into account under *IRC Section 469* in computing income or loss from passive activities, (4) qualified residence interest, (5) interest on certain unpaid installments of estate taxes, and (6) any interest on educational loans allowed as a deduction under *IRC Section 221*.ⁿ¹⁸ The Taxpayer Relief Act of 1997 added *IRC Section 221(a)* to permit a limited deduction of interest on education loans. The deduction begins at \$1,000 in the case of taxable years beginning in 1998, and increases in \$500 yearly increments to a maximum of \$2,500 for taxable years beginning in 2001 and thereafter.^{n18.1} There is a phaseout based on the taxpayer's modified adjusted gross income.^{n18.2}

The special concept in the personal interest rules is qualified residence interest, defined as interest paid or accrued on (1) "acquisition indebtedness"--any indebtedness that is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer and is secured by such residence, or (2) on any "home equity indebtedness" with respect to a qualified residence of the taxpayer.ⁿ¹⁹ Refinanced acquisition indebtedness is treated as acquisition indebtedness to the extent that the refinanced amount does not exceed the amount of outstanding acquisition indebtedness immediately before the refinancing.

Home equity indebtedness is defined by *IRC Section 163(h)(3)(C)* as any indebtedness (other than acquisition indebtedness) secured by a qualified residence to the extent that the aggregate amount of such indebtedness does not exceed (1) the fair market value of the qualified residence reduced by (2) the amount of acquisition indebtedness with respect to the residence. However, the amount of home equity indebtedness can never exceed \$100,000.

A residence is a qualified residence if it is the principal residence of the taxpayer or one other residence of the taxpayer.ⁿ²⁰

Interest paid or accrued by an estate or trust on indebtedness secured by a qualified residence of a beneficiary of the trust or estate is treated as qualified residence interest.ⁿ²¹

The aggregate amount that can be treated as acquisition indebtedness is \$1 million (\$500,000 in the case of a married individual filing a separate return).ⁿ²² The limitation does not apply to "pre-October 13, 1987 indebtedness," that is, debt incurred on or before October 13, 1987, and secured by a qualified residence on that date and at all times thereafter before the interest is paid or accrued; all of such debt is acquisition indebtedness regardless of amount.ⁿ²³ However, the amount of such debt reduces the \$1 million dollar maximum on new acquisition debt, but not below zero.ⁿ²⁴ Pre-October 13, 1987 indebtedness, also includes debt incurred after that date, secured by a qualified residence, and used to refinance pre-October 13, 1987 indebtedness, but only to the extent of the principal amount of the refinanced debt immediately before the refinancing and only for the term of the original debt.ⁿ²⁵

The following examples illustrate the operation of the qualified residence interest rules:

Example 1:

During 1988, a taxpayer borrowed \$800,000 to purchase a principal residence and \$400,000 to buy a summer residence. Interest, on \$1 million of the debt will be acquisition indebtedness; interest on an additional \$100,000 of debt will qualify as home equity indebtedness; the balance of the interest will be

nondeductible personal interest.

Example 2:

In 1988, a taxpayer borrowed \$400,000 to purchase a principal residence. Payments of principal reduced the outstanding balance of the debt to \$300,000. The taxpayer refinanced the debt by borrowing \$500,000. The new debt will be treated as acquisition indebtedness only to the extent of \$300,000 unless the taxpayer uses all or part of the additional \$200,000 to substantially improve the residence. If not, \$100,000 of the amount in excess of \$300,000 can qualify as home equity indebtedness, with the balance treated as nondeductible personal interest.

Example 3:

In 1970, a taxpayer borrowed \$90,000 to purchase a residence. The taxpayer obtained a new, 20 year mortgage of \$200,000 on July 1, 1983, when the house was worth \$300,000. The outstanding balance of the mortgage on October 3, 1987 was \$190,000. The taxpayer can continue to deduct all of the interest on the mortgage.

A set of elaborate tracing rules is used to determine whether interest is to be treated as (1) interest allocated to a trade or business, (2) interest allocated to a passive activity or former passive activity, (3) interest allocated to an investment expenditure, (4) interest allocated to a personal expenditure, or (5) interest allocated to a portfolio expenditure. In general, interest expense on a debt is allocated in the same manner as the debt to which the interest expense relates is allocated.ⁿ²⁶ Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures during the period beginning on the date the proceeds of the debt are used and ending on the earlier of the date the debt is repaid or the date the debt is reallocated.ⁿ²⁷ Except for interest treated as qualified residence interest, the allocation is unaffected by the fact that property is used to secure the debt.ⁿ²⁸

Example:

An individual pledges corporate stock held for investment as security for a loan and uses the proceeds to purchase an automobile for personal use. The interest expense accruing on the debt is allocated to personal expense. If the debt were secured by a mortgage on the individual's personal residence and the interest classified as qualified residence interest, the interest would not be treated as personal interest.

A deposit of loan proceeds into the borrower's account is treated as an investment expenditure, and amounts held in the account (whether interest bearing or not) are treated as property held for investment.ⁿ²⁹ Debt allocated to an account must be reallocated when the proceeds are used for another expenditure.

Example:

A taxpayer borrows \$50,000 on January 1 and deposits the proceeds in a noninterest bearing checking account. On May 1, the taxpayer uses \$15,000 to purchase an automobile. On October 1, he uses \$30,000 for a passive activity expenditure. From January 1 through April 1, the entire debt is allocated to an investment expenditure. From May 1 through September 30, \$15,000 of the debt is allocated to a personal expenditure and \$35,000 is allocated to an investment expenditure. From October 1 through December 31, \$15,000 of the debt is allocated to a personal expenditure, \$35,000 of the debt is allocated to a passive activity expenditure, and \$5,000 is allocated to an investment expenditure.

Ordering rules come into play if debt proceeds are deposited in an account that contains unborrowed proceeds. Generally, debt proceeds are treated as expended before any unborrowed amounts held in the account at the time of the deposit and any amounts (borrowed or unborrowed) that are deposited in the account after the debt proceeds are deposited.ⁿ³⁰

Example:

A taxpayer enters into the following transactions during the taxable year:

January 10	Deposits \$500 proceeds of Debt A and \$1,000 unborrowed funds
January 11	Deposits \$500 proceeds of Debt B
February 17	\$800 personal expenditure
February 26	\$700 passive activity expenditure
June 21	Deposits \$1,000 proceeds of Debt C
November 21	\$800 investment expenditure
December 20	\$600 personal expenditure

The \$800 personal expenditure is treated as made from the \$500 proceeds of Debt A and \$300 of the proceeds of Debt B. The \$700 passive activity expenditure is deemed to be made from the remaining \$200 proceeds of Debt B and \$500 of unborrowed funds. The \$800 investment expenditure is treated as made entirely from the proceeds of Debt C. The \$600 personal expenditure is made from the remaining \$200 proceeds of Debt C and \$400 of unborrowed funds.

Interest on Debt A allocable to the period from January 10 through February 16 is investment interest. Interest on the debt for the balance of the year is personal interest.

Interest on Debt B allocable to the period from January 11 through February 16 is investment interest. For the period from February 17 through February 25, 60 percent of the interest is personal interest; the balance is investment interest. For the remainder of the year, 60 percent of the interest is personal interest; 40 percent is passive activity interest.

Interest on Debt C from June 21 through December 19 is investment interest. Of the interest allocable to the balance of the year, 80 percent is investment interest and the balance is personal interest.

The taxpayer is given the option of using a simplified method of determining the date on which debt is reallocated. Under this method, the taxpayer can treat all expenditures made during the calendar month from debt proceeds as made on the first day of the month or the date the debt proceeds were deposited in the account, whichever is later.³¹ The optional method applies only if all expenditures from an account during the same calendar month are similarly treated.

Thus, if the taxpayer in the preceding example chooses to apply the optional rule to all expenditures, the \$800 personal expenditure (\$500 from Debt A and \$300 from Debt B) made on February 17 is deemed to be an expenditure made on February 1. The same holds true for the passive activity expenditure (\$200 from Debt B) made on February 26. The \$800 investment expenditure made on November 24 from Debt C is treated as made on November 1st. The \$600 personal expenditure (\$200 from Debt C) is treated as made on December 1st. The interest allocation is:

Interest on Debt A is investment interest from January 10 through January 31 and is personal interest for the rest of the year.

Interest on Debt B is investment interest from January 11 through January 31. It is 60 percent personal interest and 40 percent passive activity interest for the period February 1 through December 31.

Interest on Debt C is investment interest from June 21 through November 30. For the rest of the year, 80 percent of the interest is investment interest; the balance is personal interest.

An alternative allocation method allows a taxpayer to treat any expenditure made from an account within 15 days after debt proceeds are deposited in the account as made from such proceeds to the extent thereof, even if under the general rule the proceeds would be treated as used to make one or more other expenditures. A similar rule applies to debt

proceeds received in cash.ⁿ³²

Example:

Assume the same facts as in the preceding example except that the proceeds of Debt B are deposited on February 11 rather than on January 11. Since the \$700 passive activity expenditure occurs within 15 days after the proceeds of Debt B are deposited in the account, the taxpayer can treat the expenditure as being made from the proceeds of Debt B to the extent thereof. If the taxpayer does so, the expenditures from the account are treated as follows: The \$800 personal expenditure on February 17 is treated as made from the \$500 proceeds of Debt A and \$300 of unborrowed funds. The \$700 passive activity expenditure made on February 26 is treated as made from the \$500 proceeds of Debt B and \$200 of unborrowed funds. The remaining expenditures follow the general rule as to allocation.

Interest on Debt A through February 16 is investment interest. It is personal interest for the rest of the year.

Interest on Debt B is investment interest from February 11 through February 25. Thereafter, it is passive activity interest.

Interest on Debt C is investment interest from June 21 through December 19. The interest for the rest of the year is 20 percent personal interest and 80 percent investment interest.

If repayment of the debt occurs when the proceeds are allocated to more than one expenditure, the debt is treated as repaid in the following order:

- (1) Amounts allocated to personal expenditures;
- (2) Amounts allocated to investment expenditures and passive activity expenditures other than a rental real estate activity with respect to which the taxpayer materially participates;
- (3) Amounts allocated to passive activity expenditures in connection with a rental real estate activity with respect to which the taxpayer materially participates;
- (4) Amounts allocated to former passive activity expenditures (activities where the taxpayer changed from a passive investor to material participant); and
- (5) Amounts allocated to trade or business expenditures.ⁿ³³

Amounts allocated to two or more expenditures within the same class (eg, different investment expenditures) are treated as repaid in the order in which the amounts were allocated to the expenditures. The taxpayer may treat allocations that occur on the same day as occurring in any order.

Example:

A taxpayer borrows \$100,000 on May 15 and immediately deposits the proceeds in an account. He uses the proceeds to make the following expenditures:

June 12	\$40,000 passive activity expenditure
July 10	\$20,000 trade or business expenditure
July 30	\$40,000 personal expenditure

The taxpayer repays \$90,000 of the debt on January 30 of the following year. The \$40,000 allocated to the passive activity expenditure, the \$40,000 allocated to the personal expenditure, and \$10,000 of the trade or business expenditure are treated as repaid.

If the taxpayer maintains a line of credit or similar arrangement that allows the taxpayer to borrow periodically under a single line of credit, the order of repayment depends on the interest rate charged to the taxpayer. Advances that bear the same fixed or variable rate of interest are treated as a single debt. Advances on which interest accrues at different fixed or variable rates are different debts and are treated as repaid in the order deemed repaid under the loan agreement.ⁿ³⁴

If a debt is refinanced, the replacement debt is allocated to the expenditures to which the refinanced debt was allocated. The amount of replacement debt not used for refinancing is allocated to expenditures in accordance with the general rules.ⁿ³⁵

Example:

Assume the facts in the preceding example, except that \$90,000 of the original debt is repaid with the proceeds of a new debt of \$120,000. The remaining \$30,000 is used to make an investment expenditure. The new debt is allocated \$40,000 to personal expenditure, \$40,000 to passive activity expenditure, \$10,000 to trade or business expenditure, and \$30,000 to investment expenditure. The new debt will be treated as repaid in the following order: (1) amount allocated to personal expenditure, (2) amount allocated to investment expenditure, (3) amount allocated to passive activity expenditure, and (4) amount allocated to trade or business expenditure.

Reallocation of debt is required when a leveraged asset is sold and the proceeds of sale are used for a different class of expenditure. If the proceeds of sale do not exceed the debt allocated to the property, the amount of reallocation is limited to the amount of such proceeds.ⁿ³⁶ If the proceeds exceed the debt allocated to the asset at the time of sale, the proceeds are treated as (1) borrowed funds to the extent of the debt allocated to the asset when sold, and (2) unborrowed funds to the extent of the excess.ⁿ³⁷

Example 1:

A taxpayer borrows \$20,000 and uses \$15,000 of the proceeds to purchase an investment asset and \$5,000 for a personal expenditure. One year later, the taxpayer sells the investment asset for \$10,000 and uses the proceeds for a passive activity expenditure. It is clear that 25 percent of the interest remains personal interest and that 50 percent of the interest is reallocated to passive activity interest. The balance of the interest probably remains investment interest; the regulations are not specific in this regard.

Example 2:

Assume the same borrowing and initial expenditures as in Example 1. One year later, the taxpayer sells the investment asset for \$25,000, and places the proceeds in an account. Sometime thereafter, \$20,000 of the funds on deposit is used to make a passive activity expenditure. The expenditure is deemed to have been made with \$15,000 of borrowed funds (the debt allocated to the investment asset) and \$5,000 of unborrowed funds.

Debt must also be reallocated when the character of the asset changes (eg, from a trade or business asset to a personal asset). The amount of debt reallocated by reason of the change cannot exceed the fair market value on the date of change in use.ⁿ³⁸

The allocation rules apply to any interest expense paid or accrued in taxable years beginning after December 31, 1986.ⁿ³⁹ However, debt outstanding on December 31, 1986, that is properly attributable to a business or rental activity is allocated to assets held for use or sale to customers in the activity.ⁿ⁴⁰ Debt is properly attributable to a business or rental activity if the taxpayer properly and consistently deducted interest on the debt on Schedule C, E, or F of Form

1040 before 1987. The taxpayer can elect out of the transitional rule and have the new allocation rules apply.ⁿ⁴¹ For purposes of the allocation or election out, a partnership or S corporation is treated as the taxpayer with respect to the debt of the partnership or corporation.ⁿ⁴²

Debt allocated pursuant to the transitional rule must be allocated in a reasonable and consistent manner among the assets held for use or for sale to customers on the last day of the taxable year that includes December 31, 1986. Debt is not treated as allocated in a reasonable and consistent manner if the amount of debt allocated to goodwill exceeds the basis thereof, or if the amount of debt allocated to an asset exceeds or is less than the fair market value of the asset.ⁿ⁴³

A taxpayer specifies the manner in which debt is allocated under the transitional rule by attaching a statement to the taxpayer's taxable return for the first taxable year beginning after 1986. If the taxpayer chooses to allocate debt pursuant to the transitional rule, the statement must be prominently identified as a "TRANSITIONAL ALLOCATION STATEMENT UNDER § 1.163-8T(n)(3)" and contain the following information:

- (1) A description of the business or rental activity to which the debt is properly attributable;
- (2) The amount of debt allocated;
- (3) The assets among which the debt is allocated;
- (4) The manner in which the debt is allocated;
- (5) The amount of debt allocated to each asset; and
- (6) Such other information as the Service may require.ⁿ⁴⁴

A taxpayer electing out of the transitional rule attaches a statement identified as an "ELECTION OUT UNDER § 1.163-8T(n)(3)."ⁿ⁴⁵ The allocation or election out cannot be revoked or modified without the consent of the Service.ⁿ⁴⁶

[b] Excess Investment Interest. An analysis of certain nontaxable, high-income, tax returns for 1966, revealed that a significant number of the taxpayers filing such returns claimed a deduction for "other interest" (interest other than home mortgage interest or interest incurred in connection with a business) substantially in excess of their investment income.ⁿ⁴⁷ The belief that it was necessary to restrict the deduction of interest on funds borrowed to acquire or carry investment assets, in order to prevent the use of the excess interest deduction as a shelter for other income received by the taxpayer, led Congress to the enactment of *IRC Section 163(d)*.

IRC Section 163(d) limits the deduction available to a noncorporate taxpayer with respect to the taxpayer's investment interest expense, i.e., interest paid or accrued on indebtedness incurred or continued to acquire or carry property held for investment,ⁿ⁴⁸ to the amount of the taxpayer's net investment income for the taxable year.ⁿ⁴⁹ (A partner's or S corporation shareholder's proportionate share of investment interest incurred by the partnership or S corporation is taken into account separately by the partner or shareholder and added to his other investment interest to see if the deduction limit is exceeded.)ⁿ⁵⁰

The amount of any investment interest expense rendered nondeductible by operation of *IRC Section 163(d)(1)* can be carried over indefinitely to offset future years' investment income; the amount disallowed in the earlier year is treated as investment interest paid or accrued in the succeeding taxable year.ⁿ⁵¹ The Service originally took the position that when the amount of disallowed investment interest exceeded the taxable income for the year, the carryover could not exceed the amount of taxable income.ⁿ⁵² The Service changed its stance after four appellate courts and the Tax Court held that all of the disallowed interest could be carried forward.ⁿ⁵³

The limiting factor--net investment income--is simply, "the excess of investment income over investment expenses."ⁿ⁵⁴ Investment income is defined as gross income from property held for investment,ⁿ⁵⁵ but does not include any net capital gain from the disposition of investment property unless the taxpayer elects otherwise.ⁿ⁵⁶ In such case, the taxpayer is required to reduce the amount of net capital gain subject to the maximum capital gains rate by the amount treated as investment income. Investment expenses are "the deductions allowed under this chapter which are directly connected with production of investment income."ⁿ⁵⁷

IRC Section 212 permits the deduction of expenses paid or incurred for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income; the definition of investment expenses is cast in terms of expenses "directly connected with the production of ... income."ⁿ⁵⁸ An issue is presented as to whether the difference in language is evidence of a Congressional intent to restrict investment expenses to those connected with the production of income, or whether the word "production" should be broadly construed to include collection of investment income as well as the management, conservation, and maintenance of property held for the production of investment income? The issue should be resolved in favor of the more expansive construction in order to prevent an artificial inflation of net investment income (by the amount of expenses incurred in the collection of investment income, and in the management, conservation, and maintenance of property held for the production of such income) and an unwarranted increase in the amount of investment interest deductible by the taxpayer.

Income and expenses taken into account under *IRC Section 469* in computing income or loss from a passive activity are not treated as investment income and expenses.ⁿ⁵⁹ (However, because the passive loss rules were not fully phased in before 1991, the amount of such loss that was allowed in any taxable year before that date reduced the amount of the taxpayer's net investment income for that taxable year.)ⁿ⁶⁰

[c] Interest on Indebtedness Incurred to Purchase or Carry Tax-Exempt Securities. Under *IRC Section 265(a)(2)*, no deduction is allowed for "interest on indebtedness incurred or continued to purchase or carry obligations ... the interest on which is wholly exempt from [income taxation]," e.g., municipal bonds paying interest excluded from gross income under *IRC Section 103*.ⁿ⁶¹ Since the provision is not qualified in any way, it applies equally to dealers, traders, and investors.ⁿ⁶²

Prior to 1986, long-standing judicial and administrative interpretations permitted financial institutions to invest deposited funds in tax-exempt obligations, while continuing to deduct interest paid to depositors. The only limitation on the deduction was the 20 percent reduction in the amount that could be deducted for interest on funds allocable to tax-exempt obligations acquired by financial institutions after 1982.ⁿ⁶³

IRC Section 265(b)(1), added by the Tax Reform Act of 1986, disallows that portion of a financial institution's interest expense that is allocable to tax-exempt interest on obligations acquired after August 7, 1986.ⁿ⁶⁴ The portion of the institution's interest expense that is so allocable is an amount that bears the same ratio to the expense as the taxpayer's average adjusted bases of the obligations bears to the average adjusted bases of all assets of the taxpayer.ⁿ⁶⁵

An exception to the disallowance rule for financial institutions is provided in the case of a "qualified tax-exempt obligation," defined as a tax-exempt obligation issued after August 7, 1986 (other than a private activity bond that is not a qualified 501(c)(3) bond, or an obligation issued to refund, or which is part of a series of obligations issued to refund, an obligation issued before August 8, 1986 that was not an industrial development bond or private loan bond) that is designated as a qualified tax-exempt obligation by the issuer.ⁿ⁶⁶ However, an obligation will not be treated as a qualified tax-exempt obligation unless the issuer is a qualified small issuer, that is, reasonably anticipated amount of tax-exempt obligations (other than private activity bonds) and certain refunding obligations that will be issued by the issuer during the calendar year does not exceed \$10 million.ⁿ⁶⁷ An allocation of the amount of an issue is prescribed in the case of an issue under which more than one governmental unit receives benefits if all of the governmental units irrevocably agree on the allocation and the allocation bears a reasonable relationship to the benefits received by the

entities.ⁿ⁶⁸

The American Recovery and Reinvestment Act of 2009 ("ARRA") provided certain temporary incentives for financial institutions to acquire tax-exempt obligations. For purposes of determining the ratio of the financial institution's average adjusted bases of tax-exempt obligations to the average bases of its total assets under *IRC Section 265(b)(2)*, which in turn determines the pro rata amount of interest disallowed by *IRC Section 265(b)(1)*, the financial institution may exclude from the numerator of the fraction the bases of any tax-exempt obligations issued in 2009 and 2010, provided the amount excluded does not exceed 2 percent of the denominator.^{n68.1} However, tax-exempt obligations excluded from the numerator under this "de minimis exception" are treated as having been acquired on August 7, 1986,^{n68.2} meaning that the financial institution's interest expense allocable to such excluded obligations, like interest expense allocable to "qualified tax-exempt obligations," is a tax preference item subject to the 20 percent disallowance rule.

ARRA (Section 1502(a)) also liberalized, for tax-exempt obligations issued in 2009 or 2010, the rules which determine whether such obligations are "qualified tax-exempt obligations." First, the amount of tax-exempt obligations that may be issued by a "qualified small issuer" under *IRC Section 265(b)(3)(C)(i)*, the amount of "qualified tax-exempt obligations" that may be designated by such an issuer under *IRC § 265(b)(3)(D)(i)*, and the amount of refunding tax-exempt obligations that may be designated as "qualified tax-exempt obligations" under *IRC § 265(b)(3)(D)(iii)*, have all been increased from \$10 million to \$30 million.^{n68.3} Second, for purposes of determining whether an issuer has satisfied the requirements for "qualified tax-exempt obligations" with respect to bonds issued in 2009 and 2010, any "qualified 501(c)(3) bond" (as defined in *IRC Section 145*) is to be treated as though the *IRC Section 501(c)(3)* organization for whose benefit the bonds were issued was the actual issuer.^{n68.4} Finally, for purposes of testing whether the "qualified tax-exempt obligation" rules are met in the case of a "qualified financing issue" made in 2009 or 2010, the rules applicable to composite bond issues (i.e., combined issues of bonds for different entities) in *IRC Section 265(b)(3)(F)* are to be replaced by new qualifying rules in *IRC Section 265(b)(3)(G)(iii)*.^{n68.5} Under the new rules, a qualifying financing issue is no longer tested as a whole (i.e., by treating the composite issue as a single issue); rather, the qualifying rules are applied separately to each borrower, as though the portion of the proceeds used by that borrower were issued as a separate issue. According to an example given in the House Conference Report, a \$100 million pooled financing issue issued in 2009 could meet the *IRC Section 265(b)(3)* definition of a "qualified tax-exempt obligation" if the proceeds of the issue were used to make four equal loans of \$25 million to four qualified borrowers.^{n68.6} However, the entire issue would fail to meet the requirements of a "qualified tax-exempt obligation" if (1) any borrower were not a qualified borrower, (2) any qualified borrower's share of the proceeds exceeded \$30 million (the maximum amount allowed in 2009 or 2010), or (3) any qualified borrower would, if it were the issuer of a separate issue in an amount equal to the amount loaned to that borrower, fail to meet any of the other requirements of *IRC Section 265(b)(3)*.^{n68.7}

There can be no doubt that *IRC Section 265(a)(2)* must apply when the taxpayer incurs or continues a debt for the sole purpose of purchasing or carrying tax-exempt securities.ⁿ⁶⁹ But is disallowance still mandated when the purchase of such obligations is merely a temporary investment of funds borrowed primarily for a business purpose? In other words, must there be a correlation between incurrence or continuation of the debt and the purchase or carrying of tax-exempt securities? Apparently so, since a deduction for interest paid or accrued on money borrowed to finance plant expansion, increase working capital, and liquidate other corporate indebtedness has been allowed, notwithstanding the short-term investment of the funds in tax-exempt securities; the debt was not incurred for the purpose of purchasing or carrying tax-exempt bonds, but rather for a business purpose apart from the acquisition of municipal bonds.ⁿ⁷⁰

We are led to a further question. Can the necessary correlation between borrowing and carrying tax-exempt securities be inferred from the mere fact that a taxpayer incurs a debt to finance additional investments at the same time that he holds tax-exempt obligations? The Commissioner would answer in the affirmative, pointing to a statement once made by the Supreme Court:

"[I]nterest can be said to be incurred or continued as a cost of producing exempt income whenever a taxpayer borrows for the purpose of making investments and in fact invests funds in exempt

securities."ⁿ⁷¹

The courts disagree, denying the deduction only when there is a sufficiently direct relationship between the incurrence or continuance of the debt and the purchase or carrying of the securities. The thrust of this approach is best summed up in the language of the Tax Court:

"We are of the opinion that the requisite sufficiently direct relationship between the incurring of various indebtedness by petitioner and his holding of tax-exempt securities, is absent here, except for the general one that the incurring of indebtedness allowed petitioner to retain his tax-exempt holdings. However, if this were a sufficient ground for disallowing the interest deduction, then section 265(2) would in fact be a mechanical test; i.e., the deduction would be disallowed whenever indebtedness was incurred while tax-exempts were held. ... [T]his is not the result that the statute was intended to achieve."ⁿ⁷²

Unquestionably, a sufficiently direct relationship between debt and purchase exists when the new funds are invested in additional tax-exempt securities. But disallowance is not limited to that fact pattern. For example, in *Illinois Terminal R.R. v. United States*ⁿ⁷³ the borrowed funds (\$20 million) were used to purchase another corporation's properties. Two years later one of these properties was sold to a city for \$9 million in cash and \$11,000,000 in tax-exempt bonds. The cash was applied in reduction of the outstanding loan balance; the bonds were held. The Court of Claims denied the interest expense deduction, notwithstanding the taxpayer's argument that the loan was needed to sustain its business operations rather than its ownership of tax-exempt securities. The argument failed because the court found that the loan was continued out of a concern for preserving the bond holdings, something that could be accomplished only if the debt financed the taxpayer's operations.

Must disallowance be decreed whenever borrowed funds are used for a purpose or a project that could have been financed by a sale of the tax-exempt securities held by the taxpayer? This would seem to be a logical extension of *Illinois Terminal R.R.*, but it does violence to the idea that *IRC Section 265(a)(2)* is not intended to operate as a mechanical rule. And so, once again, there must be a connection between the loans and the tax-exempt securities before the interest deduction will be denied. This is, perhaps, best illustrated by the decision of the Seventh Circuit in *Wisconsin Cheeseman, Inc. v. United States*.ⁿ⁷⁴ The taxpayer, engaged in a seasonal business (Christmas sales), would obtain short-term loans each fall in order to meet its recurring working capital needs. The borrowings were repaid out of the receipts of each year's sales, any balance of such receipts going to purchase municipal bonds and treasury bills. The treasury bills were reduced to cash by the following summer, the municipal bonds were not. Instead, the latter were used as collateral for the bank loans obtained during the fall of the following year. The court held *IRC Section 265(a)(2)* applicable, being convinced that "the deduction should not be allowed if a taxpayer could reasonably have foreseen at the time of purchasing the tax-exempts that a loan would probably be required to meet future economic needs of an ordinary, recurring variety."ⁿ⁷⁵ Thus, even if the taxpayer had not pledged the municipal bonds as security for the loan, the deduction would have been barred by the fact that the underlying reason for the recurring loan was the carrying of tax-exempt obligations.

On the other hand, the court permitted a deduction for interest on a construction loan secured by a mortgage on the taxpayer's real property. The Commissioner had denied the deduction, on the ground that the taxpayer should have financed its new plant by selling tax-exempt securities instead of obtaining a mortgage loan. The Seventh Circuit found that business reasons dominated the mortgaging of the taxpayer's real estate; a reasonable person would not sacrifice liquidity and security by selling municipal bonds in lieu of incurring a debt to obtain the necessary funds for plant construction. Therefore, the relationship between the mortgage indebtedness and the holding of tax-exempt obligations was not sufficiently direct to justify a disallowance of the mortgage interest deduction.ⁿ⁷⁶

Although a sufficiently direct relationship between the incurrence of a debt and the carrying of tax-exempts is the *sine qua non* of disallowance, it is not necessary that the borrowed money be directly traceable to the continued holding of

the obligations. The result in *Leslie v. Commissioner*⁷⁷ furnishes support for this proposition. The case concerned the deductibility of interest expense accrued by a brokerage firm on funds borrowed to finance customers' purchases of securities in margin accounts. The amount of money that the firm borrowed was determined on a day-to-day basis. While the purchase and continued ownership of tax-exempt obligations had an effect on the daily cash requirements of the firm, transactions in tax-exempts were not specifically considered in determining the amount of bank borrowings. If total disbursements for a given day were expected to exceed receipts, the firm would borrow the amount needed to maintain a reasonable cash position. No thought was given to the liquidation of some of the tax-exempt securities as a means of reducing the amount which had to be borrowed, since these were held not as an investment, but as an incident of the firm's brokerage business, i.e., through participation in syndications, through maintaining a market in tax-exempts, and through purchases for customers.

The Tax Court found for the taxpayer, basing its decision that the firm did not incur a portion of its indebtedness for the purpose of purchasing or carrying tax-exempt securities on the following: (1) there was no conscious thought given to obtaining a part of the firm's cash requirements through a sale of the tax-exempts; (2) there was no relationship between the amounts borrowed and the tax-exempt securities purchased; (3) the borrowed money was not traceable to the purchase of tax-exempts, since the funds were deposited in the firm's general purpose checking accounts; (4) the ratio of tax-exempts to borrowed funds was so small that the need for capital could not have been met by liquidating the obligations; and (5) the tax-exempt securities were acquired as a consequence of the firm's brokerage business and held for only a minimal period.

The Second Circuit reversed. In its view:

"[T]he fact that money was borrowed 'in the conduct of Bache's large and many-sided business activities' by no means negates the existence of a purpose, to the extent that the borrowing allowed Bache to deal in and retain a portion of the tax-exempts. To the contrary, in computing its daily cash needs for the purposes of borrowing, Bache took into account the amount of intended purchases of tax-exempt securities. Bache was, in essence, using the United States to finance its purchases of tax-exempt securities to the extent that it obtained an interest deduction allocable to a business income on which it paid no tax."⁷⁸

Thus, the court found a direct correlation between the continuance of the debt and the carrying of the tax-exempt securities, and disallowed an allocable portion of the interest accrued on the borrowed funds.⁷⁹

IRC Section 265(a)(4) is a necessary corollary of the provision permitting a regulated investment company to pay exempt-interest dividends to its shareholders. The added subsection disallows any deduction for interest on indebtedness incurred or continued to purchase or carry shares of stock of any investment company which distributes such dividends during the taxable year of the shareholder. If the company pays only exempt-interest dividends during the taxable year, all of the interest deduction will be denied. If both tax-free and taxable dividends are distributed, there is disallowance only to the extent the interest relates to the exempt-interest dividends.⁸⁰

[d] Interest on Obligations Not in Registered Form. *IRC Section 163(f)(1)* denies a deduction for interest paid on any obligation not in registered form.^{80.1} There are, however, exceptions for obligations (1) issued by an individual, or (2) not of a type issued to the public, or (3) having a maturity (at issue) of not more than one year,⁸¹ but the last two exceptions will not apply to any obligation determined by regulations to be of a type used frequently in avoiding federal taxes.⁸²

For obligations issued on or before March 18, 2012, *IRC Section 163(f)(1)* also does not apply to a foreign targeted obligation that is (a) issued under arrangements reasonably designed to ensure that the obligation will be sold only to a person who is not a United States person,⁸³ and, (b) in the case of an obligation not in registered form, the interest is payable outside the United States and its possessions and bears a legend on its face that any United States person who

holds the obligation will be subject to all limitations imposed by the Code with respect to bonds that should have been issued in registered form.^{n83.1} However, the foreign targeted obligation exception has been repealed for obligations issued after March 18, 2012, after which interest will be nondeductible on all bearer obligations other than those falling in the three exceptions referred to above.ⁿ⁸⁴

[e] Interest Allocable to Accrued Market Discount.ⁿ⁸⁵ Current deductions for interest allocable to market discount bonds are allowable only to the extent that the taxpayer's net direct interest--the excess of the amount of interest paid or accrued to purchase or carry market discount bonds over the aggregate of interest (including original issue discount) includable in gross income for the taxable year with respect to the bond--exceeds the amount of market discount allocable to the days during the taxable year on which the bond was held by the taxpayer.ⁿ⁸⁶ The disallowed portion of the interest expense is deferred to the year of disposition of the bond and allowed as a deduction at that time.ⁿ⁸⁷ If the bond is disposed of in a nonrecognition transaction, the disallowed interest expense becomes a deduction only to the extent that gain is recognized on the exchange; the balance of the gain is treated as disallowed interest expense with respect to the transferred basis property or exchange basis property received in the transaction.ⁿ⁸⁸

It should be noted that the provision applies to all market discount obligations *acquired* after the date of enactment of the Tax Reform Act of 1984. A consequence of this results in any gain recognized by the taxpayer on the disposition of a bond *issued* on or before July 18, 1984 being treated as ordinary income to the extent of the deferred interest allowable as a deduction in the year of disposition.ⁿ⁸⁹ However, the disallowance rule does not apply at all if the taxpayer elects to include market discount in income currently.ⁿ⁹⁰

[f] Interest Allocable to Discounted Short-Term Obligations.ⁿ⁹¹ *IRC Section 1282(a)* limits the ability of taxpayers who remain eligible to defer including acquisition discount on short-term obligations in income (e.g., cash basis taxpayers) to make leveraged purchases of short-term obligations as a device to defer tax on ordinary income. The net direct interest expense with respect to any short-term obligation can be taken as a deduction only to the extent that the expense exceeds the sum of (1) the daily portions of acquisition discount for each day during the taxable year on which the taxpayer held the obligation, and (2) the amount of any interest payable on the obligation (other than interest taken into account in determining the amount of acquisition discount) that accrues during the taxable year while the taxpayer held the obligation (and is not included in the gross income of the taxpayer for the taxable year under the taxpayer's method of accounting). Rules similar to those described in the preceding subsection apply to short-term obligations.ⁿ⁹² Thus, for example, the deferred portion of the interest expense becomes a deduction at the time of disposition of the obligation.

The provision does not apply to any taxpayer required to include acquisition discount in income currently or to any taxpayer who elects to do so.ⁿ⁹³

[g] Interest on High Yield Discount Obligations. Normally, the issuer of an original issue discount (OID) bond is permitted to deduct the discount as interest over the life of the bond. *IRC Section 163(e)(5)*, added to the Code in 1989 and generally applicable to obligations issued after July 10, 1989, limits the amount of the annual deduction when a debt instrument issued by a corporation (other than an S corporation) is an "applicable high yield discount obligation,"^{n93.1} that is, an obligation that (1) has a maturity date that is more than five years from the date of issue, (2) has a yield to maturity that equals or exceeds the sum of the applicable federal rate (AFR) in effect under *IRC Section 1274(d)* for the calendar month the obligation is issued, plus five percentage points, and (3) has significant OID.ⁿ⁹⁴

The limitation is achieved by dividing the yield on the obligation into an interest portion and a "disqualified" or equity portion.ⁿ⁹⁵ The disqualified portion of the OID is the lesser of (1) the amount of the OID or (2) the portion of the total return on the obligation that bears the same ratio to the total return as the "disqualified yield" on the obligation bears to the yield to maturity on the obligation. The disqualified yield is that portion of the yield that exceeds the AFR for the month in which the obligation is issued, plus six percentage points. If the yield to maturity on the obligation, determined by disregarding the OID, exceeds the AFR plus six percentage points, the disqualified portion is the entire amount of

the OID.

Example 1:

A corporation issues an applicable instrument on January 1, 2000 with an issue price of \$10,000 and a yield to maturity of 20 percent in a month in which the AFR is 9 percent. The AFR plus 6 percentage points is 15 percent. The return on the instrument in 2000 is \$2,000 (\$10,000 issue price times the 20 percent yield to maturity); the adjusted issue price at the end of 2000 is \$12,000. The return on the instrument in 2001 is \$2,400 (20 percent of the adjusted issue price of \$12,000). The disqualified yield is 5 percent (20 percent yield to maturity minus 15 percent). The disqualified portion is 25 percent (5 percent divided by 20 percent yield to maturity). The ratio of the disallowed portion of the yield to the yield is constant throughout the term of the instrument. Thus, the amount of the disqualified portion is \$500 (\$2,000 return times 25 percent) in 2000 and \$600 (\$2,400 return times 25 percent) in 2001.

The allocation of OID payments made before maturity between the disqualified portion and the remainder is to be made pursuant to regulations to be promulgated. These regulations are expected to provide that the payments will be allocated on a pro rata basis between accrued but unpaid OID treated as interest and the accrued but unpaid disqualified portion of the discount.

Example 2:

Assume the same facts as in Example 1, except that the corporation distributes \$1,200 in cash with respect to the instrument at the end of 2001. Of that amount, 25 percent or \$300, will be considered to be payment of the accrued but unpaid disqualified portion; the balance will be allocated to unpaid OID treated as interest.

In general, earnings and profits of the issuing corporation will be computed as if *IRC Section 163(e)(5)* did not exist. However, in determining the amount of the disqualified portion that is treated as a dividend for any year, earnings and profits are not reduced by any amount attributable to the disqualified portion for that year. The computation of earnings and profits for subsequent years is unaffected by this special rule.

Example 3:

A corporation accrues \$10,000 of interest with respect to an applicable instrument held by another corporation for a taxable year. \$8,000 of that amount is treated as interest for which a deduction is allowed when paid; the balance is the disqualified portion. None of the interest is paid during the year. The corporation has earnings and profits of \$11,000 before the accrued interest on the instrument is taken into account. Applying the general and special rules gives the issuing corporation earnings and profits of \$3,000 for the purpose of determining the character of the portion of the yield that is treated as a distribution with respect to stock and \$1,000 of earnings and profits for all other purposes including the determination of earnings and profits in subsequent years.

[h] Interest Paid by a Corporation to a Related Person. Prior to the enactment of the Omnibus Budget Reconciliation Act of 1989, interest paid by a United States corporate taxpayer was generally deductible, whether or not the interest was paid to a related party and whether or not the interest income was subject to federal income taxation when received by the payee. *IRC Section 163(j)* now disallows the deduction of "disqualified interest" ^{n95.1} paid by a United States corporation ⁿ⁹⁶ to a related tax-exempt entity ^{n96.1} if the corporation (1) has a debt-equity ratio exceeding 1.5 to 1, ⁿ⁹⁷ and incurs (2) "excess interest expense"--i.e., "net interest expense" greater than the sum of 50 percent of the corporation's "adjusted taxable income" ⁿ⁹⁸ plus any "excess limitation carryforward"--for the taxable year. ⁿ⁹⁹ The amount disallowed cannot exceed the corporation's excess interest expense for the taxable year. ⁿ¹⁰⁰

Net interest expense is the excess of the amount of interest paid or accrued by the taxpayer during the taxable year over the amount of interest income includable in the taxpayer's gross income for that year. The corporation's adjusted taxable income is its taxable income computed without any interest deduction, net operating loss deduction, or deduction for

depreciation, amortization, or depletion. A taxpayer has an excess limitation whenever 50 percent of its adjusted taxable income is greater than its net interest expense for any taxable year; the difference becomes the excess limitation carryforward in the next succeeding taxable year, and to the extent not used to offset interest in that year, to the second and third succeeding years.^{n100.1}

Example:

For 2000, a corporation has \$1,500 of adjusted taxable income and \$600 of net interest expense. Thus, none of its interest expense is disallowed by *IRC Section 163(j)* in 2000, and it has a \$150 excess limitation for the year (50 percent of its adjusted taxable income or \$750 less \$600 net interest expense) that can be carried forward to 2001.

In 2001, the corporation has \$1,000 of adjusted taxable income and \$600 of net interest expense. Although net interest expense is \$100 greater than 50 percent of adjusted taxable income, there is again no disallowance because of the presence of the \$150 excess limitation carryforward. There is an excess limitation carryforward to 2002 of \$50.

A payor and recipient of interest are related if either *IRC Section 267(b)* (see § 2.07[4][a]) or *IRC Section 707(b)* specifies that they are such. However, payments of interest to a partnership that would otherwise be a related person will generally not be treated as paid to a related person if partners not subject to United States income tax on their distributive shares of the partnership's interest income own in the aggregate less than 10 percent of the profits and capital interests in the partnership. An exception to this last-stated rule applies to the extent any partner is a related person to the paying corporation.

A recipient is tax exempt for purposes of *IRC Section 163(j)* if no federal income tax is imposed on that person's receipt of interest. If interest is paid to a pass-through entity, the determination of whether the payee is tax exempt is made at the beneficial owner level. Where an income tax treaty reduces the amount of United States income tax payable with respect to the interest, the portion treated as paid to a tax-exempt person is determined by a fraction, the numerator of which is the rate of tax that would be imposed absent the treaty less the treaty rate, and the denominator of which is the nontreaty rate.ⁿ¹⁰¹

IRC Section 163(j) applies as well to interest paid or accrued after December 31, 1993 on an indebtedness to a person who is not a related person if there is a disqualified guarantee of the indebtedness.ⁿ¹⁰² A disqualified guarantee is a guarantee made by a related person that is a tax-exempt organization or a foreign person, but does not apply to a guarantee (1) in any circumstances that will be identified in regulations, where the interest on the indebtedness would have been subject to a net basis tax if the interest had been paid to the guarantor, or if (2) the taxpayer owns a controlling interest in the guarantor.ⁿ¹⁰³

In applying *IRC Section 163(j)* to a corporation that owns (directly or indirectly) an interest in a partnership, (i) the corporation's distributive share of interest income paid or accrued to the partnership is treated as interest income paid or accrued to the corporation, (ii) the corporation's distributive share of interest paid or accrued by the partnership is treated as interest paid or accrued by the corporation, and (iii) the corporation's share of the liabilities of the partnership are treated as liabilities of the corporation.^{n103.1}

[i] Interest on Disqualified Debt Instruments. No deduction is allowed for any interest paid or accrued on a disqualified debt instrument--indebtedness of a corporation that is payable in the stock of the issuer or a related party (within the meaning of *IRC Section 267(b)* or *707(b)* or equity held by the issuer (or a related party) in any other person).ⁿ¹⁰⁴ Indebtedness is treated as payable in stock of the issuer or a related party only if (1) a substantial amount of the principal or interest is required to be paid or converted, or at the option of the issuer or a related party, is payable in, or convertible into, such stock, (2) a substantial amount of the principal or interest is required to be determined, or

may be determined at the option of the issuer or a related party, by reference to the value of stock of the issuer or any other person, or (3) the indebtedness is part of an arrangement that is reasonably expected to achieve those results.ⁿ¹⁰⁵ If the disqualified debt instrument of a corporation is payable in equity held by the issuer (or a related party) in any other person (other than a related party), the basis of the equity is increased by the amount not allowed as a deduction.ⁿ¹⁰⁶

[j] Treatment of Bond Issuance Premium. The issuer of a debt instrument with bond issuance premium determines its interest deduction by offsetting the interest allocable to an accrual period with the bond issuance premium allocable to that period.ⁿ¹⁰⁷ This rule does not apply to (1) regular instruments in a REMIC, qualified mortgages held by a REMIC, and certain other debt instruments, or pools of debt instruments, with payments subject to acceleration, or (2) to debt instruments that provide for contingent payments.ⁿ¹⁰⁸

Bond issuance premium is the excess of the issue price of a debt instrument over its stated redemption price at maturity.ⁿ¹⁰⁹ For this purpose, the issue price of a convertible bond does not include any amount equal to the value of the conversion option.ⁿ¹¹⁰

An issuer amortizes bond issuance premium by offsetting the qualified stated interest allocable to an accrual period with the bond issuance premium allocable to the period; the offset occurs when the issuer takes the qualified stated interest into account under its regular method of accounting.ⁿ¹¹¹

The bond premium allocable to an accrual period is determined under a three-step process.ⁿ¹¹² Within an accrual period, the bond premium allocable to the period accrues ratably.

The first step is to determine the yield to maturity, namely, the discount rate that, when used in computing the present value of all principal and interest payments to be made under the debt instrument, produces an amount equal to the issue price of the debt instrument.ⁿ¹¹³ The yield must be constant over the term of the debt instrument and, when expressed as a percentage, must be calculated to at least two decimal places.

The second step is to determine the accrual period for the bond.ⁿ¹¹⁴ This determination is made in the same manner as the determination of the accrual period for original issue discount.ⁿ¹¹⁵

The third step calls for determining the bond issuance premium allocable to the accrual period.ⁿ¹¹⁶ The issuance premium so allocable is the excess of the qualified stated interest allocable to the accrual period over the product of the adjusted acquisition price at the beginning of the accrual period and the yield.

If the bond issuance premium allocable to an accrual period exceeds the qualified stated interest allocable to the period, the excess is treated as ordinary income by the issuer for the period.ⁿ¹¹⁷ However, the amount so treated is limited to the amount by which the issuer's total interest deductions on the debt instrument in prior accrual periods exceed the total amount treated by the issuer as ordinary income in prior accrual periods. If the bond issuance premium allocable to an accrual period exceeds the sum of the qualified stated interest allocable to the accrual period and the amount treated as ordinary income for the accrual period, the excess is carried forward to the next accrual period and is treated as bond issuance premium allocable to that period.ⁿ¹¹⁸ Any carryforward that exists on the date the instrument is retired is treated as ordinary income on that date.

An issuer determines bond issuance premium on a variable rate debt instrument by reference to the stated price at maturity of the equivalent fixed rate debt instrument constructed for the variable rate debt instrument.ⁿ¹¹⁹ The issuer also allocates bond issuance premium among the accrual periods by reference to the equivalent fixed rate debt instrument.

An issuer determines bond issuance premium on an inflation-indexed debt instrument by assuming that there will be no

inflation or deflation over the term of the instrument.ⁿ¹²⁰ The issuer also allocates any bond issuance premium among the accrual periods by assuming that there will be no inflation or deflation over the term of the instrument. However, if the bond issuance premium allocable to a period exceeds the qualified stated interest allocable to the period, the excess is treated as a deflation adjustment.

The payment schedule that an issuer must construct for a contingent payment debt instrument determines the amount of bond issuance premium on the debt instrument, the yield and maturity of the debt instrument, and the allocation of bond issuance premium to an accrual period.ⁿ¹²¹ However, if a debt instrument is subject to a mandatory sinking fund provision, the issuer must determine the payment schedule by assuming that a pro rata portion of the debt instrument will be called under the sinking fund provision.ⁿ¹²²

The foregoing rules can be illustrated by the following example that assumes a 30-day month and a 360-day year:

Example:

On March 1, 2000, A Corp. received \$2,200,000 for a \$2 million bond maturing on March 1, 2007 and payable on that date. The bond provided for unconditional payments of interest of \$200,000 payable on March 1 of each year; the payments constitute qualified stated interest. A Corp. is a cash method taxpayer using the calendar year as its taxable year. A Corp. decided to use annual accrual periods ending on March 1 of each year. Based upon these facts, the amount of bond issuance premium is \$200,000.

Based upon the payment schedule and the issue price of the bond, the yield of the debt instrument is approximately 8.07 percent, compounded annually.ⁿ¹²³ The bond issuance premium allocable to the accrual period ending on March 1, 2001 is the excess of the \$200,000 qualified stated interest allocable to the period over \$177,637 (the product of the \$2,200,000 adjusted issue price at the beginning of the period and the yield of 8.07 percent, compounded annually), or \$22,363. Thus, A Corp. can deduct only \$177,637 of the \$200,000 qualified stated interest payment made on March 1, 2001.

[k] Interest and Carrying Charges Allocable to Straddles. *IRC Section 263(g)(1)* disallows a deduction for interest and carrying charges properly allocable to personal property that is part of a straddle (as defined in *IRC Section 1092(c)*).ⁿ¹²⁴ Any amount so disallowed is chargeable to the capital account with respect to the personal property to which the amount relates. By requiring capitalization, the provision prevents a taxpayer from gaining a timing advantage by accruing deductions associated with carrying the straddle before recognizing income from a position in personal property that is part of the straddle, and from taking deductions having a character different from that of the income.

Proposed regulations define personal property as property, whether or not actively traded, that is not real property.ⁿ¹²⁵ A position in personal property can itself be personal property, but only if the position confers or may confer substantial rights on the taxpayer. Personal property includes both financial positions that provide substantial rights, but do not impose substantial obligations on the holder (e.g., common stock or a purchased option), as well as executory contracts that impose both rights and obligations on the holder (e.g., notional principal contracts and forward transactions).ⁿ¹²⁶ However, the definition excludes straddles comprised only of financial positions that impose only obligations on the holder (e.g., the obligor's position in a debt instrument or a writer's position in an option).ⁿ¹²⁷

For purposes of *IRC Section 263(g)*, the phrase "interest and carrying charges" is defined as the excess of (a) the sum of (i) interest on indebtedness incurred or continued to purchase or carry the personal property,ⁿ¹²⁸ and (ii) all other amounts (including charges to insure, store, or transport the personal property) paid or incurred to carry the personal property, over (b)(i) the amount of interest (including original issue discount) includable in gross income for the taxable year with respect to the property, (ii) any amount treated as ordinary income under *IRC Section 1271(a)(3)(A)* (certain gain attributable to acquisition discount on short-term government obligations), *IRC Section 1278* (market discount), or

IRC Section 1281(a) (discount on certain short-term obligations) with respect to the personal property for the taxable year, (iii) the excess of any dividends includable in gross income with respect to the property for the taxable year over the amount of any dividends received deduction allowable under *IRC Section 243, 244, or 245*, and (iv) any amount that is a payment with respect to a security loan (within the meaning of *IRC Section 512(a)(5)*) includable in gross income with respect to the property for the taxable year.ⁿ¹²⁹

IRC Section 263(g)(1) does not apply in the case of any hedging transaction (as defined in *IRC Section 1256(e)*).ⁿ¹³⁰ The provision is applied after *IRC Section 263(h)* in the case of a short sale, and after *IRC Section 1277* (deferral of interest deduction allocable to accrued market discount) and *IRC Section 1282* (deferral of interest deduction allocable to accrued discount).ⁿ¹³¹

[l] Interest on Underpayments Attributable to Nondisclosed Reportable Transactions. No deduction is allowed for interest paid or accrued on any underpayment of tax that is attributable to the portion of any reportable transaction for which the reasonable cause exception of *IRC Section 6664(d)(1)* does not apply.ⁿ¹³² A reportable transaction understatement is the sum of (a) the product of (i) the amount of increase (if any) in taxable income that results from a difference between the proper treatment of an item attributable to a reportable transaction and the taxpayer's treatment thereof, and (ii) the highest rate of tax applicable to the taxpayer, and (b) the amount of decrease (if any) in the aggregate amount of credits that result from a difference between the taxpayer's treatment of an item attributable to a reportable transaction and the proper treatment of the item.ⁿ¹³³ A reportable transaction is any transaction with respect to which information is required to be included with a return or statement because it is determined that the transaction has the potential for tax avoidance or evasion.ⁿ¹³⁴

[m] Interest Paid in Connection with Insurance Contracts. No deduction is allowed for (1) any amount paid or accrued on indebtedness to purchase or carry a single premium life insurance, endowment or annuity contract;ⁿ¹³⁵ (2) any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment or annuity contract (other than a single premium contract or contract treated as a single premium contract) pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract;ⁿ¹³⁶ or (3) any interest paid or accrued on any indebtedness with respect to one or more life insurance policies owned by the taxpayer covering the life of any individual, or any endowment or annuity contracts owned by the taxpayer covering any individual.ⁿ¹³⁷

In addition to the above, no deduction is allowed for that portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values.ⁿ¹³⁸ However, this disallowance rule does not apply to any policy or contract owned by an entity engaged in a trade or business if the policy or contract covers only one individual and that individual is (at the time covered by the policy or contract) a 20-percent owner of the entity, or, if not a 20-percent owner, an officer, director, or employee of the trade or business.ⁿ¹³⁹ A second exception arises when the policy or contract is held by a natural person, unless a trade or business is directly or indirectly the beneficiary of the policy.ⁿ¹⁴⁰

[n] Interest Incurred by an Electing Small Business Trust. An electing small business trust (ESBT) is one of the permitted shareholders of an S corporation. Until 2007, all shareholders of an S corporation, except an ESBT, could deduct interest expense arising from an indebtedness incurred in connection with an acquisition of S corporation stock. *IRC Section 641(c)(2)(C)(iv)*, effective for taxable years after 2006, now permits an ESBT to claim such a deduction.

[2] Dividends on Short Sales

A short sale is a sale of stock which the seller does not own, delivery to the purchaser being made with shares borrowed from some owner of the stock.ⁿ¹ Not infrequently, dividends are paid on the stock before the short sale is closed. This imposes an additional obligation on the short seller. Not only is he required to return an equivalent number of shares to the lender, he must also pay the lender the amount of dividends paid on the stock while the short sale remained open.

Prior to 1984, it was well-settled that an individual short seller, whether dealer, trader or investor, was entitled to deduct

the dividend equivalent paid to the lender of the stock, either under *IRC Section 162*, as an ordinary and necessary expense of carrying on a trade or business, or under *IRC Section 212*, as an expense incurred in the production or collection of income.ⁿ¹ Of course, for *IRC Section 212* to apply, the taxpayer had to show that his purpose in engaging in the short sale was the production of income.ⁿ²

The Tax Reform Act of 1984 added *IRC Section 263(h)* which bars the deduction to the extent that the payments made by the taxpayer exceed the amount of income received by the taxpayer for the use of any collateral with respect to stock used in the short sale, if the sale is closed on or before 45 days after the date of the sale.ⁿ³ The period is increased to one year and a day if the payment is in lieu of an extraordinary dividend.ⁿ⁴ The running of the period is suspended during any period in which the taxpayer holds, has an option to buy, or is obliged to buy, substantially identical stock or securities, or has diminished his risk of loss by holding one or more positions with respect to substantially similar or related property.

A corporate taxpayer will be permitted a deduction only if it is involved in the business of trading or dealing in securities; the corporate investor is relegated to using the payment as an offset of the selling price.ⁿ⁵ The difference in treatment between corporations and individuals stems from the fact that, while both corporate and noncorporate taxpayers are eligible to deduct trade or business expenses under *IRC Section 162*, individuals are the only ones who may claim a deduction under *IRC Section 212*.

Finally, no deduction is available to any taxpayer, whether dealer, trader, or investor, corporation or individual, for amounts paid to reimburse the lender for stock dividends or liquidating distributions paid with respect to the borrowed stock while the short sale remained open. Instead, such amounts are treated as capital expenditures.ⁿ⁶

[3] Miscellaneous Expenses.

Unless a specific provision bars deduction or an expenditure is classified as a capital item,ⁿ¹ expenses incurred in carrying or managing securities are deductible under *IRC Section 162*, if incurred in the taxpayer's trade or business, or under *IRC Section 212*, if incurred by an individual for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.ⁿ² An important point is that, for *IRC Section 212*, the term "income" encompasses income realized in the current year or in a prior year, or which may be realized in a subsequent year. Moreover, it is not confined to recurring forms of income, but applies as well to gains from the disposition of property.ⁿ³

In *Klamath Strat. Inv. Fund v US*,^{n3.1} the taxpayers created limited liability companies taxable as partnerships that were managed by an investment advisor under a plan devised by the advisor to produce substantial artificial tax losses for the taxpayers but also involving legitimate investments in foreign currency contracts by the LLCs. Despite holding that the tax shelter aspect of the plan was a sham, the district court found that the individual taxpayers had a reasonable expectation of making a profit from the LLC's foreign currency transactions. The court allowed deductions under *IRC Section 212* for certain "operational expenses" paid by the taxpayers, including a management fee to the investment advisor and a fee to their accountants. On appeal, the district court was reversed on the deduction issue. Section 212 requires a profit motive, and since the operational expenses were incurred in connection with the LLC/partnership's business, the existence of a profit motive should have been determined at the partnership level rather than at the level of the individual taxpayers. The "critical inquiry" in this connection is the motive of the partner that effectively controlled the partnership's activities. The controlling partner here was the investment advisor which, under agreements with the taxpayers, was vested with sole managerial responsibility for the LLCs. The investment advisor, unlike the individual taxpayers, was primarily motivated by tax savings, not economic profit, and that motive, attributed to the LLCs, doomed the deduction.

The list of expenses deductible under *IRC section 212* includes, but is not limited to, custodian's fees,ⁿ⁴ accountant's fees,ⁿ⁵ investment advisory fees,ⁿ⁶ the cost of financial publications,ⁿ⁷ the cost of renting a safe deposit box to

safeguard securities,ⁿ⁸ the cost of secretarial and clerical help,ⁿ⁹ office expenses,ⁿ¹⁰ fees incurred by a stockholder in a proxy contest,ⁿ¹¹ and Securities and Exchange Commission semi-annual reporting fees.ⁿ¹²

The Tax Reform Act of 1986 imposed limits on the deductibility of miscellaneous itemized expenses (including investment expenses allowed as a deduction by *IRC Section 212*) incurred after 1986. Such expenses are deductible only to the extent that the aggregate of such deductions for the taxable year exceeds 2 percent of adjusted gross income.ⁿ¹³ The provision does not apply to the certain specified deductions, including the charitable deduction and the deduction for interest, taxes, and casualty and wagering losses.ⁿ¹⁴ The Treasury is authorized to prescribe regulations that prohibit the indirect deduction through pass-through entities (other than estates, trusts, cooperatives, and real estate investment trusts) of amounts that are not allowable as a deduction to an individual.ⁿ¹⁵ The pass-through entity rule is also inapplicable to investment expenses of a publicly offered regulated investment company.ⁿ¹⁶

IRC Section 68, added by the Omnibus Budget Reconciliation Act of 1990, provides that total otherwise allowable itemized deductions (other than medical expenses, casualty and theft losses, and investment interest expense) are reduced by an amount equal to 3 percent of the taxpayer's adjusted gross income in excess of \$100,000.ⁿ¹⁷ However, in no event can the deductions be reduced by more than 80 percent.

IRC Section 274(h) disallows any deduction under Section 212 for "expenses allocable to a convention, seminar, or similar meeting." This effectively precludes any deduction for attendance at investment seminars and the like, but not if the expenses are incurred in connection with the taxpayer's trade or business.

[4] Expenses Relating to Tax-Exempt Income.

It will be recalled that, under *IRC Section 265(a)(2)*, no taxpayer--dealer, trader, or investor--can deduct the interest paid or accrued on indebtedness incurred or continued to purchase or carry tax-exempt securities. A companion provision, *IRC Section 265(a)(1)*, bars the deduction of any other amount "allowable under section 212 ... which is allocable to interest ... wholly exempt from the taxes imposed by this subtitle." Because disallowance is keyed to *IRC Section 212*, it affects only investors and traders whose transactions in securities cannot be considered the carrying on of a trade or business; expenses incurred by dealers and traders whose activities qualify as a trade or business reach deductibility through *IRC Section 162*.

IRC Section 265(a)(1) also provides that no deduction will be available for "any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest ... wholly exempt from [income taxation]." Disallowance here extends to dealers, traders, and investors; the provision covers "any amount otherwise allowable as a deduction," not just amounts allowable under *IRC Section 212*. Indeed, *IRC Section 265(a)(1)* is not limited just to expenses which qualify for deduction under *IRC Section 162* or *212*, it can operate to deny a deduction, otherwise allowable under *IRC Section 164*, for state or foreign taxes paid with respect to income exempt from federal income taxes, but not from taxation by a state or foreign government.ⁿ¹

The amount subject to the disallowance rule of *IRC Section 265(a)(1)* consists of all expenses directly allocable to any class or classes of exempt income and a proportionate share of any expenses which are indirectly related to both taxable income and tax-exempt income.ⁿ² The Regulations call for the apportionment to be made "in the light of all the facts and circumstances in each case ... "ⁿ³ And so, while an allocation of expenses to tax-exempt and nonexempt income in the proportion which each bears to the taxpayer's total income may be proper in a great majority of cases, it is not mandated if the facts and circumstances of the case dictate the use of some other method of apportionment.ⁿ⁴

An important consideration is whether *IRC Section 265(a)(1)* reaches expenses incurred in transactions producing gain which need not be recognized for federal income tax purposes. Stated in another way, is there a distinction between wholly exempt income and unrecognized gain? The Internal Revenue Service originally held that there was not;ⁿ⁵ the courts were unanimous in their disagreement with the Government.ⁿ⁶ A typical view was that expressed by the Ninth

Circuit:

"There is a valid distinction between 'wholly exempt' income and income on which 'no gain or loss is recognized.' Wholly exempt income is never taxed. Nonrecognized gains are not taxed in the particular transaction that qualifies for nonrecognition treatment. They may be taxed, however, if the transaction fails to meet the nonrecognition requirements and may also be taxed at another time. In other words, they are not 'wholly exempt' from the tax."n7

The Service finally gave in; it now agrees that nonrecognized gain is not income that is wholly exempt from tax, so that expenses attributable to such income are not denied deduction under *IRC Section 265(a)(1)*.n8

FOOTNOTES:

(n1)Footnote 1. See generally, Kanter, "The Interest Deduction: When and How Does it Work," 26 *NYU Inst on Fed Tax* 87 (1968).

(n2)Footnote 2. The indebtedness must be that of the taxpayer. There is no deduction under *IRC § 163* if the taxpayer's liability is secondary. See, eg, *Golder v Commr*, 604 F2d 34 (9th Cir 1979) ; *Hamrick v Commr*, TC Memo 1980-149 ; *Rushing v Commr*, 58 TC 996 (1972) , acq 1973-2 CB 3 ; *Rev Rul 74-592*, 1974-2 CB 47 .

Interest paid by a shareholder on an obligation with respect to which the shareholder and his corporation were jointly and severally liable was deductible by the shareholder; the fact of joint liability did not convert the shareholder's primary liability into one that was derivative. *Arrigoni v Commr*, 73 TC 792 (1980) , acq on this issue 1980-2 CB 1 .

Interest paid on recourse notes given in connection with sham transactions is deductible. *Rice's Toyota World, Inc v Commr*, 752 F2d 89 (4th Cir 1985) ; *Larsen v Commr*, 89 TC 1229 (1987) ; *Coleman v Commr*, 85 TC 622 (1985) . However, the Tax Court refused to apply this rule where the payment of the interest to the lender was not the end of the matter; the taxpayers recovered the interest in the form of gains upon the items purchased with the borrowed funds. *Seykota v Commr*, TC Memo 1991-541 . The transaction involved in *Seykota* gave rise to the litigation in *Lee v Commr*, 155 F3d 584 (2d Cir 1998) ; the deduction was denied again.

An interest deduction was allowed in *Halle v Commr*, 83 F3d 649 (4th Cir 1996) , for payments made by a purchaser to postpone closing of a stock purchase transaction. The Service contended that the existence of a liquidated damages provision in the agreement was the equivalent of an option to purchase and, therefore, that there was no indebtedness. A majority of the Fourth Circuit found that the language of the stock purchase agreement created an unconditional agreement leading it to conclude that there was a bona fide debt.

(n3)Footnote 3. 364 US 361 (1960) .

(n4)Footnote 4. 364 US at 366 . Courts of Appeal found loan transactions to be shams in *Thompson v Commr*, 631 F2d 642 (9th Cir 1980) ; *Barnett v Commr*, 364 F2d 742 (2d Cir 1966) , and *Ippolito v Commr*, 364 F2d 744 (2d Cir 1966) . The Tax Court did the same in *Salley v Commr*, 55 TC 896 (1971) , acq in result only 1975-1 CB 2 , aff'd 464 F2d 479 (5th Cir 1972) ; *Collins v Commr*, 54 TC 1656 (1970) , acq 1971-2 CB 2 ; *Dixon v Commr*, TC Memo 1991-614 ; *Rosenthal v Commr*, TC Memo 1970-332 , aff'd mem 33 AFTR2d 74-402 (9th Cir 1973) , cert denied 416 US 984 ; *Norton v Commr*, TC Memo 1970-279 , aff'd per curiam 474 F2d 608 (9th Cir 1973) ; and *Estate of Melcher v Commr*, TC Memo 1970-237 , aff'd, 476 F2d 398 (9th Cir 1973) .

Soon after the taxpayer in *Gatto v Commr*, 1 F3d 826 (9th Cir 1993) , transferred cash to a trust, the cash was returned to the grantor in exchange for interest-bearing promissory notes. The transaction was viewed, not as a transfer of cash to the trust, but rather as a donation to it of a promise to make a gift of money in the future--an unenforceable promise under the applicable local law. Thus, the taxpayer did not incur genuine indebtedness and was precluded from claiming an interest deduction.

(n5)Footnote 5. 364 F2d 734 (2d Cir 1966) , cert denied, 385 US 1005 .

(n6)Footnote 6. 364 F2d at 742 . The Court of Appeals for the Fourth Circuit came to a contrary conclusion in *Rice's Toyota World v Commr*, 752 F2d 89, 95-96 (4th Cir 1985) , when it allowed the taxpayer to deduct interest on genuine recourse indebtedness incurred to finance the purchase of a mainframe computer, even though the Court had found that the purchase itself was a sham and had disallowed the investment credit and depreciation deductions with respect to the computer. Dictum in *Jacobson v Commr*, 915 F2d 832, 838 (2d Cir 1990) ("Even if the motive for a transaction is to avoid taxes, interest incurred therein may still be deductible if it relates to economically substantive indebtedness") seemed to indicate that the Second Circuit was reconsidering its position in *Goldstein*, but it corrected that impression in *Lee v Commr*, 155 F3d 584 (2d Cir 1998) , when it again disallowed an interest deduction on genuine indebtedness incurred as an integral part of a transaction found lacking in economic substance: "To adopt petitioner's reading would be to permit every shelter, no matter how transparently sham, to qualify for an interest expense deduction as long as the money used to finance the not-for-profit transactions involved were borrowed from a lender--any commercial bank would do--that demanded repayment. That result... is contrary to the longstanding jurisprudence of sham shelters from *Knetsch* on down. It would also squarely contradict our holding in *Goldstein*." 155 F3d at 587 . Accord: *Klamath Strat Inv Fund v US*, 568 F3d 537, 549-550 (5th Cir 2009) ; *Winn-Dixie Stores, Inc v Commr*, 113 TC 254, 294 (1999) , aff'd 254 F3d 1313 (11th Cir 2001) , cert denied, 535 US 986 (2002) . See also § 1.02A regarding the application of the economic substance doctrine.

(n7)Footnote 7. *Rev Rul 68-643, 1968-2 CB 76* . This assumes that the obligation to pay interest is fixed at the end of the taxable year. *Scott Paper Co v Commr*, 74 TC 137 (1980) ; *Rev Rul 74-127, 1974-1 CB 127* .

Debentures with interest payable semiannually on March 15 and September 15 to holders of record on March 1 and September 1, respectively, were convertible into common stock. The taxpayer was not obligated to pay interest for any portion of a six-month period with respect to a debenture tendered for conversion prior to the record date of that period. The taxpayer, in *Southwestern Energy Co & Subs v Commr*, 100 TC 500 (1993) , claimed that it was entitled to accrue an interest deduction for the period September 15 to December 31 of the years in issue, regardless of whether the debentures were thereafter converted. The Tax Court denied the deduction on the ground that the "all events test" necessary to support the accrual had not been met. (Under the all events test, an amount does not accrue until all the events have occurred which fix that amount as well as determine who is to pay or receive it. *US v Anderson*, 269 US 422 (1926) .) See also *Ltr Rul 9340001* .

(n8)Footnote 7.1. *IRC § 267(a)(2)*. The covered relationships are set forth in *IRC § 267(b)*.

The disallowance continues even though the related person to whom the interest is due assigns the obligation to an unrelated third party. *Ronald Moran Cadillac v US*, 385 F3d 1230 (9th Cir 2004) , cert denied, 125 S Ct 1882 .

(n9)Footnote 8. Interest charged by a broker on an indebtedness due him under a margin account is deductible by the taxpayer only when the broker receives payments from the taxpayer, or makes collections for the account of the taxpayer and applies the amount collected or paid to the payment of interest. *Rev Rul 70-221, 1970-1 CB 33* .

Loan discount is interest that is generally deductible by a cash basis taxpayer only when actually paid. *Rev Rul 75-12, 1975-1 CB 62* . However, the Service has ruled that a bank, issuing long-term certificates of deposit at a discount, with no interest payable until maturity, is required to prorate the discount over the life of the certificate, even if it is a cash basis taxpayer. *Rev Rul 78-236, 1978-1 CB 56* .

An interest deduction is allowed a cash basis taxpayer only when the payment is made in cash or its equivalent. The lender's acceptance of the borrower's note as (1) payment of the principal sum and interest on an existing indebtedness plus (2) evidence of a new indebtedness, does not produce a deduction for the borrower. *Rev Rul 70-647, 1970-2 CB 38* . The same holds true for interest paid by cash basis taxpayers using funds obtained from the original creditor through a second loan, advance, or any other financial arrangement. *Wilkerson v Commr*, 655 F2d 980 (9th Cir 1981) ;

Battelstein v IRS, 631 F2d 1182 (5th Cir 1980) , cert. denied, 451 US 938 ; but see *Franklin v Commr*, 683 F2d 125 (5th Cir 1982) , where an interest deduction was allowed for payments to participating banks with funds borrowed from a lead bank. The Service will continue to litigate cases on facts similar to *Franklin* where no debtor-creditor relationship exists between the original debtor and the participating banks. IRS Action on Decision, reprinted at 25 *Tax Notes* 55-56 (1984).

The relevant inquiry in cases involving interest paid with proceeds obtained through a second loan from the original creditor is whether the borrower had other funds with which to pay the interest, whether the funds used to pay the interest were traceable, and whether the borrower realistically could have used the borrowed funds for any other purpose. See *Davison v Commr*, 107 TC 35 (1996) , *aff'd* 141 F3d 403 (2d Cir 1998) .

(n10)Footnote 9. Points paid in respect of any indebtedness incurred in connection with the purchase or improvement of, and secured by, the principal residence of the taxpayer are deductible in the year paid. *IRC* § 461(g)(2). The requirements necessary for the deduction are set forth in *Rev Proc* 92-12, 1992-1 CB 663 .

IRC § 461(g)(2) permits a current deduction for points paid in connection with the acquisition of a residence, but does not mandate that they be deducted currently. A taxpayer can amortize points over the term of the mortgage. *Ltr Rul* 199905033 .

(n11)Footnote 10. See Ch 17 for the way to determine the daily portion of OID. For purposes of the issuer's deduction, there is no reduction in OID because of a sale to a subsequent holder, nor is OID ever deemed to be zero through application of the *de minimis* rule of *IRC* § 1273(a)(3), discussed in Ch 17.

If a debt instrument has a *de minimis* amount of OID, the issuer may choose to deduct the OID at maturity, on a straight-line basis over the term of the debt instrument, or in proportion to stated interest payments. The issuer makes this choice by reporting the *de minimis* OID in a manner consistent with the method chosen on the issuer's timely filed federal income tax return for the taxable year in which the debt instrument is issued. *Treas Reg* § 1.163-7(b)(2).

The provision does not apply to obligations issued by natural persons before March 2, 1984, or to loans not in excess of \$10,000 between natural persons. *IRC* § 163(e)(4).

(n12)Footnote 11. *IRC* § 163(e)(3). The included relationships are those specified in *IRC* § 267(b).

IRC § 267(a)(2), and not *IRC* § 163(e)(3), governs if the OID is income effectively connected with the conduct of a US trade or business of the related foreign person. However, this exception is inapplicable if the foreign person claims an exemption from US income tax on the amount owed, or is subject to a reduced rate of tax, pursuant to a treaty obligation of the US. *Treas Reg* § 1.163-12(b)(1).

IRC § 267(a)(2) requires a matching of the interest deduction with the payee's inclusion in income. In other words, if the payee uses the cash receipts and disbursements method of accounting, and the payor is an accrual method taxpayer, the deduction is allowable only when the payment is made to the payee. In the case of an item payable to a controlled foreign corporation or passive foreign investment company, a deduction will be allowable for any taxable year before the year of payment only to the extent that an amount attributable to the item is includable in the prior taxable year in the gross income of a United States person who owns stock in the corporation. *IRC* § 267(a)(3)(B)(i).

(n13)Footnote 11.1. *IRC* § 163(e)(3)(B)(i).

(n14)Footnote 12. See § 17.05[2], *supra*.

(n15)Footnote 13. *Treas Reg* § 1.163-7(c).

(n16)Footnote 14. *Treas Reg* § 1.163-7(c). *IRC* § 483 is discussed in § 2.07[1][a], *supra*.

(n17)Footnote 15. *Treas Reg* § 1.163-7(c). *IRC* §§ 1273(b)(4) and 1274 are discussed in § 17.02A[1], *supra*.

(n18)Footnote 15.1. *Treas Reg* § 1.163-7(e)(1), effective for qualified reopenings where the reopening date is on or after March 13, 2001. *Treas Reg* § 1.163-7(f). The adjustments are taken into account in determining the issuer's adjusted issue price under *Treas Reg* § 1.1275-1(b). *Treas Reg* § 1.163-7(e)(5). See § 17.02A[1] for a discussion of qualified reopenings.

(n19)Footnote 15.2. *Treas Reg* § 1.163-7(e)(2).

(n20)Footnote 15.3. *Treas Reg* § 1.163-7(e)(3).

(n21)Footnote 15.4. The constant yield method is described in *Treas Reg* § 1.1272-1(b).

(n22)Footnote 16. See *Treas Reg* § 1.1273-1(d) and § 17.02A[1], *supra* , for the meaning of *de minimis*.

(n23)Footnote 17. Interest paid to purchase stock in order to acquire ownership of a business is not interest allocable to a trade or business, but, rather, investment interest deductible to the extent the taxpayer has investment income. *Malone v Commr*, *TC Memo* 1996-408 .

An S corporation in the business of selling timeshares elected to report the gain derived from the sales on the installment method. This triggered application of *IRC* § 453(l)(3) and required the corporation to pay interest on the tax deferred by reason of the installment sale election. The shareholder of the corporation attempted to deduct the interest on his personal return. The Service denied the deduction on the ground that the interest was not allocable to the shareholder's trade or business; the Tax Court agreed. *Carlson v Commr*, *112 TC* 240 (1999) .

(n24)Footnote 17.1. Interest paid by the taxpayer to his ex-wife on a promissory note that equalized the property distribution in the marriage dissolution was held to be investment interest. The court reached this conclusion because the taxpayer received more investment property than his ex-wife, and the note was intended to compensate her for the share of that property. *Armacost v Commr*, *TC Memo* 1998-150 .

(n25)Footnote 18. See, generally, Block, "The Trouble With Interest: Reflections on Interest Deductions After the Tax Reform Act of 1986," *40 U Fla L Rev* 689 (1988); Galvin, "The Deduction of Nonbusiness Interest: An Exercise in Planned Confusion," *41 Tax Lawyer* 803 (1988); Taggart, "Denial of the Personal Interest Deduction," *41 Tax Lawyer* 195 (1988).

Temp Treas Reg § 1.163-9T(b)(2)(i)(A) provides that interest paid on underpayments of individual income taxes is personal interest even if the source of the income generating the tax liability is from the taxpayer's trade or business. The Eighth Circuit in *Miller v US*, *65 F3d* 687 (8th Cir 1995) , held the regulation valid as a reasonable interpretation of the personal interest provisions of *IRC* § 163(h). The Tax Court disagreed, *Redlark v Commr*, *106 TC* 31 (1996) , but was reversed by the Ninth Circuit. The appellate opinion is reported at *141 F3d* 936 (9th Cir 1998) . The Tax Court will no longer follow its decision in *Redlark*. *Robinson v Commr*, *119 TC* 44 (2002) .

A district court has held the interest to be deductible. *Allen v US*, *987 F Supp* 460 (ED NC 1998) . The Fourth Circuit reversed. *173 F3d* 533 (4th Cir 1999) . The Sixth Circuit determined that such interest is nondeductible in *McDonnell v US*, *180 F3d* 721(6th Cir 1999) ; the Seventh Circuit did as well in *Kikalos v Commr*, *190 F3d* 791 (7th Cir 1999) .

The Ninth Circuit has held that the regulation does not apply to interest paid by a shareholder on a DISC's deferred tax liability because there was no underpayment. Nevertheless, it refused a deduction on the ground that the interest arose in the DISC's trade or business and was not allocable to the shareholder's trade or business. *Tedori v US*, *211 F3d* 488 (9th Cir 2000) .

(n26)Footnote 18.1. *IRC § 221(b)(1)*. The deduction enters into the computation of adjusted gross income. *IRC § 62(a)(17)*. A taxpayer is entitled to a deduction under *IRC § 221* only if the taxpayer has a legal obligation to make interest payments under the terms of the qualified educational loan. *Treas Reg § 1.221-1(b)(1)*. An individual is not entitled to the deduction for any taxable year in which the individual is claimed as a dependent by another taxpayer. *Treas Reg § 1.221-1(b)(2)(i)*. If a taxpayer is married as of the close of a taxable year, the taxpayer is entitled to a deduction only if the taxpayer and the taxpayer's spouse file a joint return for the taxable year. *Treas Reg § 1.221-1(b)(3)*.

If a third party who is not legally obligated to make a payment of interest on a qualified educational loan makes a payment of interest on behalf of a person who is legally obligated to make the payment, the taxpayer is treated as receiving the payment from the third party and, in turn, paying the interest. *Treas Reg § 1.221-1(b)(4)*.

(n27)Footnote 18.2. *IRC § 221(b)(2)*.

(n28)Footnote 19. *IRC § 163(h)(3)(A), (B)*. Indebtedness will not fail to be treated as secured by property solely because, under applicable state or local homestead or other debtor protection law in effect on Aug 16, 1986, the security interest is ineffective or the enforceability of the security interest is restricted.

Debt can qualify as acquisition indebtedness under the tracing rules of *Temp Treas Reg § 1.163-8T* and to the extent of expenditures made within 90 days before or after the date the debt is incurred. In the case of the construction or substantial improvement of a residence, debt incurred before the residence or improvement is complete may be treated as incurred to construct or improve the residence to the extent of expenditures made no more than 24 months before the date the debt is incurred. Debt incurred within 90 days after completion can be treated as incurred to construct or improve the residence to the extent of expenditures made within the period beginning 24 months prior to the date of completion and ending on the date the debt is incurred. *Notice 88-74, 1988-2 CB 386*. The Notice also provides that debt incurred to acquire an interest in a residence incident to a divorce is eligible to be treated as acquisition indebtedness without regard to the treatment of the transaction under *IRC § 1041*. See also *Seymour v Commr*, 109 TC 279 (1997). *Seymour* is discussed in Note, "Section 1041 Does Not Require Interest Paid to an Ex-Spouse to be Treated as Personal Interest: *Seymour v. Commissioner*," 51 *Tax Law* 829 (1998).

Interest on a loan used to purchase a personal residence was not qualified residence interest where the loan was secured by the taxpayer's tax-deferred annuity, or by the taxpayer's savings account. *Ltr Ruls 8742024, 8743063*.

The same holds true even if the loan is secured only by a mortgage on commercial property owned by the taxpayers. *Ltr Rul 9418001*.

If a taxpayer uses a single premium annuity contract as collateral to obtain or continue a mortgage loan, *IRC § 264(a)(2)* disallows a deduction for interest on the loan to the extent the loan is collateralized by the annuity contract. The amount disallowed is the current interest rate on the mortgage loan multiplied by the amount of the annuity contract used as collateral (or by the amount of the loan, if less). *Rev Rul 95-53, 1995-2 CB 30*.

Interest accrued on acquisition indebtedness, including a price level adjusted mortgage (PLAM), is treated as acquisition indebtedness until it is paid. *Temp Treas Reg § 1.163-11T*.

In *Ulsa v Commr*, *TC Memo 1997-551*, the taxpayers' credit rating was such that they could not obtain financing to purchase a residence. Instead the home was acquired by members of the taxpayers' family who also obtained the financing for the purchase. The taxpayers occupied the house and made all payments with respect to the property, including mortgage principal and interest. The court held that, based upon all of the evidence, the taxpayers held the benefits and burdens of ownership of the home, that they established equitable and beneficial ownership of the property, and that they were liable to the family members in respect of the mortgage indebtedness. This entitled them to claim a

home mortgage interest deduction for the year in question.

(n29)Footnote 20. A taxpayer who claims a deduction for qualified residence interest on any seller-provided financing must include the following information on the taxpayer's return for each year that a deduction is taken: the name, address, and taxpayer identification number of the person to whom the interest is paid or accrued. The recipient of the interest must report the name, address, and taxpayer identification number of the person liable for the payment of the interest. *IRC § 6109(h)*. For this purpose, seller-provided financing means any indebtedness incurred in acquiring a residence if the person to whom the indebtedness is owed is the person from whom the residence was acquired. *IRC § 163(h)(4)(A)*. A residence can be a qualified residence even if rented to others if the taxpayer uses it as such at least 14 days a year or 10 percent of the time it is rented (whichever is greater). The time test is inapplicable if the residence is not rented at all during the year. *IRC § 163(h)(4)(A)(iii)*.

The term "principal residence" has the same meaning for this purpose as it does for purposes of *IRC § 121*. *Temp Treas Reg § 1.163-10T(p)(2)*. A second residence can be a house, condominium, mobile home, boat, or house trailer that contains sleeping space and toilet and cooking facilities. *Temp Treas Reg § 1.163-10T(p)(3)(ii)*.

(n30)Footnote 21. *IRC § 163(h)(4)(D)*.

(n31)Footnote 22. *IRC § 163(h)(3)(B)(ii)*.

(n32)Footnote 23. *IRC § 163(h)(3)(D)(i), (iii)*.

(n33)Footnote 24. *IRC § 163(h)(3)(D)(ii)*.

(n34)Footnote 25. *IRC § 163(h)(3)(D)(iv)*. If the principal of the original acquisition indebtedness is not amortized over its term (eg, it calls for a balloon payment), interest can be deducted as qualified residence interest for the term of the first refinancing or 30 years, whichever period is shorter.

(n35)Footnote 26. *Temp Treas Reg § 1.163-8T(c)(2)(ii)(A)*. Accrued interest is treated as a debt until it is paid, and any interest accruing on unpaid interest is allocated in the same manner as the unpaid interest. *Temp Treas Reg § 1.163-8T(c)(2)(ii)(B)*.

(n36)Footnote 27. *Temp Treas Reg § 1.163-8T-(c)(1), (2)(i)*. *Notice 88-37, 1988-1 CB 522*, provides guidance on the reporting of interest expense with respect to debt-financed acquisitions and distributions; *Notice 89-35, 1989-1 CB 675*, does the same for acquisitions and distributions by pass-through entities.

(n37)Footnote 28. *Temp Treas Reg § 1.163-8T-(c)(1), (m)(3)*.

(n38)Footnote 29. *Temp Treas Reg § 1.163-8T(c)(4)(i)*.

(n39)Footnote 30. *Temp Treas Reg § 1.163-8T(c)(4)(ii)*. A special ordering rule treats an expenditure from a checking account as made at the time the check is written, provided the check is delivered or mailed to the payee within a reasonable period thereafter. *Temp Treas Reg § 1.163-8T(c)(4)(iii)(A)*.

In the case of an account consisting solely of the proceeds of a debt and interest earned on such account, the taxpayer may treat any expenditure from the account as made first from amounts constituting interest rather than debt proceeds. *Temp Treas Reg § 1.163-8T(c)(4)(ii)(C)*.

(n40)Footnote 31. *Temp Treas Reg § 1.163-8T(c)(4)(iv)*.

(n41)Footnote 32. *Temp Treas Reg §§ 1.163-8T(c)(4)(iii)(B), 1.163-8T(c)(5)(i)*.

(n42)Footnote 33. *Temp Treas Reg § 1.163-8T(d)(1)*.

(n43)Footnote 34. *Temp Treas Reg § 1.163-8T(d)(3)*.

(n44)Footnote 35. *Temp Treas Reg § 1.163-8T(e)(1)*.

(n45)Footnote 36. *Temp Treas Reg § 1.163-8T(j)(1)(i), (ii)*.

(n46)Footnote 37. *Temp Treas Reg § 1.163-8T(j)(2)*.

(n47)Footnote 38. *Temp Treas Reg § 1.163-8T(j)(1)(i), (ii)*.

(n48)Footnote 39. *Temp Treas Reg § 1.163-8T(n)(1)*.

(n49)Footnote 40. *Temp Treas Reg § 1.163-8T(n)(3)(i)*.

(n50)Footnote 41. *Temp Treas Reg § 1.163-8T(n)(3)(ix)*.

(n51)Footnote 42. *Temp Treas Reg § 1.163-8T(n)(3)(ii)(B)*.

(n52)Footnote 43. *Temp Treas Reg § 1.163-8T(n)(3)(v)*.

(n53)Footnote 44. *Temp Treas Reg § 1.163-8T(n)(3)(vii)*.

(n54)Footnote 45. *Temp Treas Reg § 1.163-8T(n)(3)(viii)*.

(n55)Footnote 46. *Temp Treas Reg § 1.163-8T(n)(3)(x)*.

(n56)Footnote 47. HR Rep No 413 (Pt 1), 91st Cong, 1st Sess (1969).

(n57)Footnote 48. *IRC § 163(d)(3)(A)*. Property held for investment includes (a) property that produces gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of business, and (b) any interest held by a taxpayer involving the conduct of a trade or business that is not a passive activity, and with respect to which the taxpayer does not materially participate (is not involved in the operations of the activity on a regular, continuous, and substantial basis). *IRC § 163 (d)(5)*.

IRC § 163(d) does not limit the deductibility of interest incurred in connection with a trade or business. A finding that the taxpayer, a registered representative for a stock exchange member firm, was not engaged in the business of trading securities for his own account, prevented full deduction of interest paid on his margin account. *Asch v Commr, TC Memo 1986-238*. See also *Olson v Commr, TC Memo 1989-564*. A contrary result was reached in *Morley v Commr, 87 TC 1206*, where the court found that a real estate broker acquired property with the intent of reselling it and, in fact, entered into negotiations for its sale. The fact that the taxpayer is engaged in a trade or business that produces capital gains and losses (eg, trading in securities) does not make the interest investment "interest." *King v Commr, 89 TC 445 (1987), acq 1988-1 CB 1*.

Interest on indebtedness incurred to purchase S corporation stock is investment interest subject to the limitations of *IRC § 163(d)*. The purchasers had a substantial investment motive looking toward the realization of capital gains. The result was not changed by the fact that the taxpayers were full-time employees actively engaged in management of the corporation. *GCM 39529*.

If an individual, who is neither a dealer nor a trader in stock or securities, borrows money to purchase stock in a C corporation to protect the individual's employment with the corporation, the interest on the loan is investment interest for purposes of *IRC § 163(d)*. *Rev Rul 93-68, 1993-2 CB 72*. The same result was reached in *Russon v Commr, 107 TC 263 (1996)*, where the Tax Court rejected the taxpayer's argument that investment property is limited to property that has actually produced investment income.

The existence of a substantial investment motive required a finding that interest paid on indebtedness incurred by a shareholder who used the funds as an additional capital contribution was investment interest. The fact that the capital was needed to meet state law requirements did not affect the result. *Yamamoto v Commr*, TC Memo 1986-316 . See also *Houston v Commr*, TC Memo 1989-175 ; *Recklitis v Commr*, 91 TC 874 (1988) ; *Polakis v Commr*, 91 TC 660 (1988) .

For purposes of the provision, the term "interest" includes any amount allowable as a deduction in connection with personal property in a short sale. *IRC § 163(d)(3)(C)*.

Investment interest does not include qualified residence interest, or any interest taken into account under *IRC § 469* in computing income or loss from a passive activity. However, *Temp Treas Reg § 1.163-10T(o)(5)* allows a taxpayer to elect to treat any debt secured by a qualified residence as not secured by that residence. In an appropriate case, the interest may be treated as investment interest. See, eg, *Ltr Rul 9335043* .

(n58)Footnote 49. *IRC § 163(d)(1)*. The Service, in *Miner v Commr*, TC Memo 2003-39 , contended that the taxpayer could not deduct margin interest because she was an investor and not a trader. The Tax Court held that the deduction was allowed by *IRC § 163(d)* to the extent of the taxpayer's net investment income.

(n59)Footnote 50. *Rev Rul 84-131*, 1984-2 CB 37 . The IRS ruled in *Rev Rul 2008-12*, 2008-1 CB 520 , that where a partnership actively trades securities as its trade or business, but has a noncorporate limited partner who did not materially participate in these activities, then that partner's distributive share of interest expense should be subject to the investment interest limitation of *IRC § 163(d)*. Because the business is active (despite the fact that the partner's involvement was not), the interest deduction should be above the line, that is, a deduction used in determining adjusted gross income. *Announcement 2008-65*, 2008-2 CB 279 , explained that the interest deduction in such a case would properly be taken on Schedule E. In *Rev Rul 2008-38*, 2008-2 CB 249 , the IRS compared the situation of the noncorporate taxpayer who had investment interest expenses as a result of being a nonmaterially participating partner in an active business, with the noncorporate taxpayer who simply had investment income expenses. In the former case, essentially the situation in *Rev Rul 2008-12* , the deduction allowed would be taken above the line. However, in the latter case, the deduction would be taken as an itemized deduction. In both cases, the aggregate amount of the deduction could not exceed the taxpayer's investment income for the year. This means that if the taxpayer had both investment income, and investment income interest deductions from different sources, the taxpayer would have to have a reasonable allocation of that income between these two different categories of interest expense, in order to determine how much of the income was above-the-line, and how much was below the line.

(n60)Footnote 51. *IRC § 163(d)(2)*.

(n61)Footnote 52. *Rev Rul 86-70*, 1986-1 CB 83 ; *Ltr Rul 8525002* ; *Ltr Rul 7935002* .

(n62)Footnote 53. *Allbritton v Commr*, 37 F3d 183 (5th Cir 1994) ; *Flood v Commr*, 33 F3d 1174 (9th Cir 1994) ; *Sharp v US*, 14 F3d 583 (1993) ; *Beyer v Commr*, 916 F2d 153 (4th Cir 1990) ; *Lenz v Commr*, 101 TC 260 (1993) . The announcement of the change can be found in *Rev Rul 95-16*, 1995-1 CB 9

(n63)Footnote 54. *IRC § 163(d)(4)(A)*.

(N64)Footnote 55. Interest income derived from a refund of federal taxes is treated as investment income for purposes of computing the limitation on the deduction of investment interest. *Ltr Rul 9307005* . Income realized on the cancellation of an indebtedness that was incurred to acquire property held for investment constitutes investment income. *Ltr Rul 9522008* .

(n65)Footnote 56. *IRC § 163(d)(4)(B)*. The term "property held for investment" includes interest-free gift loans that yield gross income in the form of imputed interest under *IRC § 7872*. *Ltr Rul 9526003* .

The investment interest deduction in *Talchik v Commr*, *TC Memo 2003-342*, was limited to the amount of interest and dividends received by the taxpayers during the taxable year. Although the taxpayers realized capital gains during the year, they were completely offset by capital loss carryovers from prior years.

The election is made on Form 4952 filed on or before the due date (including extensions) of the income tax return for the taxable year in which the net capital gain is recognized. *Treas Reg § 1.163(d)-1(b)*. The election is revocable with the consent of the Commissioner. *Treas Reg § 1.163(d)-1(c)*.

For taxable years 2003 through 2010, investment income does not include any qualified dividend income taxed preferentially under *IRC § 1(h)(11)(B)*. See *§ 2.06[2][a][i]*. The taxpayer can elect to include qualified dividend income in investment income. See *Treas Reg § 1.163(d)-1(a)*.

(n66)Footnote 57. *IRC § 163(d)(4)(C)*. Nonbusiness bad debts are considered investment expenses only to the extent that they are deductible in the taxable year. *Keating v Commr*, *89 TC 1071 (1987)*, *acq 1989-2 CB 1*.

(n67)Footnote 58. *IRC § 163(d)(4)(C)*.

(n68)Footnote 59. *IRC § 163(d)(4)(D)*.

(n69)Footnote 60. *IRC § 163(d)(4)(E)*.

(n70)Footnote 61. For purposes of the section, the term "interest" includes any amount paid or incurred by any person making a short sale in connection with personal property used in the short sale, or by any other person for the use of any collateral with respect to the short sale. This rule does not apply if the person making the short sale provides cash as collateral for the sale and receives no material earnings on the cash during the period of the short sale. *IRC § 265(a)(5)*.

The Service will not ordinarily issue a ruling as to whether indebtedness is incurred or continued to purchase or carry tax-free interest obligations. *Rev Proc 2009-3, 2009-1 IRB 107*.

(n71)Footnote 62. *Denman v Slayton*, *282 US 514 (1931)*; *Rev Rul 73-602, 1973-2 CB 91*. Moreover, the deduction will be disallowed even though the dealer's ultimate purpose is to profit through a resale of the bonds. *Kirchner, Moore & Co v Commr*, *54 TC 940 (1970)*, *aff'd*, *448 F2d 1281 (10th Cir 1971)*.

Rev Proc 72-18, 1972-1 CB 740, clarified by *Rev Proc 74-8, 1974-1 CB 419*, and modified by *Rev Proc 87-53, 1987-2 CB 669*, provides guidelines for the application of *IRC § 265(a)(2)* to taxpayers holding tax-exempt state and local obligations. *Rev Procs 72-18, 74-8*, and *87-53* are reprinted as Appendix F, *infra*.

(n72)Footnote 63. *IRC § 291(a)(3), (e)(1)(B)*.

(n73)Footnote 64. A financial institution is defined as one that accepts deposits from the public in the ordinary course of its business, and is either a domestic institution subject to federal or state supervision or a foreign bank doing business in the US. *IRC § 265(b)(5)*.

Rev Rul 90-44, 1990-1 CB 54, sets forth guidelines regarding the disallowance of interest expense allocable to tax-exempt obligations held by financial institutions.

Periodic and upfront payments made on bank interest rate swaps to reduce the risk of holding tax-exempt municipal bonds are not treated as interest for purposes of either *IRC § 265(b)* or *§ 291(a)*; the payments are not compensation for the use or forbearance of money. *Ltr Rul 9824026*.

A financial institution waiver of its right under an interest adjustment clause to receive a higher interest rate on tax-exempt bonds resulted in a deemed exchange of old bonds for new bonds, with the new bonds deemed to have been issued on the date of the waiver. Since the waiver occurred after Aug 7, 1986, the institution was precluded from deducting the portion of its interest expense allocable to tax-exempt interest on the new bonds. *Rev Rul 87-19, 1987-1 CB 249*.

(n74)Footnote 65. *IRC §§ 265(b)(2), 291(e)(1)(B)(II)*.

The Tax Court has held that a parent corporation does not have to include tax-exempt obligations purchased by a subsidiary in the computation of the average adjusted bases of its tax-exempt obligations. *PSB Holdings, Inc v Commr, 129 TC 131 (2007)*.

(n75)Footnote 66. *IRC § 265(b)(3)(A), (B)*. Interest allocable to qualified tax-exempt obligations remains subject to the 20-percent disallowable rule of *IRC § 291*.

(n76)Footnote 67. *IRC § 265(b)(3)(C)*. In addition, not more than \$10 million of obligations can be designated as qualified tax-exempt obligations by any issuer (including subordinate entities) for any calendar year. *IRC § 265(b)(3)(D)*. Refunding obligations are not taken into account for this purpose if (i) they were not taken into account in determining whether the issuer is a qualified small issuer; (ii) the average maturity date of the refunding obligations is not later than the average maturity date of the refunded obligations; (iii) the refunding obligation has a maturity date not later than 30 years after the date the original obligation was issued; and (iv) the aggregate face amount of the refunding issue does not exceed \$10 million. The average maturity date requirement need not be met if the average maturity of the original issue is three years or less.

For this purpose, the date of issue of a draw-down construction loan note is the date on which more than a *de minimis* amount of funds is first advanced under the note; the amount of the draw-down note is the stated principal value of the note. *Rev Rul 89-70, 1989-1 CB 88*.

(n77)Footnote 68. *IRC § 265(b)(3)(C)(iii)*.

(n78)Footnote 68.1. *IRC § 265(b)(7)*, added by Section 1501(c) of ARRA. For purposes of applying this exclusion, a refunding bond (whether a current or advanced refunding), is treated as issued on the date of the issuance of the refunded bond (or in the case of a series of refundings, the original bond). *IRC § 265(b)(7)(C)*.

(n79)Footnote 68.2. See *IRC § 291(e)(1)(B)(iv)*, also added by ARRA.

(n80)Footnote 68.3. *IRC § 265(b)(3)(G)(i)*.

(n81)Footnote 68.4. *IRC § 265(b)(3)(G)(ii)*.

(n82)Footnote 68.5. A "qualified financing issue" is a composite, pooled or other conduit financing issue the proceeds of which are used directly or indirectly to make or finance loans to one or more ultimate borrowers, all of whom are "qualified borrowers." A "qualified borrower" means (1) a State or political subdivision thereof or (2) a § 501(c)(3) organization.

(n83)Footnote 68.6. HR Conf Rep 111-16, 111th Cong, 1st Sess (Feb 12, 2009), at 576.

(n84)Footnote 68.7. *Id.*

(n85)Footnote 69. See, eg, *Denman v Slayton, 282 US 514 (1931)*; *Drybrough v Commr, 376 F2d 350 (6th Cir 1967)* (*IRC § 265(a)(2)* applied even though purchase of securities was in wife's name; taxpayer failed to show that

funds used to purchase bonds were wife's separate property; funds came from borrowings); *Jacobson v Commr*, 28 TC 579 (1957) .

The Tax Court has held that, in an appropriate case, the provisions of *IRC* § 265(a)(2) may be used when one member of an affiliated group is the borrower and another member is the purchaser of the tax-exempt obligations. *H Enterprises Intl, Inc & Subs v Commr*, 105 TC 71 (1995) . The court found such an appropriate case in a second decision involving the same taxpayer reported as *TC Memo 1998-97* . The Tax Court was affirmed by the Eighth Circuit. 183 F3d 907 (8th Cir 1999) .

In Rev Rul, 2004-47, 2004-1 CB 941 , the Service took the following positions regarding the application of *IRC* § 265(a)(2) to situations in which a member of an affiliated group borrows money and transfers the money to another member of a group that is a dealer in tax-exempt obligations:

(1) If the funds contributed to the dealer are directly traceable to the contributor's borrowing, but are not directly traceable to the dealer's purchase or carry of tax-exempt obligations, *IRC* § 265(a)(2) applies to disallow a portion of the interest expense of the contributor, as determined by the allocation formula in § 7 of *Rev Proc 72-18*, 1972-1 CB 740 .

(2) If there is no direct evidence linking the borrowed funds to any funds transferred to the dealer in tax-exempt obligations, *IRC* § 265(a)(2) does not apply to disallow any portion of the interest expense of the borrowing member on the dealer member's investment in tax-exempt obligations.

(3) If the borrowed funds are directly traceable to a loan to the dealer in tax-exempt obligations, *IRC* § 265(a)(2) does not apply to disallow the interest expense of the borrowing member, but does apply to disallow a portion of the interest expense of the dealer, as determined by the allocation formula in § 7 of *Rev Proc 72-18* .

(n86)Footnote 70. *Rev Rul 55-389*, 1955-1 CB 276 .

Rev Proc 70-20, 1970-2 CB 499 , contains guidelines for the deduction of interest by banks holding tax-exempt securities. It has been amplified and modified by *Rev Proc 83-91*, 1983-2 CB 618 ; *Rev Proc 81-16*, 1981-1 CB 688 ; and *Rev Proc 78-34*, 1978-2 CB 535 .

(n87)Footnote 71. The language appears in a footnote to the Court's opinion in *US v Atlas Life Ins Co*, 381 US 233, 248-249 (1965) .

(n88)Footnote 72. *Ball v Commr*, 54 TC 1200, 1207 (1970) , *nonacq* 1972-1 CB 1 ; see also *Wisconsin Cheeseman, Inc v US*, 388 F2d 420 (7th Cir 1968) ; *Illinois Terminal RR v US*, 375 F2d 1016 (Ct Cl 1967) ; *Batten v US*, 322 F Supp 629 (ED Va 1971) .

Interest on loans to purchase US Treasury bonds is deductible. *Treas Reg* § 1.265-2(a). However, no deduction will be allowed if the necessity for the loan can be traced to the continued retention of tax-exempt obligations. The Eighth Circuit has held that such a situation exists if tax-exempt securities are used as collateral to obtain the loan. *Levitt v US*, 517 F2d 1339 (8th Cir 1974) .

A taxpayer maintained two separate investment accounts, one for taxable securities and the other for tax-exempt obligations. He proposed to finance the purchase of additional taxable securities in a margin account. The Service held, in *Ltr Rul 8624017* , that the margin account interest would not be deductible. The same result would obtain if the taxpayer purchased zero-coupon bonds. The Tax Court had reached the same result in *McDonough v Commr*, *TC Memo 1977-50* .

(n89)Footnote 73. *Ball v Commr*, 54 TC 1200, 1207 (1970) , *nonacq* 1972-1 CB 3 , see also *Wisconsin Cheeseman, Inc v US*, 388 F2d 420 (7th Cir 1968) ; *Illinois Terminal RR v US*, 375 F2d 1016 (Ct Cl 1967) ; *Batten v US*, 322 F

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(n90)Footnote 74. 388 F2d 420 (7th Cir 1968) .

(n91)Footnote 75. 388 F2d at 422 .

(n92)Footnote 76. *Mariorenzi v Commr*, 490 F2d 92 (1st Cir 1974) (no deduction for interest or mortgage loan obtained to directly assist purchase of tax-exempt bonds); *Israelson v US*, 367 F Supp 1104 (D Md 1973) , *aff'd per curiam* 35 AFTR2d 75-461 (4th Cir 1974) (deduction allowed for purchase money mortgage interest, but not for interest on loan used to purchase nonexempt securities).

(n93)Footnote 77. 413 F2d 636 (2d Cir 1969) , *cert denied* 396 US 1007 .

A registered broker-dealer obtains funds to finance margin purchases by its customers by borrowing from commercial banks using securities (including tax-exempts) held for the accounts of customers as collateral. *IRC § 265(2)* does not disallow a deduction for interest paid on such loans where the broker-dealer properly identifies and segregates the proceeds of the loans, as required by SEC Rule 15c 3-3. In essence, the borrowed funds are traceable to a dominant business purpose apart from the purchasing or carrying of tax-exempt securities. *Rev Rul 74-294, 1974-1 CB 71* .

An indebtedness was incurred by one affiliated corporation for the benefit of another with which it filed consolidated returns. At the time of the borrowing, the second corporation held tax-exempt obligations. According to *GCM 39514* , *IRC § 265(2)* barred a deduction for the interest incurred by the borrowing corporation. A similar result involving affiliated corporations can be found in *GCM 39515* .

(n94)Footnote 78. 413 F2d at 639-640 .

(n95)Footnote 79. An allocation was required because it was impossible to trace the borrowed money directly to the holdings of tax-exempt securities. This was considered a fairer measure of the appropriate disallowance than disallowing the entire interest on the debt.

The *Leslie* formula was applied in *Dillon, Read & Co v US*, 875 F2d 293 (Fed Cir 1989) , and *EF Hutton Group, Inc v US*, 811 F2d 581 (Fed Cir 1987) . The Service took the position, in *Dillon, Read*, that interest on loans collateralized by a broker-dealer's stock of tax-exempt securities should be totally disallowed, and that the allocation called for by *Leslie* should apply only to interest on loans not so secured. The Federal Circuit, relying on the special treatment accorded broker-dealers in *Rev Proc 72-18, 1972-1 CB 740* , held that the *Leslie* approach should prevail whenever it was impossible to trace the borrowed funds to the holding of tax-exempt securities. *Rev Proc 72-18* is reprinted as Appendix F, *infra* .

(n96)Footnote 80. *Treas Reg § 1.265-3(b)*. The amount of interest relating to exempt-interest dividends is determined by a fraction, the numerator of which is the amount of exempt-interest dividends received by the taxpayer, and the denominator of which is the total amount of dividends received (excluding capital gains dividends received and capital gains required to be included in the shareholder's computation of long-term gains).

(n97)Footnote 80.1. "Registered form" has the same meaning for purposes of *IRC § 163(f)* as for purposes of *IRC §§ 103(b)(3)* and 149 (requiring tax-exempt bonds to be in registered form). See *Temp Treas Reg § 5f.163-1(a)*, defining "registered form" with reference to *Treas Reg § 5f.103-1(c)*. The definition of registered form is discussed in

Chapter 17, § 17.02[1]. As with tax-exempt bonds, *IRC § 149(a)(3)(A)*, for purposes of *IRC § 163(f)*, book entry obligation can be treated as in registered form if the right to the principal of, and interest on, the obligation can be transferred only through a book entry in a manner consistent with regulations prescribed by the Treasury. See Chapter 17, § 17.02[1], fn 19.

(n98)Footnote 81. *IRC §§ 163(f)(2)(A)(i), (ii) and (iii)*. The exception for obligations with maturity dates at issuance of not more than one year eliminates the registration requirement for most commercial paper.

(n99)Footnote 82. *IRC § 163(f)(2)(C)*. Such regulations can only be applied prospectively to obligations issued after the regulations' effective date.

(n100)Footnote 83. The term "US person" includes a citizen or resident of the US, a domestic partnership, a domestic corporation, and any estate or trust other than a foreign estate or foreign trust. *IRC § 7701(a)(30)*.

An obligation not in registered form can be sold to a United States person that is a financial institution purchasing for its own account or for the account of a customer and that agrees to comply with the requirements of *IRC § 165(j)(3)(A)-(C)*, discussed in Ch 17. *Treas Reg § 1.163-1(c)(1)*.

(n101)Footnote 83.1. *IRC §§ 163(f)(2)(A)(iv), and 163(f)(2)(B)*. This exception too is subject to the Treasury's authority to issue, with prospective effect only, regulations that exclude a type of obligation from the exception, although its authority is not limited in this case to obligations of a type determined to be used frequently in avoiding Federal taxes.

(n102)Footnote 84. See Sections 502(a) and 502(f) of the Hiring Incentives to Restore Employment Act of 2010, Pub L No 111-147, *124 Stat 71 (2010)* (the HIRE Act of 2010").

(n103)Footnote 85. The treatment of accrued market discount is discussed in Ch 17.

(n104)Footnote 86. *IRC § 1277(a), (c)*. *IRC § 1277* does not apply to any tax-exempt bond. *IRC § 1278(a)(1)(C)*.

(n105)Footnote 87. *IRC § 1277(b)(2)(A)*. If there is net interest income for any taxable year, the taxpayer can elect to deduct any disallowed interest expense to the extent of such net interest income. *IRC § 1277(b)(1)*.

(n106)Footnote 88. *IRC § 1277(b)(2)(B)*.

(n107)Footnote 89. *IRC § 1277(d)*.

(n108)Footnote 90. *IRC § 1278(b)(1)(A)*.

(n109)Footnote 91. See § 17.02[1][b][vi], for a discussion of discounted short-term obligations.

(n110)Footnote 92. *IRC § 1282(c)*.

(n111)Footnote 93. *IRC § 1282(b)*.

(n112)Footnote 93.1. The limitations on the deductibility of OID in *IRC § 163(e)(5)(A)* with respect to an "applicable high yield discount obligation" (AHYDO) will not apply to certain AHYDOs issued between September 1, 2008 and December 31, 2009, inclusive. *IRC § 163(e)(F)(i)*. (The Secretary is authorized to extend the suspension period if such extension is deemed appropriate in light of distressed conditions in the debt capital markets). *IRC § 163(e)(F)(iii)*. In general, AHYDOs issued during this suspension period will be exempt from the *IRC § 163(e)(5)* rules provided they are issued in a debt-for-debt exchange (including an exchange resulting from a significant modification of a debt instrument) for a debt instrument of the same issuer that is not an AHYDO. (If a qualifying AHYDO is later exchanged for another AHYDO the latter will also qualify for the exemption. *IRC § 163(e)(5)(F)(ii)*.) However, if a

non-AHYDO debt instrument for which an AHYDO is exchanged was issued to a "related person" (within the meaning of *IRC* § 108(e)(4)-see text at § 17.05[3][b][iv])) or pays contingent interest of the kind described in *IRC* § 871(h)(4) (applied without regard to subparagraph (D))-see text at § 20.06[1][b]), the AHYDO issued in exchange does not qualify for exemption from the *IRC* § 163(e)(5) rules. *IRC* § 163(e)(5)(F)(i).

In Notice 2010-11, 2010-4 *IRB* 326, the Treasury exercised the authority granted by *IRC* § 163(e)(5)(F)(iii) by extending the suspension period to "qualified obligations" issued after December 31, 2009 and on or before December 31, 2010. An AHYDO will be considered a "qualified obligation" if, in addition to meeting the requirements stated above, it would not have been an AHYDO if its issue price, (determined under *IRC* §§ 1273(b)(1), (2) or (3) or *IRC* § 1274(b)(3)), were increased by the amount of any discharge of indebtedness income realized by the issuer (or obligor) upon the exchange of the AHYDO for a non-AHYDO. For example, assume an issuer issues a new debt instrument in 2010 with an issue price of \$80x and a stated redemption price at maturity of \$100x for a debt instrument that is not an AHYDO and has an issue price of \$100x. The issuer realizes \$20x of discharge of indebtedness income on the exchange. The new debt instrument is a "qualified obligation" not subject to the limitation on the deductibility of interest under *IRC* § 163(e)(5) if it is considered an AHYDO at its actual issue price of \$80x but would not have been an AHYDO if its issue price had been \$80x + \$20x = \$100x at the time of the exchange.

(n113)Footnote 94. *IRC* § 163(i). In determining whether a debt instrument is an applicable high yield discount obligation, any payment under the obligation is assumed to be made on the last day permitted under the instrument, and any payment in the form of another obligation (or stock) of the issuer (or a related person within the meaning of *IRC* § 453(f)(1)) is assumed to be made when the obligation or stock is required to be paid in cash or property other than the obligation or stock.

A debt instrument has significant OID if the aggregate amount that would be includable in gross income with respect to the instrument for periods before the close of any accrual period (as defined in *IRC* § 1272(a)(5)) ending after the fifth anniversary of the issue date exceeds the sum of (i) the aggregate amount of interest to be paid under the instrument before the close of the accrual period, and (ii) the product of the issue price of the instrument (as defined in *IRC* §§ 1273(b) and 1274(a)) and its yield to maturity. The issuer's choice of accrual periods to determine OID accruals is used to determine whether a debt instrument has significant OID. *Treas Reg* § 1.163-7(d).

See generally Levin & Gallagher, "New Code Section 163(e)(5) Limiting Deductibility of Interest on OID and PIK Debentures," 46 *Tax Notes* 555 (1990).

(n114)Footnote 95. A corporate holder of the instrument is allowed a dividends received deduction for the part of the disqualified portion that would have been treated as a dividend had it been distributed by the issuing corporation with respect to stock.

(n115)Footnote 95.1. Disqualified interest includes interest paid or accrued (directly or indirectly) by a taxable REIT subsidiary of a REIT to the REIT. See § 13.02[3] for the definition of a taxable REIT subsidiary.

(n116)Footnote 96. All members of an affiliated group are treated as a single taxpayer. *IRC* § 163(j)(6)(C).

(n117)Footnote 96.1. For foreign corporation payees, the tax-exempt status of the entity can result from treaty relief or the portfolio interest rules. See Umbrecht & Llewellyn, "Planning Pitfalls and Opportunities for Foreign Owned Corporations Under the Earnings Stripping Rules," 47 *Tax Lawyer* 641, 650 (1994).

(n118)Footnote 97. For this purpose, the debt-equity ratio is the ratio that the total indebtedness of the corporation bears to the sum of its money and the adjusted bases of its assets reduced by the amount of the indebtedness. The amount of any original issue discount indebtedness taken into account is its issue price plus the portion of original issue discount accrued under the rules of *IRC* § 1272 without regard to the adjustments for acquisition premiums described in *IRC* §§ 1272(a)(7) and 1272(b)(4).

The determination of the debt-equity ratio is made as of the last day of the taxable year of the payor. *Prop Treas Reg § 1.163(j)-1(b)*.

(n119)Footnote 98. Adjusted taxable income is the corporation's taxable income for the tax year, computed without regard to any carryforwards or disallowances specified in *IRC § 163(j)*, but with the modifications contained in *Prop Treas Reg § 1.163(j)-1(f)*.

(n120)Footnote 99. The disallowed amount is treated as disqualified interest paid or accrued in the succeeding taxable year, but the debt-equity ratio does not apply to the amount so treated.

(n121)Footnote 100. *IRC § 163(j)* is applied after taking into account other provisions that might limit the interest deduction. *Prop Treas Reg § 1.163(j)-7*. However, *IRC § 163(j)* is applied before application of the at-risk rules of *IRC § 465* and the passive activity loss rules of *IRC § 469*. *IRC § 163(j)(7)*.

(n122)Footnote 100.1. The President's revenue raising proposals for the fiscal 2010 budget include a proposal to amend *IRC 163(j)* by eliminating the 1.5 to 1 debt-equity safe harbor, reducing the 50-percent of adjusted taxable income threshold to 25 percent (except guaranteed debt would remain subject to the 50 percent threshold), limiting the carryforward for disallowed interest to 10 years, and abolishing entirely the carryforward of excess limitation. See US Dept of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (May 2009) at 33-34. These changes would apply to certain "expatriated entities" as defined in *IRC § 7874*, including taxpayers that would have been "expatriated entities" had *IRC § 7874* been in effect in years beginning after July 10, 1989. Although similar proposals to tighten the earnings stripping rules have been made in the past, this one is supported by a finding in a 2007 Treasury study for Congress that "[t]here is strong evidence that [inverted corporations] are stripping a significant amount of earnings out of their U.S. operations and, consequently, it would appear that section 163(j) is ineffective in preventing them from engaging in earnings stripping." See Jt Comm on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal (Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment)* (Sept 2009), p 56-69, quoting (at p 60) from US Dept of the Treasury, *Report to the Congress on Earnings Stripping Transfer Pricing and US Income Tax Treaties* (November 28, 2007), p 26.

(n123)Footnote 101. For example, if a corporation pays \$600 in interest to a foreign taxpayer resident in a country that has a treaty with the US under which interest is taxed at 15 percent rather than, say, 30 percent, the numerator of the fraction will be 15 percent (30 percent less 15 percent) and the denominator 30 percent, so that one-half of the interest will be treated as tax-exempt.

(n124)Footnote 102. *IRC § 163(j)(6)(D)*. A guarantee includes any arrangement under which a person (directly or indirectly) assures, on a conditional or unconditional basis, the payment of another's obligation under any indebtedness.

(n125)Footnote 103. A controlling interest is the direct or indirect ownership of at least 80 percent of the total voting power and value of all classes of stock of a corporation, or 80 percent of the profit and capital interests of any other entity. The attribution rules of *IRC § 267(c)(1)* and (5) apply, but are extended to ownership interests in entities other than corporations.

A gross basis tax is any income tax that is determined by reference to the gross amount of any item of income without any deduction. A net basis tax is any tax other than a gross basis tax. *IRC § 106(j)(6)(E)*.

One commentator has concluded that, as applied to third-party loans guaranteed by a foreign shareholder, *IRC § 163(j)* treats foreign-based multinationals more harshly than their US-based counterparts and likely violates the nondiscrimination provisions in most treaties. Yanowitz, "Section 163(j) and U.S. Subsidiaries with Foreign Shareholder Guaranteed Debt," *61 Tax Notes 1099* (1993).

(n126)Footnote 103.1. *IRC § 163(j)(8)*.

(n127)Footnote 104. *IRC § 163(l)(1), (2), (6)*. The term "disqualified debt instrument" does not include indebtedness issued by a dealer in securities (or a related party) that is payable in, or by reference to, equity (other than equity of the issuer or a related party) held by the dealer in its capacity as a dealer in securities, as defined in *IRC § 475. IRC § 163(l)(5)*.

A corporation issued units consisting of a five-year note and a three-year forward contract ("Purchase-Contract/Note unit") to purchase the corporation's common stock. In Rev Rul 2003-97, 2003-2 CB 380, the Service held that the interest accruing on the note was not disallowed under *IRC § 163(l)*. In so holding, the ruling found the following four factors to be critical:

- (1) The holder had the unrestricted legal right to convert the Purchase-Contract/Note unit into a Purchase-Contract/Strip unit or to settle the contract with separate cash and retain the note, and the holder was not economically compelled to keep the unit unseparated.
- (2) In the event of the issuer's bankruptcy, the contract would terminate and the associated note or strip would be released to the holder. The issuer was advised that the holder would be treated as a creditor in the bankruptcy proceeding.
- (3) The period the notes would remain outstanding after a remarketing was significant, both absolutely and relative to the total term of the notes. Notes are considered to remain outstanding only when not subject to redemption at the option of the issuer.
- (4) On the issue date, it was substantially certain that a remarketing of the notes would succeed. For this purpose, a remarketing of the notes is not substantially certain to succeed if a reset rate is capped.

(n128)Footnote 105. *IRC § 163(l)(3)*.

(n129)Footnote 106. *IRC § 163(l)(6)*.

(n130)Footnote 107. *Treas Reg § 1.163-13(a)*. Bond issuance premium is allocable to an accrual period based on a constant yield. The use of a constant yield to amortize bond premium is intended to generally conform the treatment of debt instruments with bond issuance premium with those having original issue discount.

(n131)Footnote 108. *Treas Reg § 1.163-13(b)*.

(n132)Footnote 109. *Treas Reg § 1.163-13(c)*.

(n133)Footnote 110. The value of a conversion option is determined under *Treas Reg § 1.171-1(e)(1)(iii)(A)*. See § 17.02[5][b].

(n134)Footnote 111. *Treas Reg § 1.163-13(d)(1)*.

(n135)Footnote 112. *Treas Reg § 1.163-13(d)(3)*.

(n136)Footnote 113. *Treas Reg §§ 1.163-13(d)(3)(i), 1.1272-1(b)(1)(i)*.

(n137)Footnote 114. *Treas Reg § 1.163-13(d)(3)(ii)*.

(n138)Footnote 115. See *Treas Reg § 1.1272-1(b)(1)(ii)*.

(n139)Footnote 116. *Treas Reg § 1.163-13(d)(3)(iii)*.

(n140)Footnote 117. *Treas Reg § 1.163-13(d)(4)(i)*.

(n141)Footnote 118. *Treas Reg § 1.163-13(d)(4)(ii)*.

(n142)Footnote 119. *Treas Reg § 1.163-13(e)(1)*. The issuer constructs the equivalent fixed rate debt instrument, as of the issue date, by using the principles of *Treas Reg § 1.1275-5(e)*. See § 17.02A[d] for a discussion of variable rate debt instruments.

(n143)Footnote 120. *Treas Reg § 1.163-13(e)(2)*. A discussion of inflation-indexed debt instruments can be found in § 17.02B.

(n144)Footnote 121. *Treas Reg § 1.163-13(e)(3)(i)*. If the bond provides for a contingency that is remote or incidental, the issuer takes the contingency into account under the rules contained in *Treas Reg § 1.1275-2(h)*. *Treas Reg § 1.163-13(e)(4)*.

(n145)Footnote 122. *Treas Reg § 1.163-13(e)(3)(ii)*.

(n146)Footnote 123. The yield to maturity is approximate because it has been rounded to two decimal places. The dollar amounts in the examples use the correct yield, with the amounts rounded to the nearest dollar.

(n147)Footnote 124. *IRC § 263(g)* is inapplicable if none of the taxpayer's positions that are part of the straddle are personal property. *Prop Treas Reg § 1.263(g)-1(b)*. See § 9.02[4], *supra*, for a discussion of the tax treatment of straddles.

(n148)Footnote 125. *Prop Treas Reg § 1.263(g)-2(a)*.

(n149)Footnote 126. *Prop Treas Reg § 1.263(g)-2(a)(1)*.

(n150)Footnote 127. *Prop Treas Reg § 1.263(g)-2(a)(1), (2)*.

(n151)Footnote 128. Interest, here, includes any amount paid or incurred in connection with personal property used in a short sale.

Indebtedness is incurred or continued to purchase or carry personal property that is part of a straddle if (1) the proceeds of the indebtedness are used directly or indirectly to purchase or carry the property, (2) the indebtedness is secured directly or indirectly by the property, and (3) payments on the indebtedness are determined by reference to the value or change in value of the personal property. *Prop Treas Reg § 1.263(g)-3(c)*.

(n152)Footnote 129. *IRC § 263(g)(2)*.

(n153)Footnote 130. *IRC § 263(g)(3)*.

(n154)Footnote 131. *IRC § 263(g)(4)*.

(n155)Footnote 132. *IRC § 163(m)*.

(n156)Footnote 133. *IRC § 6662A(b)*. An increase in taxable income includes any reduction of the excess of deductions allowed for the taxable year over gross income for the year, and any reduction if the amount of capital losses that would be allowed for the year (without regard to *IRC § 1211*).

(n157)Footnote 134. *IRC § 6707A(c)(1)*.

(n158)Footnote 135. *IRC § 264(a)(2)*. A contract is treated as a single premium contract if substantially all of the premiums are paid within four years from the date on which the contract was purchased, or if an amount is deposited with the insurer for payment of a substantial number of future premiums on the contract. *IRC § 264(c)*.

(n159)Footnote 136. *IRC § 264(a)(3)*. The provision is inapplicable to any amount paid or accrued by a person (i) if no part of four of the first seven annual premiums is paid under the plan by means of indebtedness, (ii) if the total amounts paid or accrued during the taxable year does not exceed \$100, (iii) if the amount was paid or accrued on indebtedness incurred because of an unforeseen substantial loss of income or unforeseen increase in the person's financial obligations, or (iv) if the indebtedness is incurred in connection with the person's trade or business. *IRC § 264(d)*. In applying the four-of-seven rule, if there is a substantial increase in the premiums on the contract, a new seven-year period begins on the date the first increased premium is paid.

(n160)Footnote 137. *IRC § 264(a)(4)*. A deduction is allowed if the policies or contracts cover an individual who is a key person to the extent that the aggregate amount of the indebtedness covering the individual does not exceed \$50,000. *IRC § 264(e)(1)*. A key person is an officer or 20-percent owner, except that the number of individuals who can be treated as key persons with respect to any taxpayer cannot exceed the greater of (a) five individuals or (b) the lesser of five percent of the total officers and employees of the taxpayer or 20 individuals. *IRC § 264(e)(3)*.

If the taxpayer is a corporation, a 20-percent owner is any person who owns directly 20 percent or more of the outstanding stock of the corporation or stock possessing 20 percent or more of the total combined voting power of all stock of the corporation. *IRC § 264(e)(4)(A)*. If the taxpayer is not a corporation, a 20-percent owner is any person who owns 20 percent or more of the capital or profits interest in the taxpayer. *IRC § 264(e)(4)(B)*.

(n161)Footnote 138. *IRC § 264(f)(1)*. The unborrowed policy cash value is the excess of the cash surrender value of the policy or contract determined without regard to any surrender charge, over the amount of any loan with respect to the policy or contract. *IRC § 264(f)(3)*.

(n162)Footnote 139. *IRC § 264(f)(4)*.

(n163)Footnote 140. *IRC § 264(f)(5)*

(n164)Footnote 1. See chapter 10 for a discussion of the tax treatment of short sales.

(n165)Footnote 1.1. *Commr v Wilson*, 163 F2d 680 (9th Cir 1947) , cert denied 332 US 842 ; *Commr v Wiesler*, 161 F2d 997 (6th Cir 1947) , cert denied 332 US 842 ; *Dart v Commr*, 74 F2d 845 (4th Cir 1935) ; *Rev Rul 62-42*, 1962-1 CB 133 .

(n166)Footnote 2. In *Hart v Commr*, 338 F2d 410 (2d Cir 1964) , the deduction was denied where the taxpayer's purpose was tax-avoidance as opposed to the production or collection of income; see also *Gold v Commr*, 41 TC 419 (1963) (no deduction, transaction a sham).

(n167)Footnote 3. The basis of the stock used to close the short sale is increased by the amount disallowed as a deduction.

(n168)Footnote 4. For this purpose, an extraordinary dividend is one that exceeds 5 percent of the amount realized in the short sale, if preferred stock, and 10 percent of the amount realized, if common stock. *IRC §§ 263(h)(3), 1059(c)*.

(n169)Footnote 5. *Main Line Distributors, Inc v Commr*, 321 F2d 562 (6th Cir 1963) ; 1955 *Prod Exposition, Inc v Commr*, 41 TC 85 (1963) .

(n170)Footnote 6. 1955 *Prod Exposition, Inc v Commr*, 41 TC 85 (1963) ; *Rev Rul 60-359*, 1960-2 CB 104 .

(n171)Footnote 1. The initiation fee charged by the New York Stock Exchange to new members is a business benefit that lasts beyond one year and must be treated as a nondeductible capital expenditure that is added to the cost basis of the seat on the Exchange. *Harman v Commr*, 72 TC 362 (1979) .

(n172)Footnote 2. A comprehensive discussion of *IRC* §§ 162 and 212 can be found in Rabkin & Johnson, 2 *Federal Income, Gift and Estate Taxation* Ch 3 (Matthew Bender).

Legal expenses incurred to recover securities loaned to a corporation of which the taxpayer was a shareholder were deductible in *Cruttenden v Commr*, 644 F2d 1368 (9th Cir 1981) . The expenses were for management, conservation, and maintenance of investment property, not to perfect or defend title to the securities.

The Service has ruled that fees charged for checks written against an interest-bearing personal checking account (NOW account) are nondeductible. The fee is charged for the check-writing privilege and not for maintaining the interest-bearing account. *Rev Rul 82-59, 1982-1 CB 47* .

(n173)Footnote 3. *Treas Reg* § 1.212-1(b).

(n174)Footnote 3.1. 568 F3d 537, 548-551 (5th Cir 2009) .

(n175)Footnote 4. *Mallinckrodt v Commr*, 2 TC 1128 (1944) , *acq* 1944 CB 18 , *aff'd* 146 F2d 1 (8th Cir 1945) , *cert denied* 324 US 871 ; *Collidge v Commr*, TC Memo 1942-6841; *Rev Rul* 55-23, 1955-1 CB 275 ; *Rev Rul* 3, 1953-1 CB 37 ; *Treas Reg* § 1.212-1(g). The service fee charged a participant in an automatic dividend reinvestment account is deductible in the year charged. *Rev Rul* 70-627, 1970-2 CB 159 .

(n176)Footnote 5. *Mallinckrodt v Commr*, 2 TC 1128 (1944) , *acq* 1944 CB 18 , *aff'd* 146 F2d 1 (8th Cir 1945) , *cert denied* 324 US 871 ; *Winter v Commr*, 1942 Tax Ct Memo LEXIS 20 .

(n177)Footnote 6. *Williams v Commr*, 3 TC 200 (1944) , *acq* 1944 CB 30 ; *Jergens v Commr*, 1943 Tax Ct Memo LEXIS 217 ; *Treas Reg* § 1.212-1(g). The advice need not be followed. *Picker v US*, 371 F2d 486 (Ct Cl 1967) .

(n178)Footnote 7. *Walters v Commr*, TC Memo 1969-5 ; *Bishop v Commr*, 4 TC 862 (1945) , *acq* 1945 CB 2 .

(n179)Footnote 8. *Kelly v Commr*, 23 TC 682 (1955) , *acq* 1955-1 CB 5 , *aff'd on other grounds* 228 F2d 512 (7th Cir 1956) ; *Fry v Commr*, 5 TC 1058 (1945) , *acq* 1954-1 CB 4 .

(n180)Footnote 9. *Disney v US*, 267 F Supp 1 (CD Cal 1967) , *aff'd* 413 F2d 783 (9th Cir 1969) ; *Wiesler v Commr*, 6 TC 1148 (1946) , *acq* 1948-1 CB 3 , *aff'd on other grounds* 161 F2d 997 (6th Cir) , *cert denied* 332 US 842 (1947) ; *Treas Reg* § 1.212-1(g).

(n181)Footnote 10. *Roy v Commr*, TC Memo 1968-99 ; *Tully v Commr*, TC Memo 1965-232 ; *Treas Reg* § 1.212-1(g).

(n182)Footnote 11. Expenses incurred in a trustee substitution proceeding were held deductible in *Nidetch v Commr*, TC Memo 1978-313 . The substitution allowed the taxpayer to secure the voting support of a substantial block of stock, thereby strengthening her position in the event of a contest.

(n183)Footnote 12. *Rev Rul* 65-13, 1965-1 CB 87 .

(n184)Footnote 13. *IRC* § 67(a). There is an exception to the 2 percent floor for costs paid or incurred in connection with the administration of an estate or non-grantor trust which would not have been incurred if the property were not held in an estate or trust. *IRC* § 67(e); *Prop Treas Reg* § 1.67-4; *Bay v Commr*, TC Memo 1998-411 . As interpreted by the Supreme Court, *IRC* § 67(e) is limited to expenses that are not "commonly" or "customarily" incurred

by individuals. See *Knight, Trustee v Commr*, 552 US 181 (2008) . In the Knight case, a trust sought an unrestricted deduction for investment advisory fees incurred, the trust argued, in order that the trustees' investments might satisfy the "reasonably prudent investor" standard of trust law. The Supreme Court held that the deduction was nevertheless subject to the 2 percent floor because investment advisory fees are a type of expense that is commonly incurred by individuals as well as estates and trusts.

In Notice 2008-32, 2008-1 CB 593 , supplemented in Notice 2008-116, 2008-2 CB 1372, modified and superseded by Notice 2010-32, 2010-16 IRB 594, the Internal Revenue Service announced that it and the Treasury Department expect to issue final regulations under Treas Reg § 1.67-4 consistent with the Supreme Court's decision in Knight. The final regulations will also address the issue raised when a nongrantor trust or estate pays a "Bundled Fiduciary Fee" for costs incurred in-house by the fiduciary, some of which are subject to the 2-percent floor and some of which are fully deductible. See *Prop Treas Reg § 1.67-4(c)*. The Service announced that the final regulations will only be applied prospectively, and that in taxable years ending before January 1, 2010, taxpayers (trusts and estates) may deduct the full amount of such Fee without regard to the 2 percent floor. However, payments by the fiduciary to third parties for expenses that are readily identifiable as subject to the 2-percent floor must be treated separately from the otherwise Bundled Fiduciary Fee. Notice 2010-32, 2010-16 IRB 594 .

(n185)Footnote 14. *IRC § 67(b)*.

(n186)Footnote 15. *IRC § 67(c)*.

(n187)Footnote 16. A regulated investment company is publicly traded for this purpose if its shares are continuously offered pursuant to a public offering, are regularly traded on an established securities market, or are held by or for no fewer than 500 persons at all times during the taxable year.

(n188)Footnote 17. The provision is effective for taxable years beginning after Dec 31, 1990 and before Jan 1, 1996. It does not apply to estates and trusts.

(n189)Footnote 1. *Heffelfinger v Commr*, 5 TC 985 (1945) ; *Curtis v Commr*, 3 TC 648 (1944) .

(n190)Footnote 2. *Treas Reg § 1.265-1(c)*; see, eg, *Jamison v Commr*, 8 TC 173 (1947) , *acq* 1947-1 CB 2 . The failure to allocate may result in total nondeductibility. *Strauss v Commr*, 1943 Tax Ct Memo LEXIS 315 .

(n191)Footnote 3. *Treas Reg § 1.265-1(c)*. The taxpayer must submit a statement with his return showing that amount directly allocable to tax-exempt income, the amount of indirect expense apportioned to tax-exempt income and the basis of the apportionment. *Treas Reg § 1.265-1(d)*.

(n192)Footnote 4. *Rev Rul 63-27*, 1963-1 CB 57 . In *Alt v Commr*, TC Memo 1969-292 , the allocation was made in proportion to the relative values of the tax-exempt and nontax-exempt securities.

(n193)Footnote 5. *Rev Rul 60-236*, 1960-2 CB 109 .

(n194)Footnote 6. *Commr v McDonald*, 320 F2d 109 (5th Cir 1963) ; *Commr v Universal Leaf Tobacco Co*, 318 F2d 658 (4th Cir 1963) ; *Hawaiian Trust Co v US*, 291 F2d 761 (9th Cir 1961) ; *Tovrea Land & Cattle Co v US*, 11 AFTR2d 1374 (D Ariz 1963) ; *City Bank of Washington v Commr*, 38 TC 713 (1962) , *nonacq* 1964-2 CB 8 .

(n195)Footnote 7. *Hawaiian Trust Co v US*, 291 F2d 761 (9th Cir 1961) .

(n196)Footnote 8. *Rev Rul 63-233*, 1963-2 CB 113 , revoking *Rev Rul 60-236*, 1960-2 CB 109 .



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CHAPTER 20 Foreign Securities and Foreign Shareholders

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CHAPTER 20 Foreign Securities and Foreign Shareholders

2-20 Taxation of Securities Transactions § 20.01

§ 20.01 Introduction

With *IRC Section 61(a)* requiring the inclusion in gross income of "all income from whatever source derived," a U.S. taxpayer holding foreign securities treats the income from such securities in a manner no different from that accorded his other income. However, the amount of tax liability is affected by the receipt of income from foreign sources; the taxpayer is allowed a credit against U.S. tax for the income taxes paid to foreign countries on or with respect to such income. And, if the taxpayer is a domestic corporation receiving dividends from a foreign subsidiary, it might be eligible for a credit with respect to foreign taxes paid by the subsidiary on the earnings that produce the dividend.

The foregoing assumes that the investment is not made in an attempt to avoid federal income taxes. A taxpayer's tax burden could be reduced if a closely held corporation, organized in a country that imposed a lesser tax on income than the United States, were used as the vehicle for investing in foreign securities. Of course, the taxpayer would be subject to tax if the stock were sold or redeemed, or if the corporation liquidated, but the income then derived would, in all probability, be long-term capital gain taxed at preferential rates.

The sort of tax avoidance described in the preceding paragraph can no longer be accomplished. The Code requires United States shareholders of foreign personal holding companies to report their proportionate shares of the undistributed foreign personal holding company income of the corporation. A somewhat similar scheme attributes certain of the undistributed income of a controlled foreign corporation to its shareholders, while a third provision affects the character of the gain realized on the disposition of foreign investment company stock unless the company has elected to distribute its income currently.

The foreign taxpayer generally pays United States taxes only if income is derived from United States sources. And, then, investment income is taxed separately from the portion of income that is effectively connected with the conduct of a trade or business within the United States. The former is subject to tax at a flat rate of 30 percent, unless a lesser rate is imposed by treaty; the latter, which may include foreign source income if certain factors exist, is assessed at the regular rates paid by United States taxpayers.



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CHAPTER 20 Foreign Securities and Foreign Shareholders

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§ 20.02 Tax Consequences of Investments in Foreign Securities by United States Citizens and Residents--In General

[1] Gains and Losses on Dispositions of Foreign Securities

As a general rule, gains and losses derived from dealings in foreign securities are treated no differently from those resulting from transactions in domestic securities. If the security is a capital asset, its sale or exchange produces capital gain or loss, unless the transaction is subject to some nonrecognition provision of the Code, e.g., *IRC Section 1036*.ⁿ¹ The principal points of departure are (1) the sale or exchange of stock in a foreign investment company (any gain realized is treated as ordinary income to the extent of the taxpayer's ratable share of earnings and profits accumulated since December 31, 1962)ⁿ² and (2) the sales or exchange of stock in a controlled foreign corporation (in which case a portion of the gain may be treated as a dividend).ⁿ³

[2] Dividends Paid on Foreign Stock

Dividends received from foreign corporations by an individual are fully includable in gross income.

A corporate shareholder is also required to report the entire amount of foreign dividends received as gross income. However, it is entitled to a dividends received deduction on the United States source portion of the dividends if the domestic corporation owns at least 10 percent (by vote and value), of the foreign corporation paying the dividends, and the latter is not a foreign personal holding company passive foreign investment company.ⁿ¹

If the domestic corporation owns 10 percent or more of the voting stock of the foreign corporation, it will have additional dividend income--the *IRC Section 78* or "gross-up" dividend--whenever it elects to claim a foreign tax credit for taxes deemed to have been paid by it under the provisions of *IRC Section 902(a)*.ⁿ² The grossed-up amount is treated as a dividend for all purposes of the Code save one; it is ineligible for the dividends received deduction of *IRC Section 245*.

[3] Interest Paid on Foreign Securities

All interest on foreign securities received by a resident taxpayer or United States citizen must be reported as gross income. Included within this requirement is any interest paid on obligations issued by a foreign government; the exclusion provided by *IRC Section 103* does not extend to such obligations.ⁿ¹

[4] Credit for Foreign Taxes Paid

[a] Election to Take the Credit. A taxpayer incurring foreign tax liability may claim the amount of such taxes as a deduction under *IRC Section 164*. The taxpayer may also choose to take the amount paid as a credit against his federal income tax for the year.ⁿ¹ However, the credit is not allowed against the minimum tax on tax preferences, the accumulated earnings tax, the personal holding company tax, the tax on war loss recoveries, or the tax on recoveries of foreign expropriation losses.ⁿ²

As a general rule, the credit is allowed to the person on whom the tax is imposed, although a husband and wife making a joint return may compute the credit on the basis of the total taxes paid by or accrued against both spouses.ⁿ³ And if the husband and wife are domiciled in a community property state and file separate returns, any foreign tax paid on community income may be divided and a credit for one half thereof allowed to each spouse.ⁿ⁴ A partner is entitled to claim his proportionate share of the foreign taxes paid by the partnership; a beneficiary of an estate or trust may do the same with respect to the taxes of the estate or trust.ⁿ⁵ The shareholder in a regulated investment company may claim his share of the credit if the corporation makes the election provided by *IRC Section 853*.ⁿ⁶ Finally, a domestic corporation owning 10 percent or more of the voting stock of, and receiving dividends from, a foreign corporation may be deemed to have paid a proportion of the foreign taxes paid by the foreign corporation with respect to the accumulated profits from which the dividends are paid.ⁿ⁷

The election to take the credit (or to change the choice from credit to deduction or from deduction to credit) may be made when the return is filed or at any time before the expiration of the statute of limitations for filing a claim for refund for the year involved.ⁿ⁸ However, in lieu of the normal limitation period of three years after the filing of the return or two years after the payment of the tax, whichever is later,ⁿ⁹ *IRC Section 6511(d)(3)(A)* prescribes a special 10-year period if the claimed overpayment relates to foreign taxes.^{n9.1} If there is an agreement to extend the time for filing a claim for refund, the time for making the choice is likewise extended.ⁿ¹⁰ The credit can be claimed even though the taxpayer elects not to itemize deductions.ⁿ¹¹ However, it is unavailable if the taxpayer (a) elects to take any part of the eligible foreign taxes paid or accrued during the year as a deduction under *IRC Section 164*,ⁿ¹² (b) has extraterritorial income that is excluded from gross income under *IRC § 114*,^{n12.1} or (c) is a regulated investment company that has exercised the election under *IRC Section 853*.ⁿ¹³ Nor can it be claimed by (1) a United States citizen or domestic corporation entitled to the benefits of the exemption provided by *IRC Section 931* for income derived from sources within possessions of the United States,ⁿ¹⁴ (2) a citizen of a possession of the United States (except Puerto Rico) who is not otherwise a citizen of the United States, unless such person resides within the United States,ⁿ¹⁵ (3) an inhabitant of the Virgin Islands,ⁿ¹⁶ and (4) an alien resident of the United States or Puerto Rico, if (a) the alien is a citizen of a country which does not provide a tax credit to citizens of the US residing in such country, and (b) the President has declared that the credit will be allowed only if that country grants reciprocity by allowing United States citizens residing there a similar credit.ⁿ¹⁷

[b] Taxes Eligible for the Credit--The General Rule. A tax is eligible for the foreign tax credit only if it is an income, war profits, or excess profits tax imposed by a foreign country, by a political subdivision of a foreign country,ⁿ¹⁸ or by a possession of the United States--Guam, Puerto Rico, and the Virgin Islands.ⁿ¹⁹ However, any otherwise creditable tax will not be treated as such if (1) the amount of the tax is used (directly or indirectly) by the country imposing the tax to provide a subsidy by any means to the taxpayer, a related person within the meaning of *IRC Section 482*, or any party to the transaction or a related transaction, and (2) the subsidy is determined (directly or indirectly) by reference to the amount of the tax or the base used to compute it.ⁿ²⁰ The amount qualifying for the credit is limited to the tax itself;ⁿ²¹ no credit is given for interest and penalties paid in addition to the tax.ⁿ²²

The United States concept of a tax on income determines whether a particular tax can qualify as a creditable tax; the classification or characterization given the tax by the foreign legislation is not controlling.ⁿ²³ Thus, an amount paid to a foreign country for the release of claims which it had against the taxpayer was held not to be the payment of a foreign tax for which a credit was available, even though the payment was termed a tax under the laws of the foreign

country.ⁿ²⁴ And since the tax must be on income, sales taxes, turnover taxes, value added taxes, taxes on business capital, and taxes based on output are not creditable taxes.ⁿ²⁵ But this does not mean that the tax must be on net income; an impost on gross income will qualify for the foreign tax credit, since such a tax could be imposed by Congress.ⁿ²⁶

There is one other tax for which a credit can be claimed, namely, "a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States."ⁿ²⁷ A tax is in lieu of an income tax if, and only if, (1) it is a tax in the sense that it calls for a compulsory payment pursuant to the authority of the foreign country to levy taxes, and has a predominant character similar to that of an income tax in the United States sense, and (2) operates as a tax in substitution for, and not in addition to, an income tax or series of income taxes otherwise imposed.ⁿ²⁸

[c] Taxes Eligible for the Credit--Taxes Deemed Paid by Domestic Corporations. By virtue of *IRC Section 902(a)*, a domestic corporation, which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends during the taxable year,ⁿ²⁹ is deemed to have paid a proportion of the post-1986 income taxes paid or deemed paid by the foreign corporation to any foreign country, or to any possession of the United States.^{n29.1} The proportion of foreign taxes deemed paid can be expressed in terms of the following formula:

$$\frac{\text{dividends received}}{\text{.....X}} \times \text{post-1986 foreign taxes.}^{\text{n29.2}}$$

The foreign corporation's post-1986 undistributed earnings are its earnings and profits (computed in essentially the same manner as a domestic corporation, but in the foreign corporation's functional currency) accumulated in taxable years beginning after December 31, 1986, and determined as of the close of the taxable year in which the dividend is distributed without diminution by reason of dividend distributions during the taxable year.ⁿ³⁰ The corporation's post-1986 foreign income taxes are the sum of (1) the foreign income taxes with respect to the taxable year of the foreign corporation in which the dividend is distributed, and (2) the foreign income taxes with respect to prior taxable years beginning after 1986, to the extent that the taxes were not attributable to dividends distributed by the foreign corporation in prior years.ⁿ³¹ If the first day on which the domestic corporation owns 10 percent of the voting stock of the foreign corporation and the requirements of a qualified group are met is in a taxable year of the foreign corporation beginning after December 31, 1986, the post-1986 undistributed earnings and foreign income taxes of the foreign corporation are determined by taking into account only periods beginning on the first day of the first taxable year in which the requirements are met.ⁿ³²

As an illustration:

Example:

If X Corp., a domestic corporation owns at least 10 percent of the voting stock of Y Corp., a foreign corporation, which (1) has post-1986 undistributed earnings of \$120,000, (2) pays \$30,000 in taxes to foreign countries, and (3) distributes \$60,000 as a dividend to X Corp., the latter is deemed to have paid \$15,000 ($\$60,000 / \$120,000 \times \$30,000$) in foreign taxes. Because of this, X Corp.'s dividend income is \$75,000 not \$60,000; *IRC Section 78* requires the domestic corporation to "gross up" the amount of foreign taxes paid by it and to treat that amount as a dividend received from the foreign corporation. However, the gross-up dividend does not itself generate a deemed-paid credit (it is not considered a dividend received by the corporation for the purposes of *IRC Section 902*),ⁿ³³ nor is it taken into account in determining the dividends received deduction of *IRC Section 245*.ⁿ³⁴

Foreign income taxes incurred with respect to dividends paid out of accumulated profits for taxable years beginning before the first taxable year taken into account in determining the post-1986 undistributed earnings of a foreign corporation give rise to a deemed credit determined under the rules in effect before the Tax Reform Act of 1986.ⁿ³⁵

The applicable formula is:

$$\frac{\text{dividends received}}{\text{accumulated profits in excess of } x \text{ foreign taxes.}} \times \text{foreign taxes}$$

However, any dividend distributed after 1986 is treated as made out of post-1986 undistributed earnings to the extent thereof.ⁿ³⁷

If a foreign corporation is a member of a qualified group and owns 10 percent of the voting stock of another foreign corporation from which it receives dividends, the first corporation is deemed to have paid the same proportion of the post-1986 foreign income taxes paid by the second corporation as would be the case if the first corporation were a domestic corporation.ⁿ³⁸ A qualified group is defined as the first foreign corporation mentioned in the previous sentence and any other foreign corporation if (1) the domestic parent owns at least 5 percent of the voting stock of the other foreign corporation indirectly through a chain of foreign corporations connected through stock ownership of at least 10 percent of their voting stock, (2) the first corporation is the first-tier corporation in the chain, and (3) the other foreign corporation is not below the sixth tier in the chain.ⁿ³⁹ A qualified group does not include any foreign corporation below the third tier in the chain unless the foreign corporation is a controlled foreign corporation and the domestic shareholder and the domestic corporation is a United States shareholder in such foreign corporation.ⁿ⁴⁰ *IRC Section 902(b)(1)* will apply to those taxes paid by a member of the qualified group below the third tier only with respect to those periods during which it was a controlled foreign corporation.ⁿ⁴¹

No deemed-paid foreign tax credit is allowed for taxable years beginning after August 5, 1997 for foreign income taxes incurred by noncontrolled foreign corporations below the third tier or by controlled foreign corporations below the sixth tier, even though a liquidation, reorganization, or similar transaction might cause the corporations to meet the requirements of *IRC Section 902*.^{n41.1}

The following example illustrates the computation of the deemed-paid credit when there are second and third-tier corporations:

Example:

D Corp., a domestic corporation, owns 20 percent of *F Corp.*, a foreign corporation. *F Corp.*, in turn, owns 50 percent of the voting stock of another foreign corporation, *S Corp.*, which owns 60 percent of *T Corp.*, still another foreign corporation. The indirect ownership requirement is satisfied since *D Corp.* owns indirectly 10 percent (20 percent x 50 percent) of *S Corp.* and 6 percent (10 percent x 60 percent) of *T Corp.* The three foreign corporations have profits, pay foreign income taxes, and pay dividends for 1987 as follows:

T Corp.

Gains, profits, and income for 1987 ⁿ⁴²	\$250,000
Foreign in- come taxes by <i>T Corp.</i>	50,000
Dividend paid to <i>S Corp.</i>	150,000
Foreign in- come taxes	

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deemed paid
by S Corp.

\$150,000

(\$ 30,000

 x
\$50,000)n43

S Corp.

\$250,000

Gains, profits,
and income
(including di-
vidend from *T*
Corp.)

\$200,000

Foreign in-
come taxes
paid by *S*
Corp.

50,000

Foreign in-
come taxes
paid and
deemed paid
by *S Corp.* for
1987
(\$50,000 +
\$30,000)

80,000

Dividend paid
to *F Corp.*

100,000

Foreign in-
come taxes
paid and
deemed paid
by *F Corp.*

\$100,000

(\$ 40,000

 x
\$80,000)

\$200,000

F Corp.

Gains, profits,
and income
(including di-
vidend from *S*
Corp.)

\$125,000

Foreign in-

25,000

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come taxes
paid by *F*
Corp.

Foreign in-
come taxes
paid and
deemed paid
by *F* Corp.
(\$25,000 +
\$40,000)

65,000

Dividend paid
to *D* Corp.ⁿ⁴⁴

25,000

Foreign in-
come taxes
deemed paid
by *D* Corp.

\$ 25,000

(

\$ 13,000

 x
 \$65,000)

D Corp.'s
gross-up di-
vidend under
IRC Section 78

\$125,000

\$ 13,000

Additional considerations arise if there are post-1986 deficits that are carried back to pre-1987 earnings and profits or pre-1987 deficits that are carried forward. The rules described below apply only with respect to a foreign corporation whose functional currency after the effective date of the Tax Reform Act of 1986 is the same as it was before the Act.ⁿ⁴⁵

In computing the deemed-paid foreign tax credit for dividends paid in a taxable year of the foreign corporation in which there is a deficit in the post-1986 undistributed earnings pool, the deficit is carried back to years prior to the effective date of the Tax Reform Act of 1986. The amount carried back will reduce the earnings and profits of the pre-effective date years for purposes of calculating the deemed-paid credit and will be removed from the pool of post-1986 undistributed earnings.

The following examples illustrate the Service's position with respect to the carryback and carryforward of the deficits. The examples assume that (1) all earnings and profits and deficits are attributable to the taxpayer's general limitation category (*IRC Section 904(d)(1)(I)*); (2) the foreign corporation's earnings and profits and related tax amounts are computed in the corporation's functional currency, which did not change from pre-1987 years to post-1986 years; (3) the foreign taxes attributable to post-1986 taxable years have been translated into United States dollars at the exchange rate on the date of payment as required by *IRC Section 986(b)*; and (4) the domestic shareholder and foreign corporation have the same calendar taxable year.

Example 1:

The earnings of foreign taxes paid by, and distributions from, the foreign corporation (in the

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corporation's functional currency) for the period 1985 through 1990 are as follows:

Year	After-Tax Earnings	Foreign	December 31 Distributions
1985	\$150,000	\$120,000	-0-
1986	150,000	120,000	-0-
1987	(100,000)	10,000	50,000
1988	100,000	50,000	-0-
1989	-0-	-0-	50,000
1990	-0-	-0-	-0-

The above gives rise to the following cumulative amounts:

Year	Current and Accumulated Earnings	Post-1986 Undistributed Pool of Earnings	Post-1986 Pool of Foreign Taxes
1985	\$150,000		
1986	300,000		
1987	200,000	(100,000)	\$10,000
1988	250,000	100,000	60,000
1989	250,000	100,000	60,000
1990	200,000	50,000	30,000

Under *IRC Section 316(a)*, the \$50,000 distribution in 1987 is treated as a dividend in its entirety because the current and accumulated earnings of \$200,000 (\$150,000 from each of 1985 and 1986 minus the 1987 deficit of \$100,000) exceeds the amount of the distribution. The dividend is deemed to be made out of 1986 earnings and profits. The denominator for the deemed-paid dividend fraction is \$50,000 (the 1986 earnings of \$150,000 reduced by the \$100,000 deficit carried back to 1986 from the post-1986 undistributed earnings pool); the numerator is \$50,000 (the amount of the distribution); the deemed-paid credit is \$120,000.

The \$100,000 deficit for 1987 that is carried back to 1986 is removed from the post-1986 undistributed pool; the \$50,000 distribution in 1987 has no effect on the post-1986 undistributed earnings pool since the amount thereof was a negative number. (The distribution does reduce accumulated earnings.) Thus, when the foreign corporation realizes \$100,000 in earnings in 1988, the post-1986

earnings pool becomes \$100,000. The \$50,000 distribution in 1988 reduces both the amount of positive post-1986 undistributed earnings and the amount of accumulated earnings.

The \$10,000 of foreign taxes associated with the 1987 deficit will not be carried back to 1986 or removed from the pool of post-1986 foreign income taxes. Accordingly, when the \$50,000 dividend is paid in 1989, the denominator for the deemed-paid credit fraction is \$100,000 (the post-1986 undistributed earnings pool at the time of distribution), the numerator is \$50,000 (the amount of the distribution), and the deemed-paid credit is \$30,000 (\$50,000/\$100,000 times the post-1986 pool of foreign taxes).

If a foreign corporation pays a dividend in a year when it has a deficit in its post-1986 undistributed earnings pool, carrying back the deficit may prevent the crediting of foreign income taxes paid with respect to earnings and profits of a pre-1987 year. By way of illustration, if the foreign corporation in the preceding example had a deficit in earnings for 1987 of \$150,000 instead of \$100,000, the 1987 distribution of \$50,000 would still be a dividend, but it would be deemed to be made out of 1985 earnings since the deficit would offset all of the 1986 earnings. Because no future distribution would be treated as made out of 1986 earnings, the foreign income taxes paid with respect to those earnings would never be creditable. The denominator of the deemed-paid credit fraction would be \$150,000 (the 1985 earnings), and the deemed-paid credit would be \$40,000 (\$50,000/\$150,000 times the \$120,000 of foreign taxes). In addition, the \$150,000 deficit would be removed from the post-1986 undistributed pool by the 1987 distribution because the deficit was carried back to offset pre-1987 earnings and profits.

The dividend in the preceding example was paid in 1987, the first post-1986 year. However, the deficit in the post-1986 earnings pool cannot be carried back to a pre-effective date year unless there is a dividend.

Example 2:

Assume that a foreign corporation has earnings and profits, pays foreign income taxes, and makes distributions as follows:

Year	After-Tax Earnings	Foreign Taxes	December 31 Distributions
1986	\$100,000	\$80,000	-0-
1987	(50,000)	-0-	-0-
1988	150,000	120,000	100,000
1989	75,000	20,000	-0-
1990	25,000	20,000	120,000
1991	-0-	-0-	-0-

The above gives rise to the following cumulative amounts:

Year	Current and Accumulated Earnings	Post-1986 Undistributed Pool of Earnings	Post-1986 Pool of Foreign Taxes
198	\$100,0		

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6	00		
1987	50,000	(50,000)	-0-
1988	200,00	100,00	120,00
1989	175,00	75,000	20,00
1990	200,00	100,00	40,00
1991	80,000	-0-	-0-

In this case, no portion of the 1987 deficit of \$50,000 is carried back because no distribution is made until 1988, a year in which the post-1986 undistributed earnings pool is positive. The 1988 dividend is made entirely out of the post-1986 pool of undistributed earnings because the pool is at least as great as the dividend. The denominator of the deemed-paid credit fraction is \$100,000 (the post-1986 undistributed earnings pool as of 1988, the year of distribution); the numerator is \$100,000 (the amount of the distribution); the deemed-paid credit is \$120,000.

Since the post-1986 undistributed earnings pool in 1990 is only \$100,000, the portion of the 1990 dividend of \$120,000 that can be made out of post-1986 undistributed earnings is limited to \$100,000. The additional \$20,000 will be deemed made out of the 1986 earnings and profits of \$100,000. The denominator of the deemed-paid credit fraction for the portion of the dividend made out of the post-1986 undistributed earnings pool is \$100,000, and the credit derived therefrom is \$40,000. The denominator of the fraction for the portion of the dividend made out of the 1986 earnings and profits is \$100,000; the deemed-paid credit relating thereto is \$16,000 (\$20,000 dividend/\$100,000 earnings and profits times \$80,000 foreign taxes paid with respect to 1986 earnings).

The amount of a deficit in earnings and profits of the foreign corporation accumulated as of the end of the last pre-effective date taxable year is carried forward and included in the post-1986 undistributed earnings pool as of the first day of the foreign corporation's first taxable year beginning after December 31, 1986.

Example 3:

Assume that the foreign corporation has earnings and profits, pays the foreign income taxes, and makes distributions as follows:

Year	After-Tax Earnings	Foreign Taxes	December 31 Distributions
1984	\$25,000	\$20,000	-0-
1985	(100,000)	5,000	-0-
1986	(25,000)	-0-	-0-
1987	200,000	100,000	-0-
1988	100,0	50,000	200,000

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8	00		
198	100,0	50,000	-0-
9	00		

The above give rise to the following cumulative amounts:

Year	Current and Accumulated Earnings	Post-1986 Undistributed Pool of Earnings	Post-1986 Pool of Foreign Taxes
1984	\$25,000		
1985	(75,000)		
1986	(100,000)		
1987	100,000	100,000	100,000
1988	200,000	200,000	150,000
1989	100,000	100,000	50,000

The post-1986 undistributed earnings pool is reduced by the \$100,000 accumulated deficit in earnings and profits existing at the end of 1986. Under *IRC Section 316(a)*, the 1988 dividend distribution of \$200,000 represents all of the corporation's current and accumulated earnings and profits and is made out of the post-1986 undistributed earnings pool of \$200,000. The denominator of the deemed-paid credit is \$200,000 (\$300,000 in post-1986 earnings and profits reduced by the \$100,000 accumulated deficit carried forward from 1986). The deemed-paid credit is \$150,000 (\$200,000 dividend/\$200,000 post-1986 undistributed earnings pool times \$150,000 post-1986 pool of foreign taxes). The foreign taxes associated with pre-1987 tax years are not carried forward and included in the post-1986 pool of foreign income taxes.

The results will be modified if a dividend is paid out of current earnings and profits and there is a deficit in current and accumulated earnings and profits.

Example 4:

Assume the following facts with respect to the foreign corporation:

Year	After-Tax Earnings	For- eign Taxe s	December 31 Distributions
1986	(100,000)	-0-	-0-
1987	150,000	120,000	100,000
1988	(150,000)	-0-	-0-

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1989	100,000	50,000	100,000
1990	250,000	100,000	50,000

The cumulative figures are:

Year	Current and Accumulated Earnings	Post-1986 Undistributed Pool of Earnings	Post-1986 Pool of Foreign Taxes
1986	(100,000)		
1987	50,000	50,000	120,000
1988	(200,000)	(200,000)	-0-
1989	(100,000)	(100,000)	50,000
1990	50,000	50,000	150,000

The 1987 distribution of \$100,000 is a dividend in its entirety as a result of the current earnings and profits of \$150,000. The denominator of the deemed-paid credit fraction is \$50,000 (the post-1986 undistributed earnings pool of \$150,000 reduced by the \$100,000 accumulated deficit carried forward). Although the dividend is \$100,000, the deemed-paid credit cannot exceed the foreign taxes actually or deemed paid. Thus, the numerator of the fraction cannot exceed the denominator and, in this case, is limited to \$50,000. The deemed-paid credit is, therefore, \$120,000 (\$50,000/\$50,000 times \$120,000).

The 1987 dividend of \$100,000 reduces the current earnings and profits for 1987 to \$50,000, which is then added to the \$100,000 accumulated deficit from the previous year to produce an accumulated deficit at the start of 1988 of \$50,000.

The \$100,000 distribution in 1989 will be taxed as a dividend because there are current earnings and profits of \$100,000. Since there is a deficit in the corporation's post-1986 undistributed earnings pool of \$100,000 (the \$50,000 deficit in accumulated earnings and profits at the end of 1987 plus the \$150,000 deficit in earnings and profits for 1988, reduced by the \$100,000 in earnings and profits for 1989), the foreign income taxes of \$50,000 paid in 1989 will not be creditable. However, the amount will remain in the post-1986 pool of foreign taxes not previously credited.^{n45.1}

The \$100,000 dividend in 1989 is applied against and completely eliminates the \$100,000 in current earnings and profits for that year, and, thus, the accumulated deficit at the start of 1990 is the same as it was at the beginning of 1989, namely, \$200,000.

The \$50,000 distribution in 1990 is a dividend due to the existence of \$250,000 in current earnings and profits. The post-1986 undistributed earnings pool for 1990 is \$50,000 (current earnings and profits of \$250,000 less \$200,000 deficit in the pool at the end of 1989); the deemed-paid credit is \$150,000 (\$50,000/\$50,000 times \$150,000, the pool of foreign taxes not previously credited).

[d] Year in Which the Credit May Be Taken. Under *IRC Section 905(a)*, the foreign tax credit "may, at the option of the taxpayer and irrespective of the method of accounting employed in keeping his books, be taken in the year in which the taxes of the foreign country or the possession of the United States accrued" Thus, cash basis taxpayers can take the credit either in the year in which the foreign tax is paid or, if they so elect, in the year in which the taxes accrue.ⁿ⁴⁶ But, once a cash basis taxpayer makes the election to take the credit in the year of accrual, this method must be followed in all subsequent years.ⁿ⁴⁷ This prevents the claiming of a second deduction in the year in which they are paid, although, the taxpayer can get a credit for both the taxes paid and the taxes accrued in the year for which the election is first made.ⁿ⁴⁸

A foreign tax is accruable, for the purposes of the credit, for the year to which it relates, even though the taxpayer contests liability and does not pay the tax until a later year. However, the *accrual* cannot be made until the contested liability is determined.ⁿ⁴⁹ In other words, the tax cannot be accrued, and a credit claimed, until the amount due is settled, but when this occurs, the accrual relates back to the taxable year for which the tax is imposed.ⁿ⁵⁰ Such a rule furthers the purpose underlying *IRC Section 905(a)*--to allow a taxpayer employing the cash method of accounting a credit against the federal tax imposed for the year in which the income subject to the foreign tax is received.ⁿ⁵¹

Taxpayers who take foreign income taxes into account when accrued must translate the amount of those taxes into United States dollars at the average exchange rate for the taxable year to which the taxes relate.^{n51.1} This rule does not apply to any foreign income taxes paid before the beginning of the taxable year to which the taxes relate or more than two years after the close of that year, or to accrued taxes denominated in an inflationary currency.^{n51.2} If any of the exceptions apply, the amount of the foreign taxes (and adjustments) must be translated into United States dollars using the exchange rate as of the payment date of the tax (or adjustment), while refunds are translated at the exchange rate on the date of original payment.^{n51.3} None of the foregoing rules applies to a regulated investment company that accounts for income on an accrual basis; any foreign income taxes paid or accrued by it on such income must be translated into dollars using the exchange rate as of the date the income accrues.^{n51.4}

If the amount of foreign tax actually paid differs from the amount accrued, accrued taxes are not paid within two years after the close of the taxable year to which they relate, or if there is any refund of the foreign tax, the taxpayer must notify the Service, which will then redetermine the amount of federal tax due for the affected year.ⁿ⁵² If the accrued tax is not paid within two years of the year of accrual, the redetermination results in a denial of a credit for the tax.^{n52.1} If the accrued tax is paid after the two-year period, and an indirect foreign tax credit is involved, the tax is taken into account for the taxable year in which paid.^{n52.2} In the case of a direct foreign tax credit, the later payment is taken into account for the taxable year to which the tax relates.^{n52.3} In both cases, the tax is translated into United States dollars using the exchange rate as of the time the tax is paid.ⁿ⁵³

If a redetermination of United States tax liability is necessitated by a foreign tax redetermination that reduces the amount of foreign tax, the taxpayer must file the notification within 180 days after the date of the foreign tax redetermination.^{n53.1} If there is an increase in the foreign tax, the notification must be filed within the period provided by *IRC Section 6511(d)(3)(A)*--ten years from the due date of the return for the taxable year.ⁿ⁵⁴

[e] Limitations on the Credit

[i] In General. The amount of the credit that can be taken in any taxable year is subject to a limitation based on the aggregate of the income taxes paid to all foreign countries and possessions of the United States. Under this limitation, the taxpayer's credit for foreign taxes cannot exceed the same proportion of federal income taxes against which the credit is taken which the taxpayer's taxable income from all foreign sources bears to his total taxable income.ⁿ⁵⁵ The limitation formula is the following:

$$\begin{array}{l} \text{Maximum credit for} \\ \text{foreign taxes paid to} \\ \text{all foreign countries} \end{array} = \begin{array}{l} \text{Taxable income from all for-} \\ \text{eign} \\ \text{sources} \end{array} \times \begin{array}{l} \text{United States} \\ \text{tax prior to cred-} \\ \text{it} \end{array}$$

___ Total taxable income

In ascertaining the limit, the total taxable income of individuals, estates, and trusts is computed without the deduction for personal exemptions,ⁿ⁵⁶ while income exempt from United States taxes is excluded from both the numerator and denominator of the limiting fraction.ⁿ⁵⁷ But, the fact that there is income exempt from federal income taxes in no way lessens the amount of foreign tax qualifying for the credit;ⁿ⁵⁸ the limitation affects only the credit. (It can readily be seen that if all of the foreign income is exempt from federal income taxes, the taxpayer can take no credit for foreign taxes since the limiting fraction has a numerator of zero and a denominator of zero.)ⁿ⁵⁹ Finally, long-term capital gain from sources without the United States is includable in taxable income from sources without the United States only to the extent of foreign source capital gain net income (the lesser of capital gain from sources without the United States, or capital gain net income).ⁿ⁶⁰

If capital gain net income from foreign sources exceeds capital gain net income from all sources, and the taxpayer has capital gain net income from foreign sources in only one separate category (see § 20.02[4][e][iii]), the excess is allocated as a reduction to that separate category.^{n60.1} If the taxpayer has capital gain net income from foreign sources in more than one separate category, the excess must be apportioned on a pro rata basis as a reduction to each separate category.^{n60.2}

If capital gains are taxed at preferential rates, (a) foreign source capital gain net income is reduced by the rate differential portion of foreign source net capital gain, (b) the taxpayer's entire taxable income is computed by reducing capital gain net income by the rate differential portion of net capital gain, and (c) any net capital loss from sources outside the United States must be reduced by the rate differential portion of the excess of net capital gain from United States sources over net capital gain.ⁿ⁶¹ The rate differential portion is determined by the following fraction:

$$\frac{\text{Highest applicable rate} - \text{alternative tax rate}}{\text{Highest applicable tax rate}}.$$
ⁿ⁶²

If a taxpayer with a capital gain rate differential for the year has capital gain net income from foreign sources in only one rate group within a separate category, any reduction to the separate category must be allocated to that rate group.^{n62.1} If a taxpayer with a capital gain rate differential for the year has capital gain net income from foreign sources in more than one rate group within a separate category, any reduction to the separate category must be apportioned on a pro rata basis among the rate groups.^{n62.2}

In determining taxable income from foreign sources for purposes of *IRC Section 904*, capital gain income from foreign sources in each long-term rate group in each separate category (separate category long-term rate) must be reduced by the rate differential portion of the capital gain net income.^{n62.3} If a taxpayer has a net long-term capital loss from United States sources, and also has a short-term capital gain from any source, the capital gain net income from foreign sources in each separate category long-term rate must be reduced by the rate differential portion of the applicable rate differential amount.^{n62.4} In addition, a taxpayer with a net capital loss in a separate category rate group must reduce the capital loss by the sum of the rate differential portions of the capital gain net income in each long-term rate group offset by the capital loss.^{n62.5} A net capital loss in a separate category rate group is the amount, if any, by which capital losses in a rate group from foreign sources included in a separate category exceed capital gains from foreign sources in the same rate group and the same separate category.

IRC Section 904(k)(1) and (2), allow individuals with no more than \$300 (\$600 in the case of married persons filing jointly) of creditable foreign taxes, and no foreign source income other than passive income, to elect to be exempt from the foreign tax credit limitation rules.^{n62.6} An individual making the election is not entitled to any carryback or

carryover of excess foreign taxes paid in a taxable year to which the election applies. For purposes of this provision, passive income is generally defined as income that is foreign personal holding company income under the Subpart F rules, and income inclusions from passive foreign investment companies, provided the income is shown on a payee statement furnished to the individual.^{n62.7}

IRC Section 904(h) treats certain amounts derived from a United States-owned foreign corporation, that would normally be treated as foreign source income, as income from sources within the United States.ⁿ⁶³ The affected classes are (a) Subpart F income and foreign personal holding company income includable in the income of United States shareholders to the extent the income is attributable to income of the United States-owned foreign corporation from sources within the United States, (b) foreign passive investment company income that is taxed currently, (c) interest, which is allocable to income of the United States-owned foreign corporation derived from United States sources, and is paid or accrued by the foreign corporation to a United States shareholder or related party,ⁿ⁶⁴ and (d) the portion of dividends paid or accrued by the foreign corporation that is determined by multiplying the dividend by a fraction, the numerator of which is the portion of the corporation's earnings and profits for the year from sources within the United States and the denominator of which is the total amount of its earnings and profits for the taxable year.ⁿ⁶⁵ The recharacterization of interest and dividends as U.S. source income is not required if less than 10 percent of the corporation's earnings and profits for the taxable year is from sources within the United States or if a U.S. income tax treaty treats the income as foreign source income.ⁿ⁶⁶ The provisions of *IRC Section 904(h)* are applied before applying the rules of *IRC Section 904(f)*, discussed below.ⁿ⁶⁷

If a taxpayer sustains an overall domestic loss for any taxable year beginning after December 31, 2006, and elects to claim a foreign tax credit, that portion of the taxpayer's taxable income from United States sources for each succeeding taxable year that is equal to the lesser of (i) the amount of the loss (to the extent not used in prior taxable years, or (ii) 50 percent of the taxpayer's taxable income from United States sources for each succeeding taxable year will be treated as foreign source income.^{n67.1} Any income from United States sources that is so treated as foreign source income must be allocated among and increase the income categories in proportion to the loss from United States sources previously allocated to those income categories.^{n67.2}

A further limitation operates as a reduction in the amount of the allowable credit. By virtue of *IRC Section 908*, such reduction is required whenever the taxpayer, or a member of a controlled group which includes the taxpayer, participates in an international boycott (as defined in *IRC Section 999(b)*).ⁿ⁶⁸ The reduced credit is determined by multiplying the otherwise allowable credit by the international boycott factor, a fraction the numerator of which reflects the operations of the taxpayer or controlled group in countries associated in carrying on the boycott, and the denominator of which reflects the worldwide operations of the taxpayer or group.ⁿ⁶⁹ If the taxpayer clearly demonstrates that the foreign taxes paid and income earned during the year are attributable to specific operations, then, in lieu of applying the international boycott factor, the disallowed amount of the credit is the amount specifically attributable to operations connected with the boycott.ⁿ⁷⁰

Finally, *IRC Section 901(k)* denies foreign tax credits for any taxes paid or deemed paid to any country (1) that the United States does not recognize (unless the government is eligible to purchase defense articles or services under the Arms Export Control Act), (2) with respect to which the United States has severed diplomatic relations or does not conduct such relations, or (3) that the Secretary of State has designated as a country that repeatedly provides support for acts of international terrorism.ⁿ⁷¹ The denial applies during the period beginning on the later of January 1, 1987 or six months after the country becomes one of the described types, and ending on the date that the Secretary of State certifies to the Secretary of the Treasury that the country is no longer so described.ⁿ⁷²

[ii] Recapture of Overall Foreign Losses. We have seen that repeal of the per country limitation prevents the use of losses derived in one foreign country to reduce worldwide income without a corresponding reduction in the allowed credit for taxes paid on income earned in a different country. Even under the overall limitation, foreign losses in excess of foreign income could reduce the amount of tax on domestic source income. Moreover, if foreign income were

derived in a subsequent year, the taxpayer would be entitled to a credit for taxes paid thereon, securing the benefit of having reduced total income in the loss year while paying no federal tax in the later year. *IRC Section 904(f)* bars this result by requiring recapture of the loss when the taxpayer derives the foreign income.

The statute accomplishes this recapture by treating as domestic source income the lesser of the amount of the loss (to the extent not previously recaptured) or 50 percent (or more if the taxpayer so chooses) of the taxpayer's foreign taxable income for the year. By treating this sum as income from sources within the United States, the taxpayer can claim neither a foreign tax credit nor a deduction with respect to foreign taxes paid on such income.

Recapture is required only if, in a prior year, the taxpayer sustained an "overall foreign loss," defined as the amount by which the gross income for that prior year from sources without the United States was exceeded by the deductions properly apportioned or allocated thereto.ⁿ⁷³ In determining the amount of the loss, the following are not taken into account:

- (a) any net operating loss deduction allowable for such year; and
- (b) any casualty loss for such year, to the extent such losses are not compensated for by insurance or otherwise.ⁿ⁷⁴

A second recapture provision, *IRC Section 904(f)(3)*, becomes operative whenever property used predominantly outside the United Statesⁿ⁷⁵ in a trade or business is disposed of prior to recapture of the loss under the method described above. Recapture in this instance is required even though, absent the provision, gain realized on the disposition would be sheltered from recognition by some other section of the Code. The amount of gain to be taken into account in the lesser of the gain realized on the disposition or the portion of overall foreign loss not previously recaptured.ⁿ⁷⁶ The normal gain characterization rules apply with any gain recognized solely by reason of the recapture provision taking the same character it would have if the taxpayer sold the property in a taxable transaction.ⁿ⁷⁷

For purposes of *IRC Section 904(f)(3)*, "the term 'disposition' includes a sale, exchange, distribution, or gift of property whether or not gain or loss is recognized on the transfer."^{n77.1} An exception is made for a disposition of property which is not a material factor in the realization of income by the taxpayer and for a disposition of property to a domestic corporation as part of a reorganization or liquidation of a subsidiary that gives rise to carryover attributes under *IRC Section 381*.^{n77.2}

A disposition of any share of stock in a controlled foreign corporation in a transaction or series of transactions (an applicable disposition) is treated as a disposition for purposes of *IRC Section 904(f)(3)* if, immediately before the transaction or series of transactions, the taxpayer owned more than 50 percent (by vote or value) of the stock of the controlled foreign corporation.^{n77.3} A disposition is not treated as an applicable disposition if (1) it is part of a tax-free corporate or partnership organization, or if the transferor receives stock in a foreign corporation and the stock received is exchanged basis property, and (2) immediately after the disposition, the taxpayer owns (by vote or value) at least the same percentage of stock in the controlled foreign corporation (or, if the controlled foreign corporation is not in existence after the disposition, in another foreign corporation stock which was received by the transferor in exchange for stock in the controlled foreign corporation) as the percentage of stock in the controlled foreign corporation that the taxpayer owned immediately before the transaction or series of transactions.ⁿ⁷⁸ A disposition is also not an applicable transaction if it is part of a transaction or series of transactions in which the taxpayer (or any member of a controlled group of corporations filing a consolidated return under *IRC Section 1501* that includes the taxpayer) acquires the assets of the controlled foreign corporation in exchange for the shares of the controlled corporation in a tax-free liquidation of a subsidiary or a tax-free reorganization.ⁿ⁷⁹

Special foreign credit limitations exist for various types of income. Because of this, *IRC Section 904(f)(5)* provides that the amount of separate limitation losses for any taxable year will reduce income from U.S. sources only to the extent

that the aggregate amount of such losses exceeds the aggregate amount of the separate limitation incomes for the taxable year. The losses are allocated proportionately among the separate limitation income categories in which the taxpayer has income for the taxable year; U.S. source losses are allocated to those categories after the allocation of the foreign-source losses. If separate limitation losses are allocated to foreign income in a different category and the first category (the one in which the loss was incurred) has income in a subsequent year, the income is recharacterized as income in the second category in proportion to the prior allocation of the loss to that category. If any separate limitation loss for a taxable year is allocated against separate limitation income for the year, rules similar to those contained in *IRC Section 904(f)(3)* apply to gain from a disposition of property if the gain would be in the same income category as the separate limitation loss.

An additional recapture provision recharacterizes an overall domestic loss sustained by a taxpayer for any taxable year beginning after December 31, 2006. Under *IRC Section 904(g)(1)*, the portion of the taxpayer's taxable income from sources within the United States for each taxable year after 2006 that is equal to the lesser of the amount of the loss (to the extent not previously recaptured) or 50 percent of the taxpayer's taxable income from sources within the United States for the taxable year will be treated as foreign source income. An overall domestic loss is a domestic loss to the extent the loss offsets foreign source income for the taxable year or for any preceding taxable year due to a carryback.^{n79.1} A domestic loss is the amount by which the gross income for the taxable year from United States sources is exceeded by the sum of the deductions properly apportioned or allocated thereto (determined without regard to any carryback from a subsequent taxable year).^{n79.2} Any United States source income that is recharacterized under *IRC Section 904(g)(1)* will be allocated among and increase the income categories described in *IRC Section 904(f)(5)(E)(i)* in proportion to the loss from United States sources previously allocated to those sources.^{n79.3}

[iii] Special Limitation Applied to Certain Categories of Income. For taxable years prior to 2007, *IRC Section 904(d)(1)* required that the limitation on the allowable foreign tax credit be computed separately for taxes paid with respect to:

- (1) dividends from a DISC or former DISC to the extent such dividends are treated as income from foreign sources;
- (2) taxable income attributable to foreign trade income within the meaning of *IRC Section 923(b)*;
- (3) distributions from an FSC or former FSC attributable to foreign trade income and qualifying interest and carrying charges as defined in *IRC Section 945(c)*;
- (4) passive income;
- (5) high withholding tax interest;
- (6) financial services income;
- (7) shipping income; and
- (8) in the case of a corporation, dividends from noncontrolled Section 902 corporations out of earnings and profits accumulated in taxable years beginning before January 1, 2003.^{n79.4}

For taxable years beginning after December 31, 2006, the number of separate categories is reduced to two, namely passive category income and general category income.^{n79.5} Passive category income includes passive income and specified passive income, the latter including (i) dividends from a DISC or former DISC to the extent the dividends are treated as income from sources without the United States, (ii) taxable income attributable to foreign trade income, and (iii) distributions from a FSC (or a former FSC) out of earnings and profits attributable to foreign trade income or

interest or carrying charges derived from a transaction that results in foreign trade income.^{n79.6} General category income is any income other than passive category income.^{n79.7}

Passive income for this purpose is income that would be foreign personal holding company income and, generally, any passive foreign investment income inclusions (under *IRC Section 1293*).ⁿ⁸⁰ However, passive income does not include any export financing interest or high-taxed income.ⁿ⁸¹ Passive income also does not include rents and royalties paid or accrued after September 20, 2004, if they are derived in the active conduct of a trade or business, regardless of whether the rents or royalties are received from a related or unrelated person.^{n81.1}

High-taxed income is income that would be passive income if the sum of foreign income taxes paid and deemed paid by the taxpayer exceeds the highest rate of tax applicable to the taxpayer multiplied by the amount of the income (including any gross-up dividend).ⁿ⁸² Only foreign-source income is relevant in determining whether income is high-taxed income.^{n82.1}

Export financing interest is interest derived from financing the sale for use outside the United States of any property that is manufactured, produced, grown, or extracted in the United States by the taxpayer or a related person, if not more than 50 percent of the fair market value of the property is attributable to products imported into the United States.^{n82.2} For this purpose, a related person is an individual, corporation, partnership, trust, or estate that controls, or is controlled by, the person with respect to whom the determination is being made.^{n82.3}

Financial services income is income that (1) is derived in the active conduct of a banking, financing, or similar business, or from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business, or (2) is of a kind that would be insurance income as defined in *IRC Section 953(a)* determined without regard to any provisions that limit insurance income to income from countries other than the country in which the corporation was organized.ⁿ⁸³ If, for any taxable year, an entity is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, financial services income includes passive income, but does not include any high-taxed income. Financial services income is treated as general category income in the case of a member of a financial services group and any other person if the person is predominantly engaged in the active conduct of a banking, insurance, financing or similar business.ⁿ⁸⁴

Dividends received from a noncontrolled Section 902 corporation are dividends received from a foreign corporation in which the taxpayer owns between 10 percent and 50 percent of the stock.^{n84.1} If a foreign corporation is a 10/50 corporation with respect to the taxpayer, any inclusion under *IRC Section 1293* (current taxation of income from qualifying electing funds) with respect to the corporation is treated as a dividend from the corporation.^{n84.2}

IRC Section 904(d)(3) contains a set of look-through rules for controlled foreign corporations. Dividends, interest, rents and royalties received from a controlled foreign corporation by a U.S. shareholder will not be treated as passive category income, except that such interest, rent, or royalty income is properly allocable to passive category income of the controlled foreign corporation.^{n84.3} Dividends paid out of the earnings and profits of a controlled foreign corporation to a United States shareholder are treated as passive category income in proportion to the ratio of (1) the portion of the earnings and profits attributable to income in the category, to (2) the total amount of earnings and profits.^{n84.4} Subpart F inclusions are also subject to the look-through rule.^{n84.5} However, if the *de minimis* rules of Subpart F apply (the sum of the corporation's foreign base company income and gross insurance income for the taxable year is less than the lesser of 5 percent of gross income or \$1 million) to a controlled foreign corporation, none of its foreign base company income or its gross insurance income will be treated as passive category income.^{n84.6} The last stated rule does not apply to income that would otherwise be financial services income.

The look-through also applies when a passive foreign investment company is a controlled foreign corporation, and the taxpayer is a United States shareholder in the controlled foreign corporation. In such case, any amount included in gross income under *IRC Section 1293* is treated as income in a separate category to the extent the amount is attributable to

income in that category.ⁿ⁸⁵

The principles of *IRC Section 904(d)(3)* are applied as well to any foreign source interest, rents, and royalties paid by a United States corporation to a related corporation.^{n85.1} For this purpose, a United States corporation and another corporation are considered to be related if one owns, directly and indirectly, stock possessing more than 50 percent of the total voting power of all classes of stock of the other corporation or more than 50 percent of the total value of the other corporation. In addition, a United States corporation and another corporation will be considered to be related if the same United States shareholders own, directly and indirectly, stock possessing more than 50 percent of the total voting power of all classes of stock or more than 50 percent of the value of each corporation.^{n85.2} The constructive ownership rules of *IRC Section 318* apply in determining the extent of stock ownership. (For taxable years beginning before January 1, 2001, the test is 50 percent or more, not more than 50 percent.)

The look-through rules also apply to partnerships. In general, a partner's distributive share of partnership income is characterized as income in a separate category to the extent that the distributive share is a share of income earned or accrued by the partnership in that category.^{n85.3} However, if any limited partner or corporate general partner owns less than 10 percent of the capital and profits interest in a partnership, the partner's distributive share is deemed to be passive income. The exception does not apply if the partner holds the partnership interest in the ordinary course of its trade or business, or to the extent a partner's distributive share of income from the partnership is a share of high withholding interest received or accrued by the partnership, regardless of the partner's level of ownership in the partnership.^{n85.4}

The look-through rules also apply to dividends paid by a noncontrolled Section 902 corporation.^{n85.5} In this case, the dividend is treated as passive category income or general category income in proportion to the ratio of the portion of earnings and profits attributable to such income to the total amount of earnings and profits. Earnings and profits for this purpose are determined under the provisions of *IRC Section 316*.^{n85.6} The allocation of income to passive category income and general category income will also apply to any carryforward under *IRC Section 904(c)* from a taxable year beginning before January 1, 2003.^{n85.7}

[iv] Carryback and Carryover of Excess Taxes Paid. It will be recalled that no deduction for foreign taxes paid is allowed in any year that "the taxpayer chooses to take to any extent the benefits of section 901."ⁿ⁸⁶ Thus, a taxpayer cannot take a foreign credit to the extent of the applicable limitation and then claim a deduction for the balance. But this does not mean that the taxpayer can never reap a benefit from the portion of the foreign taxes not currently creditable; *IRC Section 904(c)* permits a one-year carryback and a ten-year carryforward (in that order) of the excess of the foreign tax paid over the amount which can be taken as a credit under the limitation of *IRC Section 904(a)* (the "unused foreign tax").ⁿ⁸⁷ On the other hand, the mere fact that the unused foreign tax can be carried back and carried forward is no assurance that it will ultimately be allowed as a credit; the unused foreign tax must be added to the foreign tax paid or accrued in the year to which it is carried, and the total then subjected to the *IRC Section 904(a)* limitation. In other words, the amount not currently creditable can be used as a credit in another year only if the taxes paid or accrued in that year are less than the credit ceiling imposed by the limitation.

The carryback and carryover are subject to other conditions:

- (1) The unused foreign tax cannot be used as a deduction in the year to which it is carried; it may be availed of only as a credit in such year;ⁿ⁸⁸ and
- (2) There is a separate carryback and carryover of any unused foreign taxes on income as to which a special limitation is computed under *IRC Section 904(d)*. These excess taxes can be claimed as a credit in another year only if the limitation with respect to *IRC Section 904(d)* separate category income exceeds the foreign taxes paid on such income in that year.

Example:

2-20 Taxation of Securities Transactions § 20.02

A, a calendar year taxpayer using the cash receipts and disbursements method of accounting chooses to claim a credit for foreign taxes paid to country X for each of the years set forth below. In each of the years so that he can carry back and carry forward his unused foreign taxes as follows:ⁿ⁸⁹

	1997	1998	1999	2000	2001
Limitation					
Taxes actually paid to foreign country X	100	100	300	300	350
Unused foreign taxes to be carried back or carried forward	-0-	-0-	150	100	-0-
Excess limitation	-0-	100	-0-	-0-	150
Unused foreign taxes carried back or forward under IRC Section 904(c) from					
1999	-0-	100	-0-	-0-	50
2000	-0-	-0-	-0-	-0-	100

If A had derived *IRC Section 904(d)* separate category income from sources within foreign country X, he would have made a separate, but similar, determination as to the carryback and carryover of the foreign income taxes paid with respect to such income.

IRC Section 904(d)(4)(C)(iv) provides that look-through treatment applies to the carryover of excess foreign taxes from pre-2003 taxable years to post-2002 taxable years to the extent that they are allocable to dividends from a 10/50 corporation. To the extent that a taxpayer has paid, accrued, or deemed paid excess taxes in a separate category for dividends from a 10/50 corporation paid in a pre-2003 taxable year and those excess taxes are carried over to taxable years beginning on or after the corporation's first post-2002 taxable year, the excess taxes are assigned to the appropriate separate category as if the associated dividends had been eligible for look-through treatment when based on a reconstruction of the corporation's pre-2003 earnings.^{n89.1}

Excess taxes that are allocable to dividends from a 10/50 corporation paid in post-2002 taxable years that are attributable to one or more separate categories are carried back to prior taxable years in the same separate categories to which the dividends were assigned.^{n89.2}

A foreign tax credit carryback that reduces or eliminates an underpayment of tax in a prior year does not stop interest from accruing on the underpayment for the period ending with the filing date for the subsequent taxable year in which the foreign taxes were paid or accrued.ⁿ⁹⁰ A similar rule is provided for cases in which a net operating loss carryback or a net capital loss carryback triggers a foreign tax credit carryback.

If the foreign tax credit carryback results in an overpayment of tax, the overpayment is not considered to have been made until the filing date of the subsequent taxable year in which the foreign taxes were paid or accrued.ⁿ⁹¹ A claim for refund resulting from an overpayment attributable to a foreign tax credit carryover must be filed within 10 years from the year in which the taxes were originally paid or accrued.ⁿ⁹²

[v] Minimum Holding Period for Certain Taxes. No credit is allowed for any withholding tax on a dividend paid by a corporation or a regulated investment company if the shareholder has not held the stock for 16 days in the case of common stock and 46 days in the case of preferred stock; the tax disallowed as a credit can be claimed as a deduction.^{n92.1} The disallowance applies both to foreign tax credits for foreign withholding taxes that are paid on the dividend where the dividend-paying stock is held for less than the designated holding period and to indirect credits for

deemed paid taxes where any of the required stock ownership in the chain of ownership is held for less than the specified period.^{n92.2} The disallowance also extends to the situation in which the recipient of the dividend is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.^{n92.3}

Periods during which the taxpayer is protected from risk of loss generally are not counted toward the holding period requirement; *IRC Section 246(c)(4)* applies to cases governed by *IRC Section 901(k)*.^{n92.4} If a person's holding period is reduced because of the application of the rules of *IRC Section 246(c)(4)* to any contract for the bona fide sale of stock, the determination of whether the holding period is met for purposes of indirect foreign tax credits is made as of the date the person enters into the contract.^{n92.5}

The disallowance rules do not apply to any qualified tax with respect to any security held in the active conduct in a foreign country of a securities business of any person (i) who is registered as a securities broker or dealer under Section 15(a) of the Securities Exchange Act of 1934, (ii) who is registered as a Government securities broker or dealer under Section 15C(a) of that act, or (iii) who is licensed or authorized to conduct securities activities in the foreign country and is subject to bona fide regulation by a securities regulating authority of such country.^{n92.6} A qualified tax is a tax paid to a foreign country other than the one in which the dealer is carrying on the securities business if the dividend to which the tax is attributable is subject to tax by the foreign country in which the business is conducted and that country allows a credit against its net basis tax for the full amount of the tax paid to the other foreign country.^{n92.7}

A second disallowance provision prevents the taking of a credit for any withholding tax on any item of income or gain with respect to any property other than stock if (a) the property is held by the recipient of the item for 15 days or less during the 31-day period beginning on the date that is 15 days before the date on which the right to receive payment of the item arises, or (b) to the extent that the recipient of the item is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.^{n92.8} The disallowance rule does not apply to any qualified tax with respect to any property held in the active conduct in a foreign country of a business as a dealer in such property.^{n92.9} A person is a dealer with respect to a security if the rules of *IRC Section 901(k)* would apply if the security were stock, and with respect to any other property if the person would come within the scope of *IRC Section 1221(a)(1)*.^{n92.10} A tax is a qualified tax if the tax is paid to a foreign country (other than the one in which the person is a dealer) if the item to which the tax is attributable is subject to taxation on a net basis by the country in which the person does business as a dealer, and that country allows a credit against its net basis tax for the full amount of the tax paid to the other foreign country.ⁿ⁹³ The Service is authorized to prescribe regulations that *IRC Section 901(l)(1)* does not apply to property where its application is not necessary to carry out the purposes of the provision.ⁿ⁹⁴

Every United States person who controls a foreign business entity is required to file an annual return (on Form 5471) setting forth certain information with respect to the entity.ⁿ⁹⁵ A person is in control of a corporation if the person owns stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or more than 50 percent of the total value of all shares of all classes of stock of the corporation.ⁿ⁹⁶ If a person is in control of one corporation, the person is deemed to be in control of the second corporation.ⁿ⁹⁷ The attribution rules of *IRC Section 318* are applicable in determining stock ownership, except that (1) the provisions of *IRC Section 318(a)(3)* are not to be applied so as to make a United States person the owner of stock owned by one who is not a United States person, and (2) attribution from a corporation to a shareholder is triggered whenever the shareholder is triggered whenever the shareholder owns 10 percent of the stock of the corporation.ⁿ⁹⁸

A person is in control of a partnership if the person controls directly or indirectly more than a 50-percent interest in the partnership.ⁿ⁹⁹ A 50-percent interest in a partnership is (1) an interest equal to 50 percent of the capital interest, or 50 percent of the profits interest, in the partnership, or (2) to the extent provided in regulations, an interest to which 50 percent of the deductions or losses of the partnership are allocated.ⁿ¹⁰⁰

One penalty for failure to file is a 10-percent reduction in the amount of foreign taxes eligible for credit during the taxable year.ⁿ¹⁰¹ If the failure continues for 90 days or more after notice to the taxpayer by the IRS, the reduction is increased by 5 percent for each three-month period, or fraction thereof, during which the default in filing continues.ⁿ¹⁰² However, the maximum reduction cannot exceed the greater of \$10,000 or the income of the foreign entity for the annual accounting period with respect to which the failure occurs,ⁿ¹⁰³ and, itself, is reduced by the amount of any dollar penalty imposed, as described in the next paragraph.ⁿ¹⁰⁴

A second penalty requires a payment of \$10,000 for each annual accounting period with respect to which a failure to file exists.ⁿ¹⁰⁵ If any such failure continues for more than 90 days after notice of failure is mailed, the taxpayer is subject to an additional penalty of \$10,000 for each 30-day period (or fraction thereof) during which the failure to file continues, the maximum of such additional penalty not to exceed \$50,000.ⁿ¹⁰⁶

FOOTNOTES:

(n1)Footnote 1. See Rev Rul 66-171, 1966-1 CB 181 , and Rev Rul 64-156, 1964-1 CB 139 , applying IRC § 1036 in transactions that also qualified as reorganizations.

(n2)Footnote 2. IRC § 1246(a); see § 20.05[2][a].

(n3)Footnote 3. IRC § 1248(a) discussed in § 20.04[4].

(n4)Footnote 1. IRC § 245(a); see § 4.04[2][a][iv].

(n5)Footnote 2. See § 20.02[4][c]. IRC § 960(a)(1)(C) also provides a deemed-paid credit for income attributed to domestic corporate shareholders of controlled foreign corporations. The allowance of this deemed-paid credit also gives rise to a gross-up dividend. See § 20.04[2][g].

(n6)Footnote 1. See § 17.03[2], for a discussion of IRC § 103.

(n7)Footnote 1. IRC §§ 27, 901(a). Actually the credit is allowed only against the taxes imposed by chapter 1 of the Code.

(n8)Footnote 2. IRC §§ 26, 901(a). In addition, the credit may not be taken against the 10 percent tax on premature distributions from pension plans to owner-employees, the tax on lump-sum distributions from employee trusts, and the additional tax imposed by IRC § 408(f) on income from certain retirement accounts.

(n9)Footnote 3. Treas Reg § 1.901-1(e).

(n10)Footnote 4. Cabot v Commr, BTA Memo 1939-128.

(n11)Footnote 5. IRC § 901(b)(5). The partnership rule is applicable to joint ventures. *Arundel Corp v US*, 102 F Supp 1019 (Ct Cl 1952) . However, the arrangement must be found to be a joint venture in fact. *Badger Co v Commr*, TC Memo 1967-178 ; see also *Buckley v Commr*, 22 TC 1312 (1954) , *affd per curiam* 231 F2d 204 (2d Cir 1956) (entity involved a corporation, not a trust). For purposes of applying IRC § 853, an RIC owning an interest in a partnership is deemed to own a proportionate share of the assets of the partnership and is entitled to the gross income attributable to that share. *Ltr Rul* 9507006 .

(n12)Footnote 6. IRC § 853(b)(2)(A); see § 12.04[4].

(n13)Footnote 7. IRC § 902 discussed in § 20.02[4][c].

(n14)Footnote 8. IRC § 901(a); Treas Reg § 1.901-1(d).

(n15)Footnote 9. IRC § 6511(a).

(n16)Footnote 9.1. In *Chrysler Corp v Commr*, 116 TC 465 (2001) , the taxpayer argued that the ability to carry a foreign tax credit forward for five years extended the limitations period to 15 years. The Tax Court concluded that the 10-year period to elect to change from deducting foreign taxes to taking a foreign tax credit begins running for each year on the due date of the return for that year.

(n17)Footnote 10. *IRC § 6511(c)*. Such an agreement is the only way to extend the period. *Treas Reg § 1.901-1(d)*; *Rev Rul 56-196, 1956-1 CB 655* .

(n18)Footnote 11. Prior to 1976, persons electing the standard deduction could not avail themselves of the foreign tax credit.

(n19)Footnote 12. *IRC § 275(a)(4)(A)*; *Treas Reg § 1.901-1(c)*; *Treas Reg § 1.901-1(b)(2)*.

(n20)Footnote 12.1. *IRC § 114(d)*. No deduction is allowed for taxes paid or accrued with respect to such income. *IRC § 275(a)(4)(C)*.

(n21)Footnote 13. *IRC § 853(b)(1)(A)*. See § 12.04[4].

(n22)Footnote 14. *IRC § 931(g)*; *Treas Reg § 1.901-1(g)(3)*.

(n23)Footnote 15. *IRC § 932(a)*; *Treas Reg § 1.901-1(g)(5)*. The person is treated as a nonresident alien individual. Nonresident alien individuals and foreign corporations are allowed a credit only if the foreign taxes are paid with respect to income effectively connected with the conduct of a trade or business in the US. *IRC §§ 874(c), 882(c)(3), 906(a)*. See § 20.06[2][c].

(n24)Footnote 16. *Treas Reg § 1.901-1(g)(5)*.

(n25)Footnote 17. *IRC § 901(c)*. The President must find (1) that the foreign country does not allow a similar foreign tax credit to citizens of the US residing in the foreign country; (2) that the foreign country, when requested to do so, has not acted to allow such a similar credit; and (3) that it is in the public interest to allow the US foreign tax credit to citizens or subjects of the foreign country who reside in the US only if the foreign country allows a similar credit to US citizens who reside in the foreign country.

The credit is disallowed for all taxable years beginning while a Presidential proclamation denying the credit is in effect.

(n26)Footnote 18. *Treas Reg § 1.901-2(b)*; *Burnet v Chicago Portrait Co*, 285 US 1 (1932) . The Service will not ordinarily rule whether a foreign levy meets the requirement of a creditable tax under *IRC § 901*. *Rev Proc 2007-7, 2007-1 CB 227* .

(n27)Footnote 19. *Treas Reg § 1.901-2(c)*; *Rev Rul 70-228, 1970-1 CB 160* ; *Rev Rul 8, 1953-1 CB 300* . Taxes paid with respect to distributions from corporations electing to be possessions corporations under *IRC § 936* are not treated as foreign taxes eligible for the credit if a dividends received deduction is allowed with respect to the distribution or to the extent that gain or loss is not recognized. *IRC § 901(g)*.

Foreign income, war profits, and excess profits taxes do not include taxes for which a credit is disallowed under *IRC § 901*. *Treas Reg § 1.902-1(a)(7)*.

(n28)Footnote 20. *IRC § 901(i)*.

(n29)Footnote 21. In determining the amount to be credited, a cash basis taxpayer uses the rate of currency exchange on the date of payment. *Rev Rul 73-491, 1973-2 CB 268* . See § 20.02[4][d] for the translation rules

applicable to taxpayers who accrue foreign income taxes.

(n30)Footnote 22. *Treas Reg § 1.901-2(a)*.

(n31)Footnote 23. *Biddle v Commr, 302 US 573 (1938)* .

(n32)Footnote 24. *Rev Rul 68-149, 1968-1 CB 341* .

(n33)Footnote 25. In some cases, the tax or some portion thereof may qualify for a deduction under *IRC § 164*. See eg, *Rev Rul 70-464, 1970-2 CB 152* .

(n34)Footnote 26. *Santa Eulalia Mining Co v Commr, 2 TC 241 (1943)* , *dismissed per curiam 142 F2d 450 (9th Cir 1944)* .

(n35)Footnote 27. *IRC § 903*. The Service will not ordinarily rule whether a foreign levy meets the requirements of a creditable tax under *IRC § 903*. *Rev Proc 2006-7, 2006-1 IRB 242* .

(n36)Footnote 28. *Treas Reg §§ 1.901-2(a), 1.903-1*.

(n37)Footnote 29. The 10 percent stock ownership requirement need be met only at the time the dividend is received. *Treas Reg § 1.902-3(a)(4)*. *IRC § 902(a)* does not contain any indirect ownership provisions that attribute one domestic corporation's stock to another, nor do the consolidated return provisions provide an exception to the ownership requirements contained in *IRC § 902(a)*. *Rev Rul 85-3, 1985-1 CB 222* . The court, in *First Chicago NBD Corp v Commr, 135 F3d 457 (7th Cir 1998)* , agreed with the Service that a group of affiliated corporations that filed a consolidated income tax return could not aggregate the affiliates' stockholdings in a foreign corporation to reach the 10 percent threshold.

In *Rev Rul 71-141, 1971-1 CB 211* , each of two corporations that formed a partnership to acquire 40 percent of the stock of a foreign corporation was treated as the owner of 20 percent of the stock for *IRC § 902(a)* purposes. *IRC § 902(c)(7)* now provides that stock owned, directly or indirectly, by or for a partnership is considered as being owned proportionately and actually by its partners.

The stock on which the dividends are paid may be nonvoting stock. *Rev Rul 79-74, 1979-1 CB 242* . A dividend produced by a transaction treated as a redemption under *IRC § 304* qualifies as a dividend for purposes of the deemed paid tax credit. *Rev Rul 91-5, 1991-1 CB 114* , *modified and amplified by Rev Rul 92-86, 1992-2 CB 69* . See Staffaroni, "The International Boundaries of Section 304," 46 *Tax Lawyer* 125 (1992).

(n38)Footnote 29.1. If a domestic corporation has a calendar year and its foreign subsidiary paying dividends has a later ending fiscal year, the domestic corporation shareholder may claim the deemed paid credit in the calendar year in which the dividends are received. However, the domestic corporation can claim the credit only after its foreign subsidiary has paid or accrued its foreign taxes at the end of its fiscal year. Therefore, the domestic corporation can claim the deemed paid credit on its original return for the year in which the dividend was received when that return is filed after the end of the foreign subsidiary's taxable year. If the domestic corporation's return is filed before the end of the subsidiary's fiscal year, the domestic corporate shareholder can later file an amended return to claim the deemed paid credit for the year in which the dividend was received. *Ltr Rul 9426003* .

(n39)Footnote 29.2. The pool of post-1986 foreign income taxes must be reduced by the amount of taxes attributable to earnings distributed to shareholders ineligible for the deemed paid credit (eg, a foreign shareholder, a US individual shareholder, or a domestic corporate shareholder that owns less than 10 percent of the foreign corporation's voting stock). A reduction in the pool is required as well if a shareholder eligible for the credit chooses to claim a deduction for foreign taxes paid or accrued for the taxable year of distribution or inclusion. *Treas Reg § 1.902-1(a)(8)(i)*.

(n40)Footnote 30. *IRC § 902(c)(1)*.

(n41)Footnote 31. *IRC § 902(c)(2)*.

(n42)Footnote 32. *IRC § 902(c)(3)*.

(n43)Footnote 33. *IRC § 902(a)(1)*.

(n44)Footnote 34. *IRC § 78*.

(n45)Footnote 35. *IRC § 902(c)(6)(A)*.

(n46)Footnote 36. US law controls the determination of earnings and profits for this purpose. *US v Goodyear Tire & Rubber Co*, 493 US 132 (1989). The year-by-year sourcing method required by *IRC § 902(c)(1)* for post-1986 dividends had to be used in determining a domestic parent's deemed-paid foreign tax credit for a pre-1986 dividend that consisted of all of its foreign subsidiary's accumulated profits. *Brunswick Corp & Subs v Commr*, 100 TC 6 (1993).

(n47)Footnote 37. *IRC § 902(c)(6)(B)*.

(n48)Footnote 38. *IRC § 902(b)(1)*.

Ownership by the first foreign corporation must be satisfied only at the time the dividend is received. *Treas Reg § 1.902-1(c)*.

(n49)Footnote 39. *IRC § 902(b)(2)*.

(n50)Footnote 40. *IRC § 902(b)(2)*.

(n51)Footnote 41. *Id.* In order for the deemed-paid tax credit to apply to taxes paid by a fourth-, fifth, or sixth-tier corporation, three requirements must be satisfied. First, the corporation must be a controlled foreign corporation. Second, the US corporation claiming the credit must be a US shareholder with respect to the foreign corporation. Third, the product of the percentage ownership of voting stock at each level from the US corporation down must equal at least 5 percent.

(n52)Footnote 41.1. Taxpayer Relief Act of 1997, § 1120(c)(2).

(n53)Footnote 42. This is also the amount of the corporation's post-1986 undistributed earnings.

(n54)Footnote 43. In the fraction, 150,000/250,000, the numerator is the dividend paid to S Corp., while the denominator is the amount of post-1986 undistributed earnings of T Corp.

(n55)Footnote 44. The amount of dividends entering into the formula is exclusive of the amount of gross-up dividend determined under *IRC § 78*. *IRC § 902(a)*.

(n56)Footnote 45. *IRS Notice 87-54*, 1987-2 CB 363. *IRS Notice 87-54* governs instances in which there is an actual dividend paid in a post-1986 taxable year of a foreign corporation. *IRS Notice 88-70*, 1982-2 CB 369, provides rules concerning the carryforward and carryback of deficits in earnings and profits between pre-1987 and post-1986 taxable years in those situations in which there is a deemed income inclusion occurring in a post-1986 taxable year of a foreign corporation.

Rev Rul 87-72, 1987-2 CB 170, contains rules for determining the amount of the deemed-paid credit with respect to distributions made before the effective date of the Tax Reform Act of 1986 when a deficit in earnings and profits is carried back to taxable years preceding the deficit year.

(n57)Footnote 45.1. *Treas Reg § 1.902-1(b)(4)*.

(n58)Footnote 46. By definition, an accrual basis taxpayer always takes the credit in the year that the taxes accrue.

(n59)Footnote 47. *IRC § 905(a)*; *Treas Reg § 1.905-1(a)*.

(n60)Footnote 48. *Ferrer v Commr*, 35 TC 617 (1961) , *affd on other grounds* 304 F2d 125 (2d Cir 1962) .

(n61)Footnote 49. *Cuba RR v US*, 124 F Supp 182 (SDNY 1954) ; *Rev Rul 58-55*, 1958-1 CB 266 .

(n62)Footnote 50. *Rev Rul 84-125*, 1984-2 CB 125 .

(n63)Footnote 51. HR Rep No 179, 68th Cong, 1st Sess 10 (1924). Consistent with this approach, the year that a tax is withheld is the proper year for which to claim a credit. *Lederman v Commr*, 6 TC 991 (1946) .

(n64)Footnote 51.1. *IRC § 986(a)(1)(A)*. The taxpayer can elect that the provision not apply to any foreign taxes if the liability for the taxes is denominated in a currency other than the taxpayer's functional currency. Regulations may prescribe that the election can apply to foreign income taxes attributable to a qualified business unit. *IRC § 986(a)(1)(D)*.

(n65)Footnote 51.2. *IRC § 986(a)(1)(B), (C)*.

(n66)Footnote 51.3. *IRC § 986(a)(2)*.

(n67)Footnote 51.4. *IRC § 986(a)(1)(E)*.

(n68)Footnote 52. *IRC § 905(c)(1)*. The Service can prescribe adjustments to the pools of post-1986 foreign income taxes and the pools of post-1986 undistributed earnings under the deemed paid credit rules of *IRC §§ 902* and *960* in lieu of the redetermination.

If there are no pools to adjust at the time of a foreign tax redetermination, a redetermination of US tax liability is required. This is done by adjusting the pools for the tax years to which the additional taxes relate and redetermining federal tax liability for those years using the adjusted pools. *Ltr Rul 200127011* .

In the case of any tax accrued but not paid, the taxpayer, as a condition precedent to the allowance of a credit, may be required to post a bond conditioned on the payment of any amount of tax found due on the redetermination. *IRC § 905(c)(4)*.

(n69)Footnote 52.1. *IRC § 905(c)(2)(A)*.

(n70)Footnote 52.2. *IRC § 905(c)(2)(B)(i)(I)*.

(n71)Footnote 52.3. *IRC § 905(c)(2)(B)(i)(II)*.

(n72)Footnote 53. *IRC § 905(c)(2)(B)(ii)*. To the extent provided in regulations, the average exchange rate for the period (specified in the regulations) during which the tax or adjustment is paid may be used instead of the exchange rate as of the date of payment. *IRC § 986(a)(3)*.

(n73)Footnote 53.1. A foreign tax redetermination includes (1) a refund of foreign taxes, (2) a difference between the dollar value of the accrued foreign tax and the dollar value of the foreign tax actually paid attributable to differences in units of foreign currency paid and units of foreign currency accrued, or (3) a difference between the dollar value of the accrued foreign tax and the dollar value of the accrued foreign tax actually paid attributable to fluctuations in the value of foreign currency relative to fluctuations in the value of the foreign currency relative to the dollar between the

date of accrual and the date of payment. *Temp Treas Reg § 1.905-3T(c)*.

(n74)Footnote 54. *Temp Treas Reg § 1.905-4T(b)(2)*. The taxpayer notifies the Service by filing Form 1120X or 1040X, and Form 1118 or 1116 (according to the instructions to Form 1118) with the Service Center where the tax return claiming the credit was filed. *Temp Treas Reg § 1.905-4T(b)(1)*.

IRC § 6689 prescribes a penalty of 5% a month, with a maximum of 25%, for failure to notify the Service. However, according to *Temp Treas Reg § 1.905-4T(d)*, a taxpayer has 180 days after publication of an announcement notifying the taxpayer of the availability of forms and instructions to comply with the notification provisions. No announcement has been made as of yet.

(n75)Footnote 55. *IRC § 904(a)*. In the case of an individual, the tax against which the credit is taken is reduced by the sum of nonrefundable personal credits other than the adoption expense credit, the child tax credit, and the credit for elective deferrals and certain IRA contributions. *IRC § 904(h)*. *IRC § 904(h)* does not apply to taxable years beginning during 2000, 2001, 2002, or 2003.

Foreign source taxable income must be reduced by the amount of any net operating loss deduction attributable to foreign operations. *Rev Rul 71-432, 1971-2 CB 270* ; *Rev Rul 69-121, 1969-1 CB 194* .

A loss incurred on the worthlessness of stock in a foreign subsidiary was held allocable against the taxpayer's foreign source income, and not its worldwide income, in *Black & Decker Corp v Commr, TC Memo 1991-557 affd 986 F2d 60 (4th Cir 1993)* . The loss grew out of activity and the use of property in the foreign country.

(n76)Footnote 56. *IRC § 904(b)(1)*.

(n77)Footnote 57. *Carstairs v US, 75 F Supp 683 (ED Pa 1936)* ; *Rev Rul 62-67, 1962-1 CB 128* ; see also *Rev Rul 68-622, 1968-2 CB 298* , applying the limitation to the tax credit allowed to insurance companies under *IRC § 841*. Foreign income taxable in the US, but not in the foreign country, is includable in the numerator and the denominator of the fraction.

(n78)Footnote 58. *Rev Rul 54-15, 1954-1 CB 129* .

(n79)Footnote 59. Although the tax would not be creditable in the year paid, it may be carried back and carried forward pursuant to the provisions of *IRC § 904(c)*. *Rev Rul 72-126, 1972-1 CB 217* .

(n80)Footnote 60. *IRC § 904(b)(2)(A), (3)(A)*.

(n81)Footnote 60.1. *Treas Reg § 1.904(b)-1(a)(1)(ii)(A)*.

(n82)Footnote 60.2. For this purpose, pro rata means based on the relative amounts of capital gain net income from foreign sources in each separate category. *Id.*

(n83)Footnote 61. *IRC § 904(b)(2)(B), (3)(D)*. A capital gain differential is considered to exist for a taxable year only if the taxpayer has taxable income (excluding net capital gain and qualified dividend income) for the taxable year and (i) in the case of a noncorporate taxpayer, tax is imposed on the net capital gain at a reduced rate under *IRC § 1(h)* for the taxable year, or (ii) in the case of a corporation, tax is imposed under *IRC § 1201(a)* on the taxpayer at a rate less than any rate imposed by the taxpayer by *IRC § 11, 511, or 831(a) or (b)*, whichever applies, determined without regard to any increase in tax under *IRC § 11(b)(1)*. *Treas Reg § 1.904(b)-1(b)(2)*.

A noncorporate taxpayer that has a capital gain rate differential for the taxable year and is not subject to the alternative minimum tax for the taxable year can elect not to apply the rate differential adjustments, if the highest rate of tax imposed on the taxpayer's taxable income (excluding net capital gain and any qualified dividend income) for the taxable

year under *IRC § 1* does not exceed the highest rate of tax in effect under *IRC § 1(h)* for the year and the amount of the taxpayer's net capital gain and qualified dividend income from sources outside the US is less than \$20,000. A taxpayer subject to the alternative minimum tax can make the election if all of the above conditions are met and the rate of tax imposed on the taxpayer's alternative minimum taxable income (excluding net capital gain and qualified dividend income) does not exceed 26 percent. *Treas Reg § 1.904(b)-1(b)(3)*.

(n84)Footnote 62. *IRC § 904(b)(3)(E)*.

(n85)Footnote 62.1. *Treas Reg § 1.904(b)-1(a)(1)(ii)(B)*.

(n86)Footnote 62.2. For this purpose, pro rata means based on the relative amounts of capital gain net income from foreign sources in each rate group within the applicable separate category. *Id.*

(n87)Footnote 62.3. *Treas Reg § 1.904(b)-1(c)(1)(i)*. A taxpayer with qualified dividend income must make a similar adjustment, unless the taxpayer is a noncorporate taxpayer and has elected not to apply rate differentials. *Treas Reg § 1.904(b)-1(e)(1), (2)*.

(n88)Footnote 62.4. *Treas Reg § 1.904(b)-1(c)(1)(ii)*.

(n89)Footnote 62.5. *Treas Reg § 1.904(b)-1(d)(1)*. The determination of which capital gains are offset by net capital losses from foreign sources must follow the order prescribed by *Treas Reg § 1.904(b)-1(d)(2)*.

(n90)Footnote 62.6. The election can be made only if all of the taxes for which a credit is allowable to the taxpayer under *IRC § 901* for the taxable year are creditable foreign taxes. *Treas Reg § 1.904(j)-1(a)*. The provision does not apply to estates and trusts. *IRC § 904(k)(3)(D)*.

(n91)Footnote 62.7. *IRC § 904(k)(3)(A)*. The amount of creditable taxes must also be shown on a payee statement furnished to the individual. *IRC § 904(k)(3)(B)*.

(n92)Footnote 63. A foreign corporation is a US-owned foreign corporation if 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the total value of the stock of the corporation, is held by citizens or residents of the US, domestic corporations, domestic partnerships, or domestic estates or trusts. *IRC §§ 904(h)(6), 7701(a)(30)*. In determining the extent of ownership, stock owned by a foreign corporation, foreign partnership, or foreign estate or trust is deemed to be owned by its shareholders, partners, or beneficiaries, while a person holding an option to purchase stock is treated as the owner of the stock.

The rules for resourcing interest and dividends also apply to a 10/50 corporation that meets the definition of a US-owned foreign corporation. *Temp Treas Reg § 1.904-5T(m)*.

(n93)Footnote 64. See § 20.04[1] for the definition of US shareholder and § 2.07[4][a] for the definition of related person.

In the case of interest treated as foreign-source income under *IRC § 861(a)(1)(A)*, the corporation paying the interest is treated as a US-owned foreign corporation. *IRC § 904(h)(9)(A)*.

(n94)Footnote 65. *IRC § 904(h)(1)-(4)*. The term "dividend" includes any gain treated as ordinary income under *IRC § 1246* or as a dividend under *IRC § 1248*. *IRC § 904(h)(7)*.

In the case of any dividend treated as foreign-source income under *IRC § 861(a)(2)(A)*, the corporation paying the dividend is treated as a US-owned foreign corporation. *IRC § 904(h)(9)(B)*.

(n95)Footnote 66. *IRC § 904(h)(5), (10)*. For this purpose, earnings and profits are determined without any

reduction for interest subject to the recharacterization rules.

(n96)Footnote 67. *IRC § 904(h)(8)*.

(n97)Footnote 67.1. *IRC § 904(g)(1), 2(B)*. The provision also applies for purposes of *IRC § 936*.

An overall domestic loss is any domestic loss to the extent it offsets taxable income from foreign sources for the taxable year or any preceding taxable year because of a carryback. A domestic loss is the amount by which the gross income for the taxable year from United States sources is exceeded by the amount of deductions properly apportioned or allocated thereto (determined without regard to any carryback from a subsequent year). *IRC § 904(g)(2)(A)*.

(n98)Footnote 67.2. *IRC § 904(g)(3)*. The term "income category" means each separate category of income described in *IRC § 904(d)(1)*, discussed in § 20.02[4][e][iii]. *IRC § 904(f)(5)(E)(i)*.

(n99)Footnote 68. The following countries may require participation in, or cooperation with, an international boycott: Bahrain, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates, and Republic of Yemen. 69 *Fed Reg* 1616 (Jan 6, 2004) .

(n100)Footnote 69. *IRC § 999(c)(1)*.

(n101)Footnote 70. *IRC § 999(c)(2)*.

(n102)Footnote 71. The countries presently are Cuba, Iran, North Korea, Sudan, and Syria. Rev Rul 2005-3, 2005-1 *CB* 334 .

The denial applies as well to the deemed-paid credit allowed to domestic corporate shareholders of controlled foreign corporations by *IRC § 960*. See § 20.04[2][g].

The credit denial does not preclude a deduction for the taxes. Even if no deduction is taken, the requirement that the amount of any deemed-paid tax credit be treated as a grossed-up dividend is inapplicable. *IRC § 901(j)(3)*.

(n103)Footnote 72. See Rev Rul 92-62, 1992-2 *CB* 193 , for guidance in determining what portion of foreign taxes paid are creditable when a sanction period ends during the taxpayer's taxable year.

The denial extended to the credit allowed by *IRC § 960*.

(n104)Footnote 73. *IRC § 904(f)(2)*.

(n105)Footnote 74. *IRC § 904(f)(2)*. Any foreign expropriation loss for a year prior to Jan 1, 1991 is also not taken into account.

(n106)Footnote 75. The determination as to whether the predominant use of property has been without the US is made by looking at the use made during the three-year period ending on the date of disposition (or during the entire period of ownership if less than three years). *IRC § 904(f)(3)(A)*.

(n107)Footnote 76. *IRC § 904(f)(3)(A)*.

(n108)Footnote 77. *IRC § 904(f)(3)(B)(ii)*.

(n109)Footnote 77.1. *IRC § 904(f)(3)(B)(i)*.

(n110)Footnote 77.2. *IRC § 904(f)(3)(C)*.

(n111)Footnote 77.3. *IRC § 904(f)(3)(D)(i), (ii).*

(n112)Footnote 78. *IRC § 904(f)(3)(D)(iii).*

(n113)Footnote 79. *IRC § 904(f)(3)(D)(iv).*

(n114)Footnote 79.1. *IRC § 904(g)(2)(A).* An overall domestic loss does not include any loss for any taxable year unless the taxpayer chooses to claim a foreign tax credit for the year. *IRC § 904(g)(2)(B).*

(n115)Footnote 79.2. *IRC § 904(g)(2)(A).*

(n116)Footnote 79.3. *IRC § 904(g)(3).*

(n117)Footnote 79.4. The rules of *IRC § 316* apply in determining earnings and profits for these purposes. See § 4.02[1][a] for a discussion of these rules.

As a general rule, for purposes of *IRC § 904*, loss recognized with respect to stock that is allocated to foreign source income must be allocated to the separate category under *IRC § 904(d)* to which gain on a sale of the stock would have been assigned. *Treas Reg § 1.865-2(a)(5)*. There are exceptions for losses on (i) stock with respect to which the taxpayer included a dividend recapture amount (unless the dividends are passive-basket dividends) (*Reg § 1.865-2(b)(1)*); (ii) stock that constitutes inventory (*Reg § 1.865-2(b)(2)*); and (iii) stock in an S corporation (*Reg § 1.865-2(b)(3)*).

IRC § 865(h) provides that a taxpayer may elect to treat gain from the sale of stock of a foreign corporation as foreign source gain if the gain would otherwise be sourced in the US under *IRC § 865*, but would be sourced outside the US under a treaty obligation of the US. If the taxpayer makes the election, the gain is placed in its own separate limitation category for purposes of computing the foreign tax credit limitation under *IRC § 904*. *Ltr Rul 199918047*.

(n118)Footnote 79.5. *IRC § 904(d)(1)(A), (B)*. Tax imposed under the law of a foreign country or possession of the US on an amount that does constitute income under US tax principles is treated as imposed on passive income. *IRC § 904(d)(2)(H)*.

(n119)Footnote 79.6. *IRC § 904(d)(2)(A)(i), (B)(v)*. Passive category income is any income that would be foreign personal holding company income under the Subpart F rules, as well as amounts includable in income under the passive foreign investment company rules. *IRC § 904(d)(2)(B)(i), (ii)*.

(n120)Footnote 79.7. *IRC § 904(d)(2)(A)(ii)*.

(n121)Footnote 80. *IRC § 904(d)(2)(B)*. Passive income does not include rents or royalties that are derived in the active conduct of a trade or business and received from an unrelated person. *Treas Reg § 1.904-4(b)(2)(i)*.

Royalty income received by a domestic corporation from its foreign parent was held to be passive income for purposes of the foreign tax credit in *American Air Liquide v Commr*, 116 TC 60 (2001), *affd in an unpublished opinion* (9th Cir 2002). In so holding, the Tax Court dismissed the contention that the failure to treat the income as general limitation income for purposes of the credit (as is the case when royalty income is received from a controlled foreign corporation) violated Article 24(3) of the US-France Treaty.

The Treasury Department has proposed regulations that will change the result in *American Air Liquide*. Under *Prop Treas Reg § 1.904-4(b)(2)(i)*, royalties paid by a related party are considered active and, thus, general limitation basket income, if a group member also uses the licensed technology in the active conduct of a trade or business. As proposed, the regulation is prospective.

(n122)Footnote 81. *IRC § 904(d)(2)(B)(iii).*

(n123)Footnote 81.1. *Treas Reg § 1.904-4(b)(2)(i).*

(n124)Footnote 82. *IRC § 904(d)(2)(F).* For this purpose, the term "foreign income taxes" includes any income, war profits, or excess profits tax imposed by any foreign country or possession of the US.

(n125)Footnote 82.1. *Treas Reg § 1.904-4(c)(1).*

(n126)Footnote 82.2. *IRC § 904(d)(2)(G).*

(n127)Footnote 82.3. *IRC § 904(d)(2)(I), 954(d)(3).* Ownership of stock possessing 50 percent or more of the total voting power of all classes of stock entitled to vote or of the total value of the stock of the corporation constitutes control of the corporation.

(n128)Footnote 83. *IRC § 904(d)(2)(D).* *Treas Reg § 1.904-4(e)(2)* contains a list of items of active financing income.

(n129)Footnote 84. *IRC § 904(d)(2)(C).* A financial services group is any affiliated group that is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. In determining whether a group is so engaged, there is taken into account only the income of members of the group that are US corporations or controlled foreign corporations in which the US corporations own, directly or indirectly, at least 80% of the total voting power and value of the stock.

(n130)Footnote 84.1. *IRC § 904(d)(2)(E)(i).* A controlled foreign corporation will not be treated as a noncontrolled § 902 corporation with respect to any distributions out of its earnings and profits for periods during which it was a controlled foreign corporation.

(n131)Footnote 84.2. *IRC § 904(d)(2)(E)(ii).*

(n132)Footnote 84.3. *IRC § 904(d)(3)(A), (C).* In determining whether any income of a controlled foreign corporation is passive category income, the exclusion of high-taxed income does not apply. *IRC § 904(d)(3)(F)(i).* Any amount of the taxpayer that is treated as passive category income under *IRC § 904(d)(3)(F)* is so treated notwithstanding any provision of *IRC § 904(d)(2)*, except that the determination of whether any amount is high-taxed income is made after the application of *IRC § 904(d)(3)(F)*. *IRC § 904(d)(3)(F)(ii).*

(n133)Footnote 84.4. *IRC § 904(d)(3)(D).* For purposes of *IRC § 904(d)(3)(G)* provides that the term "dividend" includes any amount included in gross income under *IRC § 951(a)(1)(B)* (see § 20.04[2][a]). Any amount included in gross income as a gross-up dividend under *IRC § 78* to the extent attributable to amounts included in gross income in *IRC § 951(a)(1)(A)* is not treated as a dividend but is included in gross income under *IRC § 951(a)(1)(A)*.

(n134)Footnote 84.5. *IRC § 904(d)(3)(B).*

(n135)Footnote 84.6. *IRC § 904(d)(3)(E).*

(n136)Footnote 85. *IRC § 904(d)(3)(H).*

(n137)Footnote 85.1. *Treas Reg § 1.904-5(g).*

(n138)Footnote 85.2. One partnership is considered as owning more than 50 percent of the value of another partnership if the first owns more than 50 percent of the capital and profits interests in the second. *Treas Reg § 1.904-5(h)(4).*

Two look-through entities are related if the same US shareholders own, directly or indirectly, stock possessing more than 50 percent of the total voting power of all classes of stock (in the case of a corporation) or more than 50 percent of the total value of each look-through entity. *Treas Reg § 1.904-5(i) ((1))*.

(n139)Footnote 85.3. *Treas Reg § 1.904-5(h)(2)(i)*.

(n140)Footnote 85.4. *Treas Reg §§ 1.904-5(h)(2)(ii), 1.904-5(h)(4)*. A partnership interest will be considered to be held in the ordinary course of a partner's active trade or business if the partner (or a member of the partner's affiliated group of corporations) engages (other than through a less than 10 percent interest in a partnership) in the same or related trade or business as the partnership.

(n141)Footnote 85.5. *IRC § 904(d)(4)(A)*. In the case of a distribution from a controlled foreign corporation to a US shareholder, similar rules apply in determining which earnings and profits of the controlled foreign corporation that are attributable to dividends received from a noncontrolled Section 902 corporation can be treated as income in a separate category. *IRC § 904(d)(4)(B)*.

(n142)Footnote 85.6. *IRC § 904(d)(4)(C)(i)*. If the Service determines that the allocation to either passive category income or general category income has not been substantiated, the dividend is treated as passive category income. *IRC § 904(d)(4)(C)(ii)*.

(n143)Footnote 85.7. *IRC § 904(d)(4)(C)(iv)*.

(n144)Footnote 86. *IRC § 275(a)(4)* (emphasis supplied).

(n145)Footnote 87. Prior to enactment of the American Jobs Creation Act of 2004, the carryback period was two years, while the carryover period was five years. The new carryback rule applies to excess foreign taxes arising in taxable years beginning after the date of enactment of the Act. The carryover rules apply to excess foreign taxes that may be carried to any taxable year ending after the date of enactment.

A wholly-owned subsidiary that had been unable to claim its entire foreign tax credit was liquidated by its parent under *IRC § 332*. In the year of liquidation, the parent had taxable income from foreign sources attributable to the continuation of the subsidiary's business. The foreign taxes paid were less than the limitation prescribed by *IRC § 904(a)*, allowing the parent to carry over and use the uncredited foreign taxes of the subsidiary. *Rev Rul 72-453, 1972-2 CB 439*.

An excess foreign tax that is carried forward cannot be claimed as a credit in a year in which the taxpayer does not have foreign source income. *Smith v Commr, TC Memo 1984-509*.

(n146)Footnote 88. However, the excess foreign tax may be used as a credit in such other year even though the taxpayer decides to deduct the taxes actually paid or accrued during that year. In such case, the amount of the limitation is determined as though the taxpayer had chosen to claim a credit for that year. *Treas Reg § 1.904-2(d)*.

(n147)Footnote 89. The carryback and carryover of unused foreign taxes by a husband and wife filing a joint return for all years is computed on the basis of the joint unused foreign taxes and limitations. *Treas Reg § 1.904-3(c)*.

(n148)Footnote 89.1. *Temp Treas Reg § 1.904-2T(h)(1)*. Any excess taxes carried over from pre-2003 taxable years to post-2002 taxable years that would otherwise be assigned to the passive category are assigned to the general limitation category.

The reconstruction of earnings is accomplished in accordance with *Temp Treas Reg § 1.904-7T(f)*.

(n149)Footnote 89.2. *Temp Treas Reg § 1.904-2T(h)(2)*.

(n150)Footnote 90. *IRC § 6601(d)(2)*.

(n151)Footnote 91. *IRC § 6611(f)(2)*. Thus, interest accrues on the deficiency expunged by the later foreign tax carryback until the due date of the return for the taxable year from which the carryback arises. *Hallmark Cards, Inc v Commr*, 111 TC 266 (1998) ; *Intel Corp v Commr*, 111 TC 90 (1998) .

(n152)Footnote 92. *IRC § 6511(d)(3)(A)*.

The Court of Claims has taken the position that the 10-year period of limitations begins to run on the date prescribed by law for filing the return for the year for which a refund is sought. *Ampex Corp v US*, 620 F2d 853 (Ct Cl 1980) . The Sixth Circuit has ruled that the period runs from the due date for filing the return for the year from which the excess foreign taxes are carried. *Chrysler Corp v Commr*, 436 F3d 644 (6th Cir 2006) .

(n153)Footnote 92.1. *IRC § 901(k)(1)(A)(i), (3), (7)*. A withholding tax includes any tax determined on a gross basis, but does not include any tax that is in the nature of a prepayment of a tax imposed on a net basis. *IRC § 901(k)(1)(B)*.

IRC § 78 does not apply to the tax that is not allowed as a credit. *IRC § 901(k)(7)*. Therefore, the amount of the tax is not grossed up and included in income.

The disallowance rule applies to dividends received or accrued after September 4, 1997.

(n154)Footnote 92.2. *IRC § 901(k)(2)*.

(n155)Footnote 92.3. *IRC § 901(k)(1)(A)(ii)*.

(n156)Footnote 92.4. *IRC § 901(k)(5)*. The rules of *IRC § 246(c)(3)* regarding the determination of the holding period also apply.

(n157)Footnote 92.5. *IRC § 901(k)(6)*.

(n158)Footnote 92.6. *IRC § 901(k)(4)(A)*.

(n159)Footnote 92.7. *IRC § 901(k)(4)(B)*.

(n160)Footnote 92.8. *IRC § 901(l)(1)*.

(n161)Footnote 92.9. *IRC § 901(l)(2)(A)*.

(n162)Footnote 92.10. *IRC § 901(l)(2)(C)*.

(n163)Footnote 93. *IRC § 901(l)(2)(B)*.

(n164)Footnote 94. *IRC § 901(l)(3)*. Pursuant to this authority, the Service issued *Notice 2005-90, 2005-2 CB 1163* , in which it announced that it had been determined that the application of *IRC § 901(l)(1)* to foreign withholding taxes imposed on payments in a back-to-back computer program licensing arrangement in the ordinary course of the licensor's and licensee's respective trades or businesses is not necessary to carry out the purposes of *IRC § 901(l)*. Taxpayers can rely on the guidance in *Notice 2005-90* until regulations incorporating the guidance are issued.

(n165)Footnote 95. *IRC § 6038(a)*. A "United States person" means a citizen or resident of the US, a domestic corporation or partnership, and any estate or trust other than one, the income of which, from sources without the US which is not effectively connected with a trade or business within the US, is not includable in gross income. *IRC § 7701(a)(30)*.

The term "foreign business entity" means a foreign corporation or foreign partnership. *IRC § 6038(e)(1)*.

US persons owning at least 10 percent of a controlled foreign corporation or controlled foreign partnership may be required to furnish the designated information. *IRC § 6038(a)(4), (5)*.

(n166)Footnote 96. *IRC § 6038(e)(2)*.

(n167)Footnote 97. *IRC § 6038(e)(2)*.

(n168)Footnote 98. *IRC § 6038(e)(2)*.

(n169)Footnote 99. *IRC § 6038(e)(3)(A)*.

(n170)Footnote 100. *IRC § 6038(e)(3)(B)*. Rules similar to the rules of *IRC § 267(c)* (other than *IRC § 267(c)(3)*) apply in determining whether a person has a 50-percent interest.

(n171)Footnote 101. *IRC § 6038(c)(1)*.

(n172)Footnote 102. *IRC § 6038(c)(1)*.

(n173)Footnote 103. *IRC § 6038(c)(2)*.

(n174)Footnote 104. *IRC § 6038(b)(3)*.

(n175)Footnote 105. *IRC § 6038(b)(1)*.

(n176)Footnote 106. *IRC § 6038(b)(2)*.



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Taxation of Securities Transactions

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CHAPTER 20 Foreign Securities and Foreign Shareholders

2-20 Taxation of Securities Transactions § 20.03

§ 20.03 Tax Consequences of Investments in Foreign Securities by United States Citizens and Residents--Controlled Foreign Corporations

Prior to 1962, no United States tax was imposed with respect to the foreign source earnings of a foreign corporation controlled by American shareholders until dividends paid by the corporation were received by its shareholders. This was subject to only one exception--when the foreign corporation was a foreign personal holding company.

In 1961, President Kennedy questioned the desirability of providing tax deferral with respect to the earnings of corporations controlled by American shareholders. In his words:

"The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. Recently more and more enterprises organized abroad by American firms have arranged their corporate structures ... so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad. ...

"If we are seeking to curb tax havens, if we recognize that the stimulus of tax deferral is no longer needed in the developed countries ... we can no longer afford existing tax treatment of foreign income."n1

After recommending that tax deferral remain in effect for income from investment in developing economies, the President continued:

"On the other hand, I recommend elimination of the tax haven device anywhere in the world, even in the underdeveloped countries, through the elimination of tax deferral privileges for those forms of activities, such as trading, licensing, insurance, and others, that typically seek out tax haven methods of operation. There is no valid reason to permit their remaining untaxed regardless of the country in which they are located."n2

The Congressional response--the enactment of "Subpart F"--was less sweeping. Tax deferral was eliminated only with respect to tax-haven operations by controlled foreign corporations. To achieve this, the United States shareholders of

foreign corporations are taxed on their pro rata share of certain classes of income whether distributed to them or not.ⁿ³ A discussion of the provisions of Subpart F follows. In this treatment, no consideration is given to the special rules provided for corporations which derive income from the insurance of United States risks, or for corporations organized in Puerto Rico or possessions of the United States.ⁿ⁴

[1] Controlled Foreign Corporation Defined

A foreign corporation becomes a controlled corporation within the purview of Subpart F when 50 percent or more of the total combined voting power of all classes of voting stock, or of the total value of the stock of the corporation, is owned by United States shareholders on any day during the corporation's taxable year.ⁿ¹ The term "United States shareholder" is defined as any United States person--a citizen or resident of the United States, a domestic corporation, a domestic partnership, or any estate or trust other than a foreign estate or trust--owning 10 percent or more of the total combined voting power of the corporation.ⁿ² Thus, a dual test is imposed with respect to stock ownership. United States persons must own at least 50 percent of the voting power or value, but stock owned by a United States person is not counted unless the person owns at least 10 percent of the voting power. In other words, there is little likelihood that a foreign corporation will be classified as a controlled foreign corporation if its stock is widely held by unrelated persons.

Generally, the determination as to whether United States shareholders own 50 percent or more of the total combined voting power of all classes of stock entitled to vote is made in light of all of the facts and circumstances of the case.ⁿ³ However, the United States shareholders will automatically be deemed to own the requisite percentage of total combined voting power whenever:

- (1) they have the power to elect, appoint, or replace a majority of the corporation's board of directors (or, if it does not have a board of directors, then a majority of the comparable governing board);
- (2) they can elect exactly one-half of the members of the governing body of the corporation and any person or persons elected or designated by such shareholders have the power either to cast a vote deciding an evenly divided vote of the body or, for the duration of any deadlock which may arise, to exercise the powers ordinarily exercised by the body; or
- (3) the powers ordinarily exercised by the board of directors of a domestic corporation are exercised by a person whom they can elect, appoint, or replace.ⁿ⁴

The crucial factor is the reality of voting power, not mere ownership of voting stock. Nominal ownership of voting stock will be disregarded if the shareholder has agreed not to vote his stock or to vote it only in a specified manner; the determination as to voting power will be made on the basis of the agreement.ⁿ⁵ Any arrangement to shift formal voting power away from United States shareholders will not be given effect if, in fact, voting power is retained.ⁿ⁶ In addition, record ownership will be disregarded if (a) there is a separate class of stock with percentage voting power greater than its share of earnings, (b) the holders of the separate class do not exercise their voting power independently, or fail to exercise their rights, and (c) a principal purpose of the arrangement is to avoid classification as a controlled foreign corporation.ⁿ⁷

Indirect and constructive ownership of stock must be taken into account in computing the extent of a United States person's voting power in a foreign corporation. The indirect ownership rule is prescribed by *IRC Section 958(a)(2)*; stock owned by a foreign corporation, foreign partnership, foreign estate, or foreign trust is considered as being owned proportionately by its shareholders, partners, or beneficiaries. The constructive ownership rules are those contained in *IRC Section 318(a)*,ⁿ⁸ with the following modifications:

- (1) a citizen or resident alien does not constructively own the stock owned by any family member who is a non-resident alien;

(2) for the purpose of applying *IRC Section 318(a)(2)* (attribution from corporations, partnerships, estates, or trusts), a partnership, estate, trust, or corporation owning more than 50 percent of the combined voting power of a corporation is considered as owning all of the stock of the corporation;

(3) stock owned by a corporation will be attributed proportionately to any shareholder owning 10 percent or more of its stock; and

(4) *IRC Section 318(a)(3)* will not be applied to make a domestic corporation, domestic partnership, or nonforeign estate or trust the constructive owner of stock owned by one who is not a United States person.ⁿ⁹

The following example illustrates some of the foregoing principles:

Example:

United States citizen *A* owns 5 percent of the one class of stock in domestic corporation *X*, which owns 60 percent of the one class of stock in foreign corporation *Y*, which, in turn, owns 75 percent of the one class of stock in foreign corporation *Z*. *A*'s father, *F*, a nonresident alien, owns the balance of the stock in foreign corporation *Z*. By virtue of the indirect ownership rule of *IRC Section 958(a)(2)*, corporation *X* is treated as the owner of 45 percent (60 percent of 75 percent) of the stock in corporation *Z*. The indirect ownership rule cannot be applied to make *A* the owner of any of the *Z* stock; attribution under *IRC Section 958(a)(2)* ends with the first United States person in the chain of ownership running from the foreign entity.ⁿ¹⁰ If the indirect ownership rule were the only one applicable, foreign corporation *Z* would not be a controlled foreign corporation since United States shareholders do not own more than 50 percent of the combined voting power of the corporation. However, the constructive ownership rules also apply to make corporation *X* the owner of 60 percent of the *Z* stock. (Corporation *Y* owns more than 50 percent of the stock in corporation *Z*, causing it to be treated as the owner of 100 percent of the *Z* stock; corporation *X* owns 60 percent of that 100 percent.) And since the rule which imputes the greatest degree of stock ownership controls for any one determination,ⁿ¹¹ a United States person owns more than 50 percent of the voting power in foreign corporation *Z*, making it a controlled foreign corporation. The attribution rules cannot be applied to make *A* a United States shareholder. His ownership of less than 10 percent of the stock in corporation *X* precludes attribution from entity to shareholder; his father's status--that of a nonresident alien--prevents application of the family attribution rule.

[2] Effect on the Shareholder

[a] Inclusion in Gross Income of Certain Undistributed Income of the Corporation. *IRC Section 951(a)* requires every United States shareholder who owns stock in a controlled foreign corporation on the last day of its taxable year (or on the last day in the year on which it was a controlled foreign corporation) to report the shareholder's pro rata share of (1) the corporation's Subpart F income,ⁿ¹ (2) the corporation's previously excluded Subpart F income withdrawn from investment in less developed countries (determined under *IRC Section 955(a)(3)* as in effect before the enactment of the Tax Reduction Act of 1975), (3) the corporation's previously excluded Subpart F income withdrawn from foreign base shipping companies for such year (determined under *IRC Section 955(a)(3)*,^{n1.1} and (4) the amount determined under *IRC Section 956* with respect to the shareholder for the taxable year (but only to the extent not excluded from income under *IRC Section 959(a)(2)*).ⁿ² (The foreign trade income of a foreign sales corporation and any deductions apportioned or allocated to such income are not taken into account under Subpart F).ⁿ³ The amount includable is computed by reference only to stock owned directly or indirectly (through foreign entities); the shareholder need not include any amounts attributable to stock constructively owned, even though such stock is taken into account in determining whether the shareholder is a United States shareholder and whether the corporation is a controlled foreign corporation.ⁿ⁴ If controlled foreign corporation status did not exist for the entire year, a further

proration is required to reflect that fact. But no inclusion in gross income is required unless the corporation was a controlled foreign corporation for an uninterrupted period of at least thirty days during the taxable year.

If a controlled foreign corporation has only one class of stock outstanding during the taxable year, each United States shareholder's pro rata share of the corporation's Subpart F income or withdrawal for the taxable year is determined by allocating the corporation's earnings and profits on a per share basis.^{n4.1} If the corporation has more than one class of stock outstanding, then, generally, the Subpart F income or withdrawal is allocated to the multiple classes of stock by reference to the distributions that would be made to each class if the corporation's earnings and profits for the year were distributed on the last day of the corporation's taxable year (the hypothetical distribution).^{n4.2} Where, however, the allocation of the amount of the corporation's earnings and profits between multiple classes of stock depends on the exercise of discretion by the corporation's board of directors or similar governing body, earnings and profits are allocated to classes of shares with discretionary rights by reference to the relative values of those classes at the time of the hypothetical distribution.^{n4.3} No amount will be considered as distributed as part of the hypothetical distribution with respect to any class of stock to the extent that a distribution of the amount would constitute a distribution in redemption of stock (even if the distribution would be treated as a dividend), a distribution in liquidation, or a return of capital.^{n4.4}

A restriction or other limitation on distributions or earnings and profits by the controlled foreign corporation is not taken into account in determining the amount of earnings and profits allocated to a class of stock of the corporation or the amount of the United States shareholder's pro rata share of the corporation's Subpart F income or withdrawal for the taxable year.^{n4.5} Types of restrictions covered by the foregoing rule include (a) an arrangement that restricts the ability of the corporation to pay dividends on a class of stock owned by United States shareholders until a condition or conditions are satisfied (as until another class of stock is redeemed), (b) a loan agreement entered into by the corporation that restricts or otherwise affects the ability to make distributions on its stock until certain requirements are satisfied, or (c) an arrangement that conditions the ability of the corporation to pay dividends to its shareholders on the financial condition of the corporation.^{n4.6}

If a controlled foreign corporation has more than one class of stock outstanding and the corporation has earnings and profits and Subpart F income for a taxable year attributable to a redemption by a subsidiary or affiliated corporation as described in *IRC Section 304*, and the transaction is part of a plan a principal purpose of which is the avoidance of federal income taxation, the amount of earnings and profits allocated to any one class of stock is that amount that bears the same ratio to the remainder of the earnings and profits as the value of all shares of such class of stock, determined on the hypothetical distribution date, bears to the total value of all shares of all classes of stock of the corporation, determined on that date.^{n4.7}

If a controlled foreign corporation has one or more classes of preferred stock with cumulative dividend rights, the stock is considered as stock with discretionary distribution rights for purposes of the allocation of earnings and profits.^{n4.8} As a result, *Regulation Section 1.951-1(e)(3)(ii)* will apply for purposes of allocating earnings and profits to the stock, except that earnings and profits must first be allocated to the stock under the provisions of *Regulation Section 1.951-1(e)(3)(i)* to the extent of any dividends paid with respect to the stock during the taxable year.^{n4.9} Additional earnings and profits will be allocated to the stock only in an amount equal to the excess (if any) of the amount allocated with respect to dividends paid during the year.^{n4.10} However, if a class of redeemable preferred stock with cumulative dividend rights has a mandatory redemption date, and all dividend arrearages with respect to the stock compound at least annually at a rate not lower than the applicable federal rate that applies on the date the stock is issued for the term from the issue date to the mandatory redemption rate, based on a comparable compounding assumption, the stock is not considered stock with discretionary distribution rights for purposes of the allocation of earnings and profits.^{n4.11}

IRC Section 951 coordinates its provisions with those pertaining to passive foreign investment companies. Income that would be includable both under the controlled foreign corporation rules and *IRC Section 1293* (relating to current taxation of income from certain passive foreign investment companies) is includable only under *IRC Section 951*.ⁿ⁵

[b] The Includable Income--Subpart F Income.

As defined by *IRC Section 952*, a controlled foreign corporation's Subpart F income is the sum of its insurance income,ⁿ⁶ an amount equal to the product of the income of the corporation (other than income attributable to earnings and profits of the corporation otherwise includable in the income of a U.S. person under *IRC Section 951* and income from U.S. sources effectively connected with a trade or business conducted by the corporation in the United States) multiplied by the international boycott factor,ⁿ⁷ the amount of any illegal kickbacks or bribes paid by or on behalf of the corporation directly or indirectly to an official, employee, or agent of a government, its foreign base company income, and any income derived from any country during which *IRC Section 901(k)* (discussed in § 20.02[4][e][i]) applies to such country, but does not include any item of income from sources within the United States which is effectively connected with the conduct by the corporation of a trade or business within the United States unless such item is exempt from taxation or subject to a reduced rate of tax under a treaty obligation of the United States.ⁿ⁸ However, the amount of Subpart F income that may be taxed in any given year is limited to the earnings and profits of the controlled foreign corporation for such year.ⁿ⁹ However, if Subpart F income is reduced by reason of the last-stated rule, any excess of earnings and profits for any subsequent taxable year over the Subpart F income of the corporation for the year is recharacterized as Subpart F income.ⁿ¹⁰

The amount included in the gross income of any United States shareholder for any taxable year, and attributable to a qualified activity is reduced by the amount of the shareholder's pro rata share of any qualified deficit--a deficit in earnings and profits of the controlled foreign corporation for any prior taxable year that began after December 31, 1986 (in which the corporation was a controlled foreign corporation)--but only to the extent the deficit is attributable to the same qualified activity giving rise to the income being offset, and has not previously been taken into account.ⁿ¹¹ A qualified activity is defined as one giving rise to (1) foreign base company oil income, (2) foreign base company sales income, (3) foreign base company services income, (4) in the case of a controlled foreign corporation predominantly engaged in the active conduct of an insurance business in the taxable year and in the prior taxable year in which the deficit arose, insurance income or foreign personal holding company income, and (5) in the case of a controlled foreign corporation predominantly engaged in the active conduct of a banking, financing, or similar business in the taxable year and in the prior taxable year in which the deficit arose, foreign personal holding company income.

A controlled foreign corporation can elect to reduce the amount of its Subpart F income for any taxable year that is attributable to any qualified activity by the amount of any deficit in earnings and profits of a qualified chain member for a taxable year ending with (or within) the taxable year of the controlled foreign corporation to the extent the deficit is attributable to the activity. To the extent the deficit reduces Subpart F income, the deficit is not again taken into account under *IRC Section 952(c)(1)(B)*.ⁿ¹² A qualified chain member is a corporation organized under the laws of the same foreign country as the controlled foreign corporation if at all times during the taxable year in which the deficit arose (a) all of its stock (other than directors' qualifying shares) is owned (directly or indirectly) by the controlled foreign corporation, or (b) it owns (directly or indirectly) all of the stock of the controlled foreign corporation (other than directors' qualifying shares).

[i] Foreign Base Company Income. The gross foreign base company income component of Subpart F income consists of four items, namely, foreign personal holding company income, foreign base company sales income, foreign base company services income, and foreign base company oil related income.ⁿ¹³ Any interest that is paid or accrued by the controlled foreign corporation to any United States shareholder (or to any controlled foreign corporation related to the shareholder) must first be allocated to foreign personal holding company income that is passive income.ⁿ¹⁴

Adjusted gross foreign base company income is computed using *de minimis* and full inclusion tests. Under the *de minimis* test, adjusted gross foreign base company income is treated as being equal to zero if the sum of the gross foreign base company income and gross insurance income of the controlled foreign corporation is less than the lesser of 5 percent of gross income or \$1 million.ⁿ¹⁵ Even if the *de minimis* test is otherwise satisfied, the adjusted gross foreign base company income of a controlled foreign corporation always includes income from trade or service receivables

acquired from a related person, income from loans made to a person to acquire inventory from a related person or for the performance of services by a related person, and portfolio interest.ⁿ¹⁶

An anti-abuse rule requires that the *de minimis* test be applied by aggregating the income of two or more controlled foreign corporations if a principal purpose for separately organizing, acquiring, or maintaining multiple corporations is to prevent income from being treated as foreign base company income under the *de minimis* test; a purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).ⁿ¹⁷ Two or more controlled foreign corporations are presumed to have been organized, acquired, or maintained to prevent income from being treated as foreign base company income or insurance income under the *de minimis* test if the corporations are related parties and one of the following situations exists:ⁿ¹⁸

- (1) The activities carried on by the controlled foreign corporations, or the assets used in those activities, are substantially the same activities that were previously carried on, or assets that were previously held, by a single controlled foreign corporation. Further, the United States shareholders of the controlled foreign corporations or related persons are substantially the same as the United States shareholders of the one controlled foreign corporation in a prior taxable year.ⁿ¹⁹
- (2) The controlled foreign corporations carry on a business, financial operation, or venture as partners directly or indirectly in a partnership that is a related person with respect to each of the controlled foreign corporation.
- (3) The activities carried on by the controlled foreign corporations would constitute a single branch operation if carried on by a United States person.^{n19.1}

Under the full inclusion test, if the sum of the gross foreign base company income and the gross insurance income for the taxable year exceeds 70 percent of the gross income of the corporation, adjusted gross foreign base company income consists of all gross income of the corporation other than gross insurance income, while adjusted gross insurance income consists of all gross insurance income.^{n19.2} In either case, gross income does not include income derived from United States sources effectively connected with the conduct of a United States trade or business, unless the income is exempt from tax (or taxed at a reduced rate) by treaty.^{n19.3}

The gross income included in adjusted gross foreign base company income of a controlled foreign corporation generally retains its character as foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, or foreign base company oil income.^{n19.4} However, gross income included in adjusted gross foreign base company income because of the full inclusion test is termed full inclusion foreign base company income and constitutes a separate category of adjusted foreign base company income for purposes of allocating and apportioning deductions allowed in computing net foreign base company income.^{n19.5}

Net foreign base company income is computed by reducing each constituent item of foreign base company income by deductions properly allocable to such item.^{n19.6} If, after such reduction, the amount of each category of foreign base company income or foreign personal holding company income is less than zero, the loss in that category cannot reduce any other category of foreign base company income or foreign personal holding company income except by operation of the earnings and profits limitation of *IRC Section 952(c)(1)*.^{n19.7}

Foreign base company income does not include any item of income received by a controlled foreign corporation if the taxpayer establishes to the satisfaction of the Service that such income was subject to an effective rate of foreign income tax greater than 90 percent of the maximum rate imposed on corporations by *IRC Section 11*.ⁿ²⁰ The preceding rule does not apply to foreign base company oil related income or portfolio interest.

Adjusted net foreign base company income equals the net foreign base company income of a controlled foreign

corporation, reduced by any net item of such income that qualifies for the high tax exception.^{n20.1} A net item of income qualifies for the high tax exception only if (1) an election is made to exclude the income from the computation of Subpart F income, and (2) it is established that the net item of income was subject to foreign income taxes imposed by a foreign country or countries at an effective rate that is greater than 90 percent of the maximum rate of tax specified in *IRC Section 11* for the taxable year of the controlled foreign corporation.^{n20.2}

The effective rate at which taxes are imposed on a net item of income is (a) the United States dollar amount of foreign income taxes paid or accrued with respect to the net item of income divided by (b) the United States dollar amount of the net item of foreign base company income, increased by the amount of such foreign taxes.^{n20.3} The amount of foreign taxes accrued with respect to a net item of income (other than foreign personal holding company income that is passive) for purposes of the high tax exception is the United States dollar amount of foreign income taxes that would be deemed paid under *IRC Section 960* with respect to that item if the item were included in the gross income of a United States shareholder under *IRC Section 951(a)(1)(A)* (determined, in the case of an individual, as if an election under *IRC Section 962* to be taxed at corporate rates, has been made).ⁿ²¹ The amount of income taxes paid or accrued with respect to a net item of foreign personal holding company income that is passive is the United States dollar amount of foreign income taxes deemed paid under *IRC Section 960* and that would be taken into account in determining the foreign tax credit limitation with respect to high taxed income.ⁿ²²

[ii] Foreign Personal Holding Company Income. Foreign personal holding company income for Subpart F purposes is defined as the portion of gross income that consists of (1) dividends, interest, royalties, rents, and annuities,ⁿ²³ (2) the excess of gains over losses from the sale or exchange of property that gives rise to income described in (1), that is an interest in a trust, partnership, or REMIC, or that does not give rise to any income, (3) the excess of gains over losses from transactions (including futures, forward and similar transactions) in commodities, (4) the excess of foreign currency gains over foreign currency losses attributable to an *IRC Section 988* transaction (other than one directly related to the business needs of the controlled foreign corporation), (5) any income equivalent to interest, including income from commitment fees (or similar amounts) for loans actually made, (6) income from notional principal contracts, (7) payments in lieu of dividends made pursuant to an agreement to which *IRC Section 1058* applies (equity securities lending transactions, and (8) amounts received under a personal service contract, if some person other than the corporation has the right to designate the individual who is to perform the services or the individual who is to perform the services is designated in the contract, and amounts received from the sale or other disposition of the personal service contract.ⁿ²⁴ Gains and losses from commodities transactions are not included here if (1) they arise out of commodity hedging transactions, (2) are active business gains or losses from the sale of commodities, but only if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant or handler of commodities, or (3) are foreign currency gains or losses (as defined in *IRC Section 988(b)*) attributable to any Section 988 transaction.ⁿ²⁵ In determining the foreign personal holding company income of a regular dealer in certain property,ⁿ²⁶ forward contracts, option contracts, notional principal contracts, or similar financial instruments (including instruments referenced to commodities), there is not taken into account (i) any item of income, gain, deduction, or loss from any transaction (including hedging transaction and transactions involving physical settlement) entered into in the ordinary course of the dealer's trade or business, and (ii) if the dealer is a dealer in securities, any interest or dividend or equivalent amount from any transaction (including any hedging transaction or transaction described in *IRC Section 956(c)(2)(J)*)ⁿ²⁷ entered into in the ordinary course of the dealer's trade or business as a dealer in securities, but only if the income from the transaction is attributable to activities of the dealer in the country under the laws of which the dealer is created or organized (or in the case of a qualified business unit is attributable to activities of the unit in the country in which the unit both maintains its principal office and conducts substantial business activity).ⁿ²⁸ Foreign currency gains or losses are not taken into account if they are directly related to the business needs of the controlled foreign corporation.ⁿ²⁹

Foreign personal holding company income does not include rents or royalties derived in the active conduct of a trade or business and received from a person other than a related person,ⁿ³⁰ or any export financing interest that is derived in the conduct of a banking business.ⁿ³¹ It also does not include any (1) dividendsⁿ³² and interest received from a related

person that (a) is organized under the laws of the same foreign country as the controlled foreign corporation, and (b) has a substantial part of its assets used in its trade or business in that foreign country, and (2) rents and royalties received from a related person for the use of, or privilege of using, property within the country in which the controlled foreign corporation is organized.ⁿ³³ To determine the extent to which a controlled foreign corporation's distributive share of an item of partnership income is foreign personal holding company income, the exceptions contained in *IRC Section 954(c)* that are based on whether the controlled foreign corporation is engaged in the active conduct of a trade or business will apply only if the exception would have applied if the controlled foreign corporation had earned the income directly, taking into account only the activities of, and property owned by, the partnership.ⁿ³⁴

If a controlled foreign corporation sells an interest in a partnership with respect to which the corporation is a 25-percent owner, the corporation is treated for purposes of *IRC Section 954(c)* as selling the proportionate share of the assets of the partnership attributable to the interest.ⁿ³⁵ A controlled foreign corporation is a 25-percent owner when it owns directly 25 percent or more of the capital or profits interest in a partnership.ⁿ³⁶ If a controlled foreign corporation is a shareholder or partner of a corporation or partnership, the controlled foreign corporation is treated as owning its proportionate share of any capital or profits interest held directly by such corporation or partnership.ⁿ³⁷

IRC Section 954(h)(1) contains a special rule that removes qualified banking or financing income of an eligible controlled foreign corporation from the category of foreign personal holding company income.ⁿ³⁸ To be an eligible controlled foreign corporation, the corporation must be predominantly engaged in the active conduct of a banking, finance, or similar business, and conduct substantial activity with respect to that business.ⁿ³⁹

A controlled foreign corporation is predominantly engaged in the active conduct of a banking, financing, or similar business if (1) more than 70 percent of the gross income of the corporation is derived directly from the active and regular conduct of a lending or finance business from transactions with customers who are not related persons;ⁿ⁴⁰ (2) it is engaged in the active conduct of a banking business and is an institution licensed to do business as a bank in the United States (or is any other corporation that is not licensed but is specified in regulations); or (3) it is engaged in the active conduct of a securities business and is registered as a securities broker or dealer under Section 15 of the Securities Exchange Act of 1934 or is registered as a Government securities broker or dealer under Section 15C(a) of that Act (or is any other corporation that is not registered and is specified in regulations).ⁿ⁴¹

Qualified banking or financing income is income of an eligible controlled foreign corporation that (i) is derived by the eligible controlled foreign corporation or a qualified business unit of the corporation; (ii) is derived from one or more transactions with customers located in a country other than the United States, and substantially all of the activities in connection with the transactions are conducted directly by the corporation or unit in its home country; and (iii) is treated as earned by the corporation or unit in its home country for purposes of that country's tax laws.ⁿ⁴² No income of an eligible controlled foreign corporation (or qualified business unit of the corporation) that is not engaged in the banking or securities business can be treated as qualified banking or financing income unless more than 30 percent of the corporation's or unit's gross income is derived directly from the active and regular conduct of a lending or finance business from transactions with customers that are not related persons and that are located within the corporation's or unit's home country.ⁿ⁴³ In addition, qualified banking or financing income does not include income derived from transactions with customers located in a country other than the home country of the foreign corporation (or a qualified business unit of the corporation) unless the corporation or unit conducts substantial activity with respect to a banking, finance or similar business in its home country.ⁿ⁴⁴ Finally, the qualified banking or finance income of an eligible controlled foreign corporation or a qualified business unit of the corporation must be determined separately for the corporation and each unit by taking into account (1) in the case of the corporation, only items of income, deduction, gain, or loss and activities of the corporation not properly allocable or attributable to any qualified business unit of the corporation, and (2) in the case of a qualified business unit, only items of income, deduction, gain, or loss and activities properly allocable to that unit.ⁿ⁴⁵

A controlled foreign corporation's distributive share of partnership income will not be excluded from foreign personal

holding company income under the exception contained in *IRC Section 954(h)* unless the controlled foreign corporation is an eligible controlled foreign corporation (taking into account the income of the controlled foreign corporation and any partnerships or other qualified business units of the controlled foreign corporation, including the controlled foreign corporation's distributive share of partnership income) and the partnership, of which the controlled foreign corporation is a partner, generates qualified banking or financing income (taking into account only the income of the partnership).ⁿ⁴⁶

Pursuant to *IRC Section 954(i)(1)*, foreign personal holding company does not include qualified insurance company income of a qualifying insurance company. To be treated as such, the income must be received (a) from a person other than a related person and be derived from investments made by a qualifying insurance company or a qualifying insurance company branch of its reserves allocable to exempt contracts or of 80 percent of its unearned premiums from exempt contracts, or (b) from a person other than a related person and be derived from investments made by the insurance company or branch of an amount of its assets allocable to exempt contracts equal to (i) in the case of property, casualty, or health insurance contracts, one-third of its premiums earned on such insurance contracts during the taxable year, and (ii) in the case of life insurance or annuity contracts, 10 percent of the reserves described in (a) for such contracts.ⁿ⁴⁷ A controlled foreign corporation's distributive share of partnership income will not be excluded from foreign personal holding company income under the exception contained in *IRC Section 954(i)* unless the controlled foreign corporation partner is a qualifying insurance company (determined by examining premiums written by the controlled foreign corporation and any partnerships or qualified business units of the controlled foreign corporation partner) and the income of the partnership, of which the controlled foreign corporation is a partner, would have been qualified insurance income if received directly by the controlled foreign corporation.ⁿ⁴⁸

[iii] Foreign Base Company Sales Income. Foreign base company sales income is income derived from the purchase and sale of personal property, provided:

- (1) the property is either purchased from or sold to a related person;
- (2) the property is manufactured, produced, grown, or extracted outside of the country which the controlled foreign corporation is organized; and
- (3) the property is sold outside of that country.ⁿ⁴⁹

The concern of Congress in this instance is the sales income of a selling subsidiary which has been separated from the manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income.ⁿ⁵⁰ This accounts for the requirement that either the sale or purchase be transacted with a related party. It also accounts for the fact that the provision is inapplicable unless the property is produced and sold outside of the country in which the controlled foreign corporation is organized; a lower rate of tax is likely to be obtained only through purchases and sales made in another country. Finally, it accounts for the provision in the Regulations that foreign base company sales income does not include income derived in connection with the sale of personal property manufactured, produced, or constructed by the controlled foreign corporation from personal property which it has purchased.ⁿ⁵¹

A person is a related person in this case if the person is an individual, corporation, partnership, trust, or estate that controls the controlled foreign corporation, or is controlled by the controlled foreign corporation or the same persons that control the controlled foreign corporation.ⁿ⁵² Control of a corporation requires the direct or indirect ownership of more than 50 percent of the voting stock or of the total value of stock of the corporation. For a partnership, trust, or estate, control means the direct or indirect ownership of more than 50 percent (by value) of the beneficial interests therein.

The selling corporation will be considered to have manufactured, produced, or constructed personal property if it substantially transforms the property it purchases, or if it uses the purchased property as a component part of the

property which is sold.ⁿ⁵³ This contemplates a significant amount of manufacturing, major assembling, or construction; activity such as minor assembling, packaging, repackaging, or labeling will not be sufficient to remove the income from the ambit of foreign base company sales income.ⁿ⁵⁴

Foreign base company sales income can also be derived from the purchase and sale of personal property through a branch operating in a country other than the one in which the controlled foreign corporation is organized, where the use of the branch to carry on such activities has substantially the same tax effect as if the branch were a subsidiary corporation incorporated in the country in which it operates.ⁿ⁵⁵

Will a controlled foreign corporation be deemed to have "manufactured" property if it contracts with a related or unrelated contract manufacturer to have products manufactured for it? The Internal Revenue Service initially held, in *Rev Rul 75-7*,ⁿ⁵⁶ that the controlled foreign corporation would be considered the manufacturer if it retained ownership of and control over the property and had no profit-sharing or similar relationship with the contract manufacturer, although the contract manufacturer would then be considered a branch of the controlled foreign corporation and, under certain circumstances, subpart F income could still result from the arrangement.ⁿ⁵⁷ But the Service revoked *Rev Rul 75-7* after the Tax Court held in, *Ashland Oil* and *Vetco*, that neither an unrelated nor a related contract manufacturer could be considered a "branch" of a controlled foreign corporation for purposes of the "branch rule."ⁿ⁵⁸

In final regulations effective July 1, 2009,ⁿ⁵⁹ the Treasury provided, as an alternative to the physical manufacturing tests, a fact-based "substantial contribution test," under which products manufactured for a controlled foreign corporation by a contract manufacturer will be considered manufactured by the controlled foreign corporation if the latter makes a substantial contribution through the activities of its employees to the manufacture of such products.ⁿ⁶⁰ The final regulations look exclusively to the activities of the controlled foreign corporation's employees in a contract manufacturing arrangement to determine whether the resulting product may be deemed manufactured by the controlled foreign corporation; other factors, such as contractual risks assumed by the controlled foreign corporation, are not relevant to this determination.ⁿ⁶¹

The regulations separately address issues that arise when a controlled foreign corporation owns an interest in a partnership that does business either with the controlled foreign corporation itself or with persons "related" to the controlled foreign corporation. In general, the controlled foreign corporation's distributive share of the partnership's income is foreign base company sales income if it would have been so characterized if earned directly by the corporation instead of the partnership.ⁿ⁶² For this purpose, when the characterization of an item of partnership income as foreign base company sales income depends on whether a transaction involved a "related party" or occurred outside a party's country of organization, such determinations are to be made by substituting the controlled foreign corporation for the partnership.ⁿ⁶³ Further, if the controlled foreign corporation engages in a transaction involving the sale of personal property to, or purchase of personal property from, a partnership in which it holds an interest, for purposes of determining whether the controlled foreign corporation's distributive share of that partnership's income constitutes foreign base company sales income, the corporation's transaction with the partnership is deemed to be one with a "related party" if the controlled foreign corporation purchased property sold to the partnership from a related party, or the controlled foreign corporation resold property purchased from the partnership to a related party.ⁿ⁶⁴

Example:

CFC1, a Country A corporation, is an 80 percent partner in Partnership, which is organized in Country B. CFC2, a Country B corporation, owns the remaining 20 percent of Partnership. CFC1 and CFC 2 are both controlled foreign corporations of USP, their common US parent. Partnership purchases Product from CFC2, which manufactures Product in Country B, and then resells Product to unrelated third parties in Country B. Because CFC2's Product was not acquired from a related party, and is both manufactured and sold to unrelated parties in the country in which CFC2 was organized, CFC2's transactions with Partnership are not deemed to be with a "related party" and no part of its distributive share of Partnership's income is foreign base company sales income. CFC1's 80 percent distributive share of

Partnership's income is, however, foreign base company sales income to CFC1. Had CFC1 engaged in the transactions directly in place of Partnership, foreign base company sales income would have resulted from the purchase of Product from a related party (CFC2) organized outside CFC1's country of organization (Country A), and the resale of Product to unrelated parties who are likewise outside CFC1's country of organization (in Country B).ⁿ⁶⁵

[iv] Foreign Base Company Services Income. This component of foreign base company income consists of income derived from the performance of "technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services" if performed for a related person and performed outside of the country in which the controlled foreign corporation is incorporated.ⁿ⁶⁶ As in the case of sales income, the purpose here is to deny tax deferral where the service subsidiary is separated from the manufacturing company and organized in another country primarily to obtain a lower rate of tax for the service income.ⁿ⁶⁷ Therefore, foreign base income does not include income derived from the performance of services that are directly related to the sale or exchange by the controlled foreign corporation of property manufactured, produced, grown, or extracted by it and are performed prior to the time of sale or exchange, an offer to sell or exchange such property, or to income that is exempt insurance income or that is not treated as foreign personal holding company income under *IRC Section 954(c)(2)(C)(ii)*, *954(h)*, or *954(i)*, discussed in § 20.03[2][b][ii].

[v] Foreign Base Company Oil Related Income. Foreign base company oil related income is nonextraction income derived from sources outside the United States from the processing of minerals extracted (by the taxpayer or any other person) from oil and gas wells into their primary products, the transportation or distribution of those minerals or primary products, the disposition of assets used in a trade or business encompassing the activities just described, or the performance of any other related service.ⁿ⁶⁸ Excepted from the scope of the definition is (1) income derived from a source within a foreign country in connection with oil or gas extracted from wells within the foreign country, or oil, gas, or a primary product sold by the controlled foreign corporation or a related person for use or consumption within the foreign country or loaded there on a vessel or aircraft for use as fuel, and (2) dividends and interest from a foreign corporation qualifying for the deemed paid credit under *IRC Section 902*, dividends from domestic corporations treated as income from foreign sources, amounts giving rise to a deemed paid credit under *IRC Section 960*, and the taxpayer's distributive share of the income of partnerships, to the extent attributable to foreign oil and gas extraction income, or to foreign oil related income.ⁿ⁶⁹

Income which normally would be foreign base company oil related income is not treated as such if the foreign corporation is not a large oil producer, that is, if the aggregate daily production of foreign crude oil and natural gas of the corporation and related persons for the taxable year is less than 1,000 barrels per day (or its equivalent in gas).ⁿ⁷⁰

[c] The Includable Income--Previously Excluded Subpart F Income Withdrawn From Investment in Foreign Base Company Shipping Operations. A reduction in the amount of qualified investments in foreign base company shipping operations of a controlled foreign corporation for any taxable year produces includable income for United States shareholders to the extent to which the decrease in investment does not exceed the amount of foreign base company shipping income that was excluded from income for all prior taxable years beginning before 1987 and not previously withdrawn from investment in foreign base company shipping operations.ⁿ⁷¹ The decrease in qualified investments for any taxable year is determined by subtracting the amount of the corporation's qualified investments at the close of the year from the amount of such investments at the close of the last taxable year beginning before 1987 (to the extent such amounts do not exceed the sum of the decreases in qualified investments for prior taxable years beginning after 1986), and then reducing the determined figure by the amount by which losses realized on the disposition of qualified investments exceed the gains on such dispositions during the taxable year.ⁿ⁷² However, in no case can the decrease be considered greater than the sum of (1) the earnings and profits for the taxable year, (2) the earnings and profits accumulated for taxable years beginning after December 31, 1975, and (3) the amount of previously excluded Subpart F income invested in less developed country corporations, as defined by *IRC Section 955(c)(2)* prior to its amendment by the Tax Reduction Act of 1975, to the extent attributable to earnings and profits accumulated for

taxable years beginning after December 31, 1962.ⁿ⁷³

Qualified investments in foreign base company shipping operations consist of investments in aircraft and vessels used in foreign commerce and in other assets used in connection with the performance of services directly related to the use of such aircraft and vessels.ⁿ⁷⁴ Qualified investment also includes investments by a controlled foreign corporation in the stock or obligations of a related controlled foreign corporation that holds assets described in the preceding sentence. In addition, *IRC Section 955(b)(2)* provides for the promulgation of regulations under which an investment by one or more controlled foreign corporations may be treated as an investment by a related foreign corporation. Finally, amounts that had been invested in shipping companies that were classified as less developed country corporations prior to the enactment of the Tax Reduction Act of 1975 are to be treated as qualified investments in foreign base company shipping operations.ⁿ⁷⁵

[d] The Includable Income--Investment of Earnings in U.S. Property. The third category of income taxed to the U.S. shareholders of controlled foreign corporations requires each to report the lesser of:

(1) the excess (if any) of (a) the shareholder's pro rata share of the average amounts of U.S. property held (directly or indirectly) by the controlled foreign corporation as of the close of each quarter of the taxable year, over (b) the amount of earnings and profits of the corporation treated as having been included in the shareholder's income due to earnings invested in U.S. property;ⁿ⁷⁶ or

(2) the shareholder's pro rata share of the applicable earnings of the controlled foreign corporation.ⁿ⁷⁷

For this purpose the corporation's applicable earnings consist of its current and accumulated earnings and profits reduced by distributions made during the year and by retained earnings previously included in the shareholder's income because of investments in U.S. property.ⁿ⁷⁸

In applying this inclusion rule to any taxable year, any item of U.S. property that was acquired by the controlled foreign corporation before the first day on which it became a controlled foreign corporation is disregarded.ⁿ⁷⁹ However, the aggregate amount that can be disregarded cannot exceed the portion of the applicable earnings of the corporation that were accumulated before that day.ⁿ⁸⁰

If the corporation ceases to be a controlled foreign corporation during any taxable year:

(1) the determination of any U.S. shareholder's pro rata share is made on the basis of stock owned by the shareholder on the last day during the taxable year on which the corporation is a controlled foreign corporation;

(2) the amount of the corporation's investment in U.S. property is determined by only taking into account quarters ending before that last day; and

(3) in determining applicable earnings, the amount of current earnings taken into account is prorated to the part of the year during which the corporation is a controlled foreign corporation.ⁿ⁸¹

"U.S. property" is defined as any property acquired after December 31, 1962, which is:

(1) tangible property located in the United States;

(2) stock of a domestic corporation;

(3) an obligation of a U.S. person;ⁿ⁸²

(4) any right to the use in the United States of a patent, copyright, invention, secret formula or process, or similar property right, if acquired or developed by the controlled foreign corporation for use in the United States; and

(5) any trade or service receivable acquired directly or indirectly from a related person who is a U.S. person, if the obligor is also a U.S. person.ⁿ⁸³

United States property does not include:

(1) obligations of the United States, money, or bank deposits;

(2) property located in the United States, but purchased for export to, or use in, foreign countries;

(3) obligations of a United States person arising in the ordinary course of business from the sale or processing of property;

(4) transportation equipment used primarily outside the United States;ⁿ⁸⁴

(5) an amount equal to that portion of the earnings and profits of the controlled foreign corporation accumulated after 1962, and composed of items of income which are derived from sources within the United States and are effectively connected with the conduct of a trade or business within the United States (such items being excluded from Subpart F income under *IRC Section 952(b)*);ⁿ⁸⁵

(6) any movable property (other than a vessel or aircraft) used for resource exploration and exploitation activities on the Continental Shelf of the United States;

(7) the stock or obligations of a domestic corporation (unless the corporation is a United States shareholder of the controlled foreign corporation) if United States shareholders of the controlled foreign corporation own, directly or indirectly, less than 25 percent of the total combined voting power of the domestic corporation;ⁿ⁸⁶

(8) property which is otherwise United States property which is held by a foreign sales corporation and is related to its export activities;

(9) deposits of cash or securities made or received on commercial terms in the ordinary course of a United States or foreign person's business as a dealer in securities or in commodities, but only to the extent the deposits are made or received as collateral or margin for (i) a securities loan, notional principal contract, options contract, forward contract, or futures contract, or (ii) any other financial transaction in which the Service determines that it is customary to post collateral or margin;

(10) an obligation of a United States person to the extent the principal amount of the obligation does not exceed the fair market value of readily marketable securities sold or purchased pursuant to a sale and repurchase agreement or otherwise posted or received as collateral for the obligation in the ordinary course of its business by a United States or foreign person that is a dealer in securities or commodities;

(11) securities acquired and held by a controlled foreign corporation in the ordinary course of its business as a dealer in securities if the dealer accounts for the securities as held primarily for sale to customers in the ordinary course of its business, and the dealer disposes of the securities (or the securities mature while held by the dealer) within a period consistent with the holding of securities for sale to customers in

the ordinary course of business; and

(12) an obligation of a United States person that is not a domestic corporation, and is not a (i) United States shareholder of the controlled foreign corporation, or (ii) a partnership, estate, or trust in which the controlled foreign corporation, or any related person (as defined in *IRC Section 954(d)(3)*), is a partner, beneficiary, or trustee immediately after the acquisition of any obligation of the partnership, estate, or trust by the controlled foreign corporation.ⁿ⁸⁷

[e] Exclusion From Gross Income of Previously Taxed Earnings and Profits. In order to prevent the double taxation of income imputed to United States shareholders under the provisions of Subpart F, *IRC Section 959(a)* provides that amounts previously included in income under *IRC Section 951(a)* will not be taxed again when distributed as increases in earnings invested in United States property.ⁿ⁸⁸ (Any amount included in gross income under *IRC Section 1248(a)* or *(f)*, discussed in § 20.03[4], is treated as an amount previously included in income under *IRC Section 951(a)(1)(A)*).ⁿ⁸⁹ *IRC Section 959(a)* also provides an exclusion for amounts which have been included in the gross income of a United States shareholder and are then distributed to the shareholder either directly, or indirectly through a chain of ownership of foreign entities. A similar exclusion, provided by *IRC Section 959(b)*, prevents the imposition of a second tax on amounts taxed to United States shareholders of one controlled foreign corporation and then distributed through a chain of ownership to another controlled foreign corporation in which the taxpayer is also a United States shareholder.

Example 1:

A, a United States citizen, owns 100 percent of the stock of *CF Corporation*, a foreign corporation, throughout 2001 and 2002. During 2001, the corporation derives \$1,000 of Subpart F income and has \$1,000 of earnings and profits. Under *IRC Section 951(a)*, A must include the \$1,000 in gross income for 2001. However, when *CF Corporation* distributes \$1,000 to A in 2002, the entire amount can be excluded from gross income for that year inasmuch as the distribution represents earnings and profits attributable to an amount previously included in gross income under the provisions of Subpart F. There would also be no inclusion in 2002, if, instead of distributing the \$1,000 to A, *CF Corporation* had invested the amount in United States property, say, stock in a domestic corporation.

Example 2:

A, a United States citizen, owns 100 percent of the stock of *CF Corporation*, a foreign corporation, which, in turn, owns 100 percent of another foreign corporation, *R Corporation*. During 2001, *R Corporation* derives \$1,000 of Subpart F income and has earnings and profits in excess of that amount. Because A indirectly owns 100 percent of the stock of *R Corporation*, A is required to include the \$1,000 in his gross income for 2001. In 2002, *R Corporation* distributes the \$1,000 to *CF Corporation*, which has no Subpart F income for the year. However, *CF Corporation* invests the sum in United States property. This would trigger an additional inclusion of \$1,000 in 2002 were it not for *IRC Section 959(b)*; the amount is excludable because it is attributable to earnings and profits previously taxed to a United States shareholder under the provisions of *IRC Section 951(a)*.

To apply *IRC Section 959*, actual distributions during the taxable year are taken into account before determining the amount of increase in investment in U.S. assets that may be excluded because of *Section 959*.ⁿ⁹⁰

IRC Section 959(c) provides a hierarchy of sources of actual distributions. They are treated as being paid first out of the aggregate of earnings and profits attributable to earnings invested in United States property and earnings and profits attributable to earnings invested in excess passive assets, with any distribution being allocated between the two on the basis of the respective amounts of earnings and profits of each, then out of Subpart F income, and only then, if any balance remains, out of earnings and profits which have not already been taxed to the shareholders. Only when the last

source is reached is any portion of the distribution taxable to the shareholders as dividend.ⁿ⁹¹

Amounts that would be included in income as investments in U.S. property under *IRC Section 956* are treated as attributable first to retained earnings that are included in income as Subpart F income and then to other earnings and profits.ⁿ⁹²

[f] Adjustments to the Shareholder's Basis. The inclusion of an amount in gross income under *IRC Section 951(a)* works a corresponding increase in the shareholder's basis for stock in the controlled corporation (or in the basis of the property in a foreign entity which causes the taxpayer to be treated as the indirect owner of stock in a controlled foreign corporation).ⁿ⁹³ The exclusion of an amount from gross income under *IRC Section 959* produces the opposite result--a reduction in basis.ⁿ⁹⁴ (If the reduction exceeds the adjusted basis of the stock, the excess is treated as gain from the sale or exchange of property.)ⁿ⁹⁵ The increase in basis takes effect as of the last day in the taxable year of the corporation on which it is a controlled corporation; the reduction in basis is effective as of the time the excluded amount is received.ⁿ⁹⁶

When a lower-tier controlled foreign corporation earns Subpart F income, and stock in that corporation is later disposed of by an upper-tier controlled foreign corporation, the gain is treated as a dividend to the extent provided under *IRC Section 1248* as if the controlled foreign corporation were a United States person.ⁿ⁹⁷ The Code authorizes the issuance of regulations to provide for adjustments similar to those detailed in the preceding paragraph.ⁿ⁹⁸

Example:

A United States person owns all of the stock of a controlled foreign corporation (upper-tier corporation) that owns all of the stock of a second controlled foreign corporation (lower-tier corporation). In 1998, the lower-tier corporation earns \$2,000 of Subpart F income that must be included in the United States shareholder's income for that year. In 1999, the upper-tier corporation sells the stock of the lower-tier corporation and recognizes \$6,000 of gain with respect to the sale; the gain must be treated as a dividend and, thus, as Subpart F personal holding company income. Regulations can provide that the basis of the upper-tier corporation's stock be increased by the \$2,000 that was included in the United States shareholders income in 1998, thereby reducing the amount of gain to be recognized on the sale to \$4,000.

[g] The Corporate Shareholder's Foreign Tax Credit. If the United States shareholder is a domestic corporation, and the amount included in its gross income under *IRC Section 951(a)* is attributable to the earnings and profits of a foreign corporation that is a member of a qualified group (as defined in *IRC Section 902(b)*), the domestic corporation is deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes determined under *IRC Section 902* in the same manner as if the amount so included were a dividend paid by the foreign corporation.ⁿ⁹⁹ Once having claimed this credit, the corporation is barred from taking an additional credit when it receives a distribution of the previously taxed income.ⁿ¹⁰⁰

[3] Mitigating the Effect of the Controlled Foreign Corporation Provisions

[a] Election by Individuals to Be Taxed at Corporate Rates. An individual United States shareholder (or a trust or estate that is a United States shareholder) can elect to have the income imputed under *IRC Section 951(a)* taxed at the rates imposed on corporations by *IRC Section 11* or *IRC Section 55* (the alternative minimum tax) instead of those levied on individuals by *IRC Section 1*.ⁿ¹ There is one wrinkle: the amount in each taxable income bracket in the rate table for corporations "shall not exceed an amount which bears the same ratio to [the] bracket amount as the amount included in [the shareholder's] gross income under section 951(a) for the taxable years bears to [the] shareholder's pro rata share of the earnings and profits for the taxable year of all controlled foreign corporations with respect to which such shareholder includes any amount in gross income under section 951(a)." ⁿ²

Consistency in tax treatment is accorded by *IRC Section 962(a)(2)*. Inasmuch as the electing shareholder is taxed as a corporation, the deemed-paid foreign tax credit allowed can be claimed by domestic corporations under *IRC Section 960*

. However, the electing shareholder is faced with the inclusion of another item of gross income, namely, the gross-up dividend of *IRC Section 78*.ⁿ³

The foregoing may be seen more graphically in the following illustration:

Example:

A, a married individual, owns 60 percent of the one class of stock of *F Corporation*, a controlled foreign corporation. For 1993, the corporation has Subpart F income of \$150,000 and pretax earnings and profits of \$300,000, and pays foreign income taxes of \$100,000. A's gross income apart from A's *IRC Section 951(a)* income is \$100,000; allowable deductions amount to \$50,000. A is required to include \$90,000 of the corporation's \$150,000 of Subpart F income in gross income for 1993. If A elects to have the provisions of *IRC Section 962* apply for that year, the tax will be computed as follows:

Income required to be included under <i>IRC Section 951(a)</i>	\$90,000
Gross-up dividend ($\$90,000/\$300,000 \times \$100,000$) ⁿ⁴	30,000
Taxable income under <i>IRC Section 11</i>	\$120,000
Tax under <i>IRC Section 11</i> ⁿ⁵	38,425
Foreign tax credit	30,000
United States tax payable on amounts included under <i>IRC Section 951(a)</i>	8,425
Tax with respect to other taxable income (\$50,000)	12,022
Total tax	20,447

If the taxpayer does not elect to be taxed at corporate rates, the total tax for 1993 (on \$90,000 + \$50,000, or \$140,000) will be \$35,929. It can be seen that the election will work to the advantage of the taxpayer only if the corporate rate applicable to the income is less than the individual rate.

If the election is feasible, it is not without adverse tax consequence for the shareholder. A subsequent distribution of the income taxed at corporate rates must be included in gross income to the extent that the amount distributed exceeds the amount of tax paid pursuant to the election.ⁿ⁶

A shareholder makes the *IRC Section 951(a)* election by filing a statement to that effect with the tax return for the taxable year with respect to which the election applies.ⁿ⁷ The election pertains to all controlled foreign corporations whose income is imputed to the shareholder, and is binding for the taxable year for which it is made unless the Commissioner consents to its revocation.ⁿ⁸ But "approval will not be granted unless a material and substantial change in circumstances occurs which could not have been anticipated when the election was made."ⁿ⁹

[b] Export Trade Corporations. ⁿ¹⁰*IRC Section 970*, a second relief provision, permits a controlled foreign corporation that qualified also as an export trade corporation prior to October 31, 1971 and does not fail to meet the prescribed requirements for three consecutive taxable years,ⁿ¹¹ to reduce its foreign base company income by the portion of such income that consists of "export trade income." This provision is intended as an encouragement to the export trade by continuing tax deferral for corporations exporting products produced in the United States.ⁿ¹² However, in order to keep the income attributed to export trade corporations in line with the income actually created by export trade activities, and to restrict the exclusion to the extent to which the income receiving special treatment is used for the expansion of the export trade business itself, the amount of the reduction is limited to the lesser of:

- (1) 1 1/2 times the export promotion expensesⁿ¹³ allocable to export trade income included in foreign base company income;

(2) 10 percent of the gross receipts from which the corporation derives export trade income included in foreign base company income; or

(3) an amount, which bears the same ratio to the increase in the corporation's export trade assetsⁿ¹⁴ for the year, as the export trade income that constitutes foreign base company income bears to the entire export trade income of the corporation for the taxable year.ⁿ¹⁵

To further insure that the excluded income is used to increase the controlled foreign corporation's export trade assets, *IRC Section 970(b)* treats each United States shareholder's pro rata decrease in the corporation's investments in export trade assets for the taxable year (determined by subtracting the amount of such investments at the close of the taxable year from the amount of such investments at the close of the preceding taxable year)ⁿ¹⁶ as an item of previously excluded Subpart F income withdrawn from investment in less developed countries and, thus, as an item of income includable in the shareholder's gross income under *IRC Section 951(a)*.ⁿ¹⁷ However, the amount of such inclusion in gross income cannot exceed the lesser of (1) the portion of the shareholder's pro rata share of excluded export trade income not previously included in gross income by reason of the application of *IRC Section 970(a)*, or (2) the shareholder's pro rata share of the sum of the controlled foreign corporation's earnings and profits accumulated after 1962 and its earnings and profits for the taxable year in question.ⁿ¹⁸

A controlled foreign corporation is an export trade corporation if, for the three-year period immediately preceding the close of the taxable year (1) 90 percent or more of its gross income was derived from foreign sources, and (2) 75 percent or more of its gross income was export trade income.ⁿ¹⁹ (The second requirement is reduced to 50 percent for corporations exporting agricultural products grown in the United States.)ⁿ²⁰ The corporation has export trade income if it derives net income from (1) the sale to an unrelated person of property produced in the United States for use, consumption, or disposition abroad, or from the performance of services related to the sale, installation, or maintenance of such property, (2) the performance of services in connection with the use by an unrelated person outside the United States of patents, copyrights, secret processes, and other like property owned by the manufacturer or producer of export property in respect of which the corporation derives export trade income, (3) the use of export property by an unrelated person or the use of export property in the rendition of technical services to an unrelated person, and (4) interest from export trade assets.ⁿ²¹

[4] Sales or Exchanges of Stock in Corporations That Are or Have Been Controlled Foreign Corporations

As a general rule, the tax consequences of a disposition of stock in a foreign corporation are the same as those attending the sale or exchange of stock in a domestic corporation. The similarity vanishes when the shareholder disposing of the stock owned (directly, indirectly, or constructively under the rules contained in *IRC Section 958*) 10 percent or more of the total combined voting power of the foreign corporation at any time during the five-year period ending on the date of disposition, and the corporation was a controlled foreign corporation at some time during the period of the shareholder's 10 percent ownership. Under *IRC Section 1248(a)*, any gain realized by such shareholder on the sale or exchange of the stock in the foreign corporation is treated as a dividend "to the extent of the earnings and profits of the foreign corporation attributable ... to such stock which were accumulated in taxable years ... beginning after December 31, 1962, and during the period or periods the stock sold or exchanged was held by [the shareholder] while such foreign corporation was a controlled foreign corporation."ⁿ¹ (The taxpayer has the burden of establishing the amount of earnings and profits to be taken into account; otherwise the entire gain will be treated as a dividend.)ⁿ²

If a controlled foreign corporation sells or exchanges stock in any other foreign corporation, the gain is treated as a dividend for purposes of Subpart F income inclusions to the United States shareholder, to the extent of earnings and profits of the second corporation attributable to periods in which the first foreign corporation owned the stock of the second while the latter was a controlled foreign corporation with respect to the United States shareholder.ⁿ³ The same country exception of *IRC Section 954(c)(3)(A)(i)* does not apply, so the dividend must be included in the foreign personal holding company income of the selling corporation.ⁿ⁴

It is important to note that *IRC Section 1248* may be applicable even though, when the disposition occurs, the shareholder owns less than 10 percent of the corporation's voting stock and the corporation is not a controlled foreign corporation; the provision is triggered as long as the shareholder's 10 percent ownership and the corporation's controlled foreign corporation status coexisted at some time during the five-year period, although dividend consequences will attach only to that portion of the gain attributable to earnings and profits accumulated while the two conditions coincided.ⁿ⁵

If the shareholder is a corporation, the dividend nature of the income may entitle the corporation to a credit for foreign taxes paid by the foreign corporation on the earnings and profits producing the "dividend" (the deemed-paid credit of *IRC Section 902*).ⁿ⁶ If the shareholder is an individual, and the stock sold or exchanged is a capital asset which has been held for more than one year, the tax attributable to the amount included in gross income as a dividend--the difference between the shareholder's tax liability taking *IRC Section 1248(a)* into account and the tax liability determined as if the portion falling within *IRC Section 1248(a)* had not been recognizedⁿ⁷--cannot be greater than the sum of (1) the shareholder's pro rata share of the taxes that would have been paid by the foreign corporation with respect to its income had it been a domestic corporation, and (2) the tax that would have been paid on the shareholder's share of the balance of the corporation's earnings had they been distributed and included in gross income as long-term capital gain.ⁿ⁸

Although the earnings and profits of the foreign corporation for any taxable year are determined according to rules substantially similar to those applicable to domestic corporation,ⁿ⁹ the following amounts are expressly excluded:

- (1) earnings and profits previously taxed to the shareholder under *IRC Section 951*;ⁿ¹⁰
- (2) earnings and profits of the foreign corporation attributable to any amount previously included in gross income of the shareholder under *IRC Section 1293* (current taxation of income from a passive foreign investment company that is a qualified electing fund) with respect to the stock sold or exchanged, but only to the extent inclusion of the amount did not result in an exclusion when the income was distributed;ⁿ¹¹
- (3) any item of income derived from sources within the United States, and includable in the gross income of the corporation for taxable years prior to 1967 as income of a foreign corporation engaged in a trade or business within the United States, and, for taxable years after 1966, as income effectively connected with the conduct of a trade or business within the United States;ⁿ¹²
- (4) earnings and profits accumulated during any taxable year beginning before January 1, 1976, while the corporation was a less developed country under *IRC Section 902(d)*, as in effect prior to the Tax Reduction Act of 1976;ⁿ¹³ and
- (5) earnings and profits attributable to foreign trade income (other than certain exempt foreign income) of a foreign sales corporation.ⁿ¹⁴

There is another modification, one which causes an increase in earnings and profits. This will come about when (a) the sale or exchange is of stock in a foreign corporation (first-tier corporation) that owns stock in another foreign corporation (lower-tier corporation), and (b) the shareholder selling or exchanging the stock owned (directly, indirectly, or constructively) 10 percent or more of the stock of the lower-tier corporation at any time during the five-year period ending on the date of sale or exchange, and at a time when the lower-tier corporation was a controlled foreign corporation; the earnings and profits of the first-tier corporation will be deemed to include the earnings and profits of the lower-tier corporation that (1) are attributable to the stock of that corporation owned indirectly by the shareholder because of his ownership of the stock sold or exchanged, and (2) were accumulated after 1962 during periods when the

lower-tier corporation was a controlled foreign corporation and the shareholder, an indirect owner of its stock.ⁿ¹⁵ This provision prevents the avoidance of *IRC Section 1248(a)* through the sale of stock in a foreign corporation having no earnings and profits but owning a subsidiary that does.

A second provision curbs avoidance of *IRC Section 1248* through the use of domestic holding companies. Under *IRC Section 1248(e)*, the sale or exchange of stock in a domestic corporation "formed or availed of principally for the holding, directly or indirectly, of stock of one or more foreign corporations," is treated as a sale or exchange of the stock of the foreign corporation held by the domestic corporation.ⁿ¹⁶

Under *IRC Section 1248(f)(1)*, a domestic corporation that satisfies the 10 percent stock ownership requirement of *IRC Section 1248(a)(2)* and distributes stock of the foreign corporation in a distribution to which *IRC Section 311(a)*, 337, 355(c)(1), or 361(c)(1) applies, the excess of the fair market value of the stock over its adjusted basis in the hands of the corporation as a dividend to the extent of the earnings and profits of the foreign corporation which were accumulated after 1962 and during the period the stock was held by the domestic corporation while the foreign entity was a controlled foreign corporation.ⁿ¹⁷ However, this rule will not apply, and nonrecognition treatment will ensue, if the domestic corporation distributes the stock to another domestic corporation which is treated as holding the stock for the period the stock was held by the distributing corporation, and which, immediately after the distribution, satisfies the stock ownership requirements of *IRC Section 1248(a)* with respect to the foreign corporation.ⁿ¹⁸

A further provision affects the character of the gain realized by a partner on certain partnership distributions or by reason of the sale of the partnership interest. The stock is treated as an unrealized receivable of the partnership to the extent that a sale of the stock by the partnership would have produced dividend income.ⁿ¹⁹ Thus, ownership of controlled foreign corporation stock by a partnership may cause some of the gain realized by the partner on distribution or sale to be taxed as ordinary income.ⁿ²⁰

Under *IRC Section 1248(i)*, if any shareholder of a 10-percent corporate shareholder of a foreign corporation exchanges stock in the 10-percent corporate shareholder for stock of the foreign corporation, the 10-percent corporate shareholder recognizes gain in the same manner as if the stock of the foreign corporation received in the exchange had been issued to the 10-percent corporate shareholder and then distributed by it to the exchanging shareholder in redemption or liquidation (whichever is appropriate). The amount of gain recognized by the 10-percent corporate shareholder cannot exceed the amount treated as a dividend under *IRC Section 1248*.

Even though *IRC Section 1248(a)* potentially affects all sales or exchanges on which gain is recognized,ⁿ²¹ it is made inapplicable to redemptions of stock to pay death taxes and administration expenses (redemptions governed by *IRC Section 303*) and to any gain treated as a dividend, as gain from the sale of a noncapital asset, or as short-term capital gain.ⁿ²²

[5] Temporary Dividends Received Deduction

A corporation that is a United States shareholder of a controlled foreign corporation may elect, for one taxable year, an 85 percent dividends received deduction with respect to certain cash dividends the shareholder received from its controlled foreign corporations.ⁿ¹ For this purpose, the term "dividends" includes cash amounts included in gross income as dividends under *IRC Sections 302, 304, and 356(a)(2)*, but does not include amounts treated as dividends under *IRC Sections 78 or 1248*.ⁿ² In addition, a cash dividend includes a cash distribution from a controlled foreign corporation that is excluded from gross income under *IRC § 959(a)* (exclusion from income of previously taxed earnings and profits), to the extent of any amount included in income by the shareholder under *IRC Section 951(a)(1)(A)* as a result of a cash dividend during the taxable year to (a) the controlled foreign corporation from another controlled foreign corporation that is in a chain of ownership as described in *IRC Section 958(a)*, or (b) any other controlled foreign corporation in that chain of ownership, but only to the extent of cash distributions that are described in *IRC § 959(b)* made during the taxable year to the controlled foreign corporation from which the United States

shareholder received the distribution.ⁿ³

The temporary dividends received deduction is subject to several limitations. First, the amount of dividends eligible for the deduction cannot exceed the greatest of the following: (1) \$500 million; (2) the amount shown on the shareholder's applicable financial statement as earnings permanently reinvested outside the United States; or (3) in the case of an applicable financial statement that fails to show a specific amount of earnings permanently reinvested outside the United States and that shows a specific amount of tax liability attributable to such earnings, the amount of the liability divided by 0.35.ⁿ⁴ The amounts described in (2) and (3) are treated as zero if there is no applicable financial statement or the statement does not show a specific amount of earnings or liability.

Second, the dividends must be extraordinary, that is, the deduction is allowed only to the extent the cash dividends received exceed the annual average for the base period years of (i) the dividends received during each base period year by the shareholder from controlled foreign corporations, (ii) the amount includable in the shareholder's gross income for each base period year under *IRC Section 951(a)(1)(B)*, and (iii) the amounts that would have been included for each base period year but for *IRC Section 959(a)* with respect to the controlled foreign corporations.ⁿ⁵ The base period years are the three taxable years that are among the five most recent taxable years ending on or before June 30, 2003, disregarding the taxable year for which the sum of the described amounts is the largest and the year for which the sum is the smallest.ⁿ⁶

Third, under *IRC Section 965(b)(4)*, the amount of the dividend must be invested in the United States pursuant to a domestic reinvestment plan approved by the taxpayer's president, chief executive officer, or comparable official before the payment of the dividend and then subsequently approved by the taxpayer's board of directors, management committee, executive committee, or similar body. The domestic reinvestment plan must provide for the investment of the dividend in the United States (other than as payment for executive compensation), including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for purposes of job retention or creation.ⁿ⁷ Expenditures that are not considered investments in the United States include executive compensation, intercompany distributions, obligations, and transactions, dividends and other distributions with respect to stock, stock redemptions, portfolio investments in business entities, debt instruments or other evidences of indebtedness, and tax payments.ⁿ⁸

The domestic reinvestment plan must describe specific anticipated investments in the United States in sufficient detail to enable the taxpayer to show upon examination that the expenditures that subsequently occurred were of the kind that were in fact contemplated at the time of adoption of the plan.ⁿ⁹ However, a taxpayer is not required to trace or segregate the specific dividend proceeds it receives to demonstrate that it has properly invested the amount of the dividend in the United States pursuant to the plan.ⁿ¹⁰

Further limitations affect the shareholder's taxable income for any taxable year, which cannot be less than the amount of nondeductible CFC dividends received during the year.ⁿ¹¹ In addition, the nondeductible CFC dividends for any taxable year are not taken into account in determining the amount of any net operating loss for the taxable year, or the amount of income for purposes of a net operating loss carryback or carryover to that year.ⁿ¹² Finally, no foreign tax credit can be claimed with respect to the deductible portion of any dividend or any amount described in *IRC Section 965(a)(2)* that is included in income under *IRC Section 951(a)(1)(A)*, nor is any deduction allowed for expenses properly allocated and apportioned to the deductible amount.ⁿ¹³

The taxpayer may elect to apply *IRC Section 965* to the taxpayer's last taxable year that begins before October 22, 2004, or to taxpayer's first taxable year that begins during the one-year period beginning on that date.ⁿ¹⁴ The election must be made before the due date (including extensions) of the tax return for the taxable year. The taxpayer must also comply with certain reporting requirements.ⁿ¹⁵

FOOTNOTES:

(n1)Footnote 1. Special message to Congress "Our Federal Tax System," April 20, 1961, reprinted in US Code Cong & Adm News, pp 1129, 1133 (1961).

(n2)Footnote 2. Special message to Congress "Our Federal Tax System," April 20, 1961, reprinted in US Code Cong & Adm News, 1134 (1961).

(n3)Footnote 3. See generally Adess, Angus & Villmow, "The Erosion of Deferral: Subpart F After the 1993 Act," 47 *Tax Lawyer* 933 (1994); O'Connor, "United States Taxation of Earnings of American-Controlled Foreign Corporations," 42 *Taxes* 588 (1964); McDonald, "Controlled Foreign Corporations," 5 *Inst on Private Investments Abroad & Foreign Trade* 5 (1963).

(n4)Footnote 4. "In an effort to cover every contingency, the rules of Subpart F share the complexity that typifies virtually all of the Code provisions dealing with foreign corporations and transactions, yet in the end it turns many tasks over to the Treasury to discharge by regulations." Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* 17-70 (5th ed 1987).

(n5)Footnote 1. *IRC* § 957(a).

(n6)Footnote 2. *IRC* §§ 951(b), 957(c), 7701(a)(30). *IRC* § 7701(a)(31) defines a foreign estate or trust as one "the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A."

A person born in, and a resident of, Puerto Rico is a US person for this purpose. *Rev Rul* 74-375, 1974-2 *CB* 215 .

(n7)Footnote 3. *Treas Reg* § 1.957-1(b)(1). Thus, in *Rev Rul* 70-426, 1970-2 *CB* 157 , a foreign corporation was held to be a controlled foreign corporation where the renewal of its one-year charter required approval of shareholders owning 75 percent of the total combined voting power and a domestic corporation owned 50 percent of the voting stock; the domestic corporation had the power to prevent renewal and cause liquidation.

(n8)Footnote 4. *Treas Reg* § 1.957-1(b)(1).

(n9)Footnote 5. *Treas Reg* § 1.957-1(b)(2).

(n10)Footnote 6. *Treas Reg* § 1.957-1(b)(2).

(n11)Footnote 7. *Treas Reg* § 1.957-1(b)(2). *Koehring v Commr*, 583 F2d 313 (7th Cir 1978) .

(n12)Footnote 8. The attribution rules of *IRC* § 318(a) are discussed in § 5.02[1].

(n13)Footnote 9. *IRC* § 958(b)(1)-(4). The topic of attribution in this context is discussed in Alexander, "Controlled Foreign Corporations and Constructive Ownership," 18 *Tax L Rev* 531 (1963).

(n14)Footnote 10. *Treas Reg* § 1.958-1(b).

(n15)Footnote 11. *Treas Reg* § 1.958-2(f)(2).

(n16)Footnote 1. The pro rata share of any US shareholder's Subpart F income is the (1) amount that would have been distributed with respect to the stock owned by the shareholder if, on the last day of the corporation's taxable year on which it is a controlled foreign corporation, it had distributed pro rata to its shareholders an amount (a) that bears the same ratio to its Subpart F income for the taxable year as (b) the part of the year during which the corporation is a controlled foreign corporation, reduced by (2) the amount of distributions received by any other person during the year with respect to such stock, but only to the extent of the dividend that would have been received if the amount (a) that bears the same ratio to the Subpart F income of the corporation for the taxable year, as (b) the part of the year during

which the US shareholder did not own the stock bears to the entire year. Any gain included in the gross income of any person as a dividend under *IRC § 1248* is treated as a distribution with respect to the stock involved. *IRC § 951(a)(2)*.

(n17)Footnote 1.1. See § 20.04[2][c].

(n18)Footnote 2. The US shareholder includes the requisite amount in gross income for the taxable year in which or with which the taxable year of the corporation ends.

If the taxpayer omits from gross income an amount properly includable under *IRC § 951(a)*, the tax may be assessed, or a proceeding in court for the collection of the tax may be done without assessing, at any time within six years after the return was filed. *IRC § 6501(e)(1)(B)*.

A controlled foreign corporation having one US shareholder owning more than 50 percent of the total voting power of all classes of stock entitled to vote or 50 percent of the total value of all classes of stock of the corporation must adopt a taxable year that corresponds to, or ends one month earlier than, the taxable year of its majority US shareholder. *IRC § 898*.

Rev Proc 90-26, 1990-1 CB 512, contains guidance with respect to the required taxable year of controlled foreign corporations.

(n19)Footnote 3. *IRC § 951(c)*.

(n20)Footnote 4. A taxpayer owning 95 percent of the stock of a foreign corporation placed the stock in a voting trust. Under the voting trust agreement, the taxpayer was barred from exercising any voting rights of the shares or from controlling the board of directors. At issue in *Textron, Inc. v Commr*, 117 TC 67 (2001), was whether the taxpayer was subject to the inclusion provisions of *IRC § 951(a)*. The Tax Court held that it was not because it did not stock in the foreign corporation directly or indirectly (through a foreign entity). However, because the voting trust was a trust for tax purposes and the taxpayer was the grantor and sole beneficiary of the trust, the income earned by the trust was includable by the taxpayer under the grantor trust rules of the Code.

(n21)Footnote 4.1. *Treas Reg § 1.951-1(e)(2)*.

(n22)Footnote 4.2. *Treas Reg § 1.951-1(e)(3)(i)*. If there are dividends in arrears for prior taxable years with respect to a class of preferred stock of the corporation, the earnings and profits for the taxable year are attributed to the arrearage only to the extent the arrearage exceeds the corporation's earnings and profits remaining from prior taxable years beginning after Dec 31, 1962, or the date on which the stock was issued, whichever is later. *Treas Reg § 1.951-1(e)(3)(iv)*.

(n23)Footnote 4.3. *Treas Reg § 1.951-1(e)(3)(ii)*.

(n24)Footnote 4.4. *Treas Reg § 1.951-1(e)(3)(ii)(A)*. Earnings and profits are allocated, first, to any class of stock with nondiscretionary distribution rights such as preferred stock entitled to a fixed return.

Discretionary distribution rights do not include rights to redeem shares of a class of stock even if the distribution would be treated as a dividend. *Treas Reg § 1.951-1(e)(3)(ii)(B)*.

If a class of stock has both discretionary and nondiscretionary rights, earnings and profits are allocated to the nondiscretionary distribution rights under *Treas Reg § 1.951-1(e)(3)(i)* and to the discretionary rights under *Treas Reg § 1.951-1(e)(3)(ii)*. As to the latter, the value used in determining the amount of the distribution is the value of the stock solely attributable to the discretionary distribution rights. *Treas Reg § 1.951-1(e)(3)(iii)*.

(n25)Footnote 4.5. *Treas Reg § 1.951-1(e)(5)(i)*. A restriction or other limitation includes any limitation that has

the effect of limiting the allocation or distribution of earnings and profits by a controlled foreign corporation, other than currency or other restrictions or limitations imposed under the laws of any foreign corporation under *IRC* § 964(b). *Treas Reg* § 1.951-1(e)(5)(ii). The right to a periodic receipt of a fixed amount with respect to a class of stock that is a condition precedent to a further distribution of earnings and profits with respect to a class of stock (not including a distribution in partial or complete liquidation) is not a restriction or limitation on the distribution of earnings and profits of the controlled foreign corporation. *Treas Reg* § 1.951-1(e)(5)(iii).

(n26)Footnote 4.6. *Treas Reg* § 1.951-1(e)(5)(iv).

(n27)Footnote 4.7. *Treas Reg* § 1.951-1(e)(3)(v), applicable for taxable years of a controlled foreign corporation beginning after Jan 1, 2006.

For a discussion of *IRC* § 304, see § 5.04.

(n28)Footnote 4.8. *Treas Reg* § 1.951-1(e)(4)(ii), applicable for taxable years of a controlled foreign corporation beginning after Jan 1, 2006.

(n29)Footnote 4.9. *Id.*

(n30)Footnote 4.10. *Id.*

(n31)Footnote 4.11. *Id.* The applicable federal rate is determined under the rules of *IRC* § 1274(d)(1).

(n32)Footnote 5. *IRC* § 951(d).

(n33)Footnote 6. The term "insurance income" is defined in *IRC* § 953. It will not be discussed here.

(n34)Footnote 7. The international boycott factor is a fraction, the numerator of which reflects the corporation's world-wide operations in countries associated with an international boycott, and the denominator of which reflects its total world-wide operations. *IRC* § 999(c)(1). In lieu of the factor, the corporation can add income specifically attributable to boycott operations. *IRC* § 999(c)(2).

(n35)Footnote 8. Interest, dividends, royalties, other investment income, and carrying charges received or accrued by a foreign sales corporation are treated as US-source income for this purpose.

(n36)Footnote 9. *IRC* § 952(c)(1)(A). The manner in which the current earnings and profits limitation is applied is set forth in *Treas Reg* § 1.952-1(e).

For years after December 31, 1986, earnings and profits must be computed in the controlled foreign corporation's functional currency. *Temp Treas Reg* § 1.964-1T(g)(1)(i).

A controlled foreign corporation that receives a dividend from another controlled foreign corporation within the same chain of ownership is required to increase earnings and profits by the amount of the distribution. *Rev Rul* 86-33, 1986-1 CB 287.

(n37)Footnote 10. *IRC* § 952(c)(2).

(n38)Footnote 11. *IRC* § 952(c)(1)(B). In determining the deficit attributable to a qualified activity giving rise to foreign base company sales income or foreign base company services income, deficits in earnings and profits (to the extent not previously taken into account) for taxable years beginning after 1962 and before 1987 are also taken into account. Deficits for years beginning after 1982 and before 1987 are taken into account for a qualified activity giving rise to foreign base company oil related income.

For this purpose, the earnings and profits of a controlled foreign corporation are determined without regard to the LIFO inventory, installment sales, and completed contract method of accounting adjustments to earnings and profits required by *IRC § 312(n)*. *IRC § 952(c)(3)*.

(n39)Footnote 12. *IRC § 952(c)(1)(C)*. The provision is applied after *IRC § 952(c)(1)(A)* and *(B)*.

A sister corporation of a controlled corporation that had a common parent was held not to be a qualified chain member in *Stanford v Commr*, 152 F3d 450 (5th Cir 1998) . This prevented the use of that corporation's deficit to reduce the controlled foreign corporation's Subpart F income.

(n40)Footnote 13. *IRC § 954(a)*. A controlled foreign corporation that is a member of a partnership determines the character of its share of the partnership's income as if the income were realized directly by the controlled foreign corporation. *Treas Reg § 1.952-1(g)(1)*. The regulation, effective for taxable years of a controlled foreign corporation beginning on or after July 23, 2002, overrules the decision of the Eighth Circuit in *Brown Group, Inc & Subs v Commr*, 1996 US App LEXIS 8129 (8th Cir 1996) , *nonacq* 1996-2 CB 2 .

(n41)Footnote 14. *IRC § 954(b)(5)*.

(n42)Footnote 15. *IRC § 954(b)(3)(A)*; *Treas Reg § 1.954-1(b)(1)(i)(A)*. A controlled foreign corporation having a functional currency other than the US dollar must translate the \$1 million threshold using the weighted average exchange rate for the taxable year of the corporation. *Treas Reg § 1.954-1(b)(1)(i)(B)*.

(n43)Footnote 16. *Treas Reg § 1.954-1(b)(1)(i)(C)*.

(n44)Footnote 17. *Treas Reg § 1.954-1(b)(4)(i)*.

(n45)Footnote 18. *Treas Reg § 1.954-1(b)(4)(ii)*. The presumption can be rebutted by proof to the contrary.

Persons are related if they are in a relationship described in *IRC § 267(b)*. In determining whether two or more corporations are members of the same controlled group under *IRC § 267(b)(3)*, a person is considered to own stock owned directly by such person and stock owned with the application of *IRC §§ 267(c)* and *1563(e)(1)*. In determining whether a corporation is related to a partnership under *IRC § 267(b)(10)*, a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of *IRC § 267(e)(3)*. *Treas Reg § 1.954-1(b)(4)(iii)*.

(n46)Footnote 19. The presumption arising from activities or assets can be rebutted by proof that the activities carried on by each controlled foreign corporation would constitute a separate branch under the principles of *Temp Treas Reg § 1.367(a)-6T(g)(2)* if carried on by a United States person. In general, a separate branch exists if a particular group of activities is sufficiently integrated to constitute a single business that could be operated as an independent business.

(n47)Footnote 19.1. The principles of *Temp Treas Reg § 1.367(a)-6T(g)(2)* apply in determining whether the activities would constitute a single branch operation.

(n48)Footnote 19.2. *IRC § 954(b)(3)(B)*; *Treas Reg § 1.954-1(b)(1)(ii)*.

(n49)Footnote 19.3. *Treas Reg § 1.954-1(b)(1)(ii)*; *IRC § 952(b)*. For purposes of *IRC § 952(b)*, any exemption (or reduction) with respect to the branch profits tax imposed by *IRC § 884* is not taken into account.

(n50)Footnote 19.4. *Treas Reg § 1.954-1(b)(2)*.

(n51)Footnote 19.5. *Treas Reg § 1.954-1(b)(2)*.

(n52)Footnote 19.6. *IRC § 954(b)(5); Treas Reg § 1.954-1(c).*

(n53)Footnote 19.7. *Treas Reg § 1.954-1(c)(ii).* The provisions of *IRC § 952(c)(1)* are discussed in § 20.04[2][b].

(n54)Footnote 20. *IRC § 954(b)(4).* The Service will not issue rulings concerning the effective rate of tax that a foreign country will impose on income. *Rev Proc 2007-7, 2007-1 CB 227* .

Full inclusion foreign base company income will be excluded from Subpart F income if more than 90 percent of the adjusted gross foreign base company income and adjusted gross insurance income of a controlled corporation (determined without regard to the full inclusion test) is attributable to net amounts excluded from Subpart F income to have the high tax exception apply. *Treas Reg § 1.954-1(d)(6).*

(n55)Footnote 20.1. *Treas Reg § 1.954-1(d)(1).*

(n56)Footnote 20.2. *Treas Reg § 1.954-1(d)(1).* An election to exclude passive foreign personal holding company income must be made consistently for all items of such income eligible to be excluded for the taxable year. *Treas Reg § 1.951-1(d)(4).*

(n57)Footnote 20.3. *Treas Reg § 1.954-1(d)(2).*

(n58)Footnote 21. *Treas Reg § 1.954-1(d)(3)(i).*

(n59)Footnote 22. *Treas Reg § 1.954-1(d)(3)(ii).*

(n60)Footnote 23. Dividends, interest (including factoring income that is treated as income equivalent to interest), rents, and royalties received or accrued from a controlled foreign corporation that is a related party are not treated as foreign personal holding company income to the extent attributable or properly allocable (determined under rules similar to those applicable to a look-through of such income when received by a US shareholder from a controlled foreign corporation) to income of the related person that is neither Subpart F income nor income treated as effectively connected with the conduct of a trade or business in the US. *IRC § 954(c)(6)(A).* The rule applies to taxable years of foreign corporations beginning after Dec 31, 2003, and ending before Jan 1, 2009, and to taxable years of US shareholders with or within which such taxable years end. *IRC § 954(c)(6)(B).*

The Service intends to issue additional regulations concerning *IRC § 954(c)(6)*. *Notice 2007-9, 2007-5 IRB 401* .

(n61)Footnote 24. *IRC § 954(c)(1).* In the case of any regular dealer in property, foreign personal holding company income does not include the excess of gains over losses from the sale or exchange of property if the property is held by the taxpayer for sale to customers in the ordinary course of business, or if the sale or exchange does not give rise to any income. *IRC § 954(c)(1)(B).* In *Dover Corp & Subs v Commr, 122 TC 324 (2004)* , a deemed sale of a subsidiary's assets immediately after a check-the-box liquidation of the subsidiary did not constitute foreign personal holding company income.

Any item of income, gain, deduction, or loss from a notional principal contract entered into for purposes of hedging any item described in (1)-(5) of the text is taken into account under the rules applicable to the other category and not as a separate item of foreign personal holding company income.

United States municipal bond interest received by a controlled foreign corporation is includable in its foreign personal holding company income. *Treas Reg § 1.954-2(b)(3).*

If a distribution by a controlled foreign corporation results in the inclusion of an amount in income as a deemed dividend by a foreign corporation, the deemed dividend is not included as foreign personal holding company income. *Treas Reg § 1.367(b)-5(f).*

Income that is personal holding company income in the hands of the controlled foreign corporation retains that character when it enters the income of domestic corporations under *IRC § 951*. *Rev Rul 76-403*, 1976-2 CB 229 .

Income from notional principal contracts based solely on interest rates or interest rate indices is income equivalent to interest unless earned by a "regular dealer"--a controlled foreign corporation that regularly and actively deals in property and positions in property with unrelated persons in the ordinary course of business. *Treas Reg §§ 1.954-2(a)(4)(iv)*, *1.954-2(h)(3)*.

Amounts received under a personal service contract are included only if at some time during the taxable year 25% or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the person who has performed, is to perform, or may be designated as the one to perform, the services.

(n62)Footnote 25. *IRC § 954(c)(1)(C)*. A commodity hedging transaction is a hedging transaction entered into by the controlled foreign corporation in the normal course of the corporation's trade or business primarily to manage risk of price changes or currency fluctuations with respect to ordinary property or property described in *IRC § 1231(b)* held by the corporation, or to manage such other risks as may be prescribed in regulations; the transaction must be clearly identified as a hedging transaction in accordance with *IRC § 1221(a)(7)*. *IRC §§ 954(c)(5)(A)*, *1221(b)(2)*.

The "substantially all" test is met if 85% of the controlled foreign corporation's taxable income is derived from its business as an active producer, processor, merchant, or handler of commodities. *Treas Reg § 1.954-2(f)(iii)(C)*. Commodities with respect to which gains and losses are not taken into account under *IRC § 954(c)(2)(C)* in computing a controlled foreign corporation's foreign personal holding company income are not taken into account in applying the substantially all test to the corporation. *IRC § 954(c)(5)(B)*.

Regulations provide that a hedging transaction entered into by a controlled foreign corporation with respect to its business as a producer, processor, merchant, or handler of commodities may be a qualified hedging transaction. *Treas Reg § 1.954-2(f)(2)(v)*. For this purpose, a producer, processor, merchant, or handler of commodities includes a controlled foreign corporation that regularly uses commodities in a manufacturing, construction, utilities, or transportation business. A corporation is not a producer, processor, merchant, or handler of commodities if its business is primarily financial. *Treas Reg § 1.954-2(f)(2)(vi)*. The regulations are effective for hedging transactions entered into on or after Jan 31, 2003.

(n63)Footnote 26. The property involved consists of property that (a) gives rise to dividends, interest, royalties, rents and annuities (other than rents or royalties that are derived from the active conduct of a trade or business and that are received from a person other than a related person), but not property that gives rise to income that is not treated as foreign personal holding company income under *IRC § 954(h)* or *954(i)*; (b) is an interest in a trust, partnership, or REMIC; or (c) does not give rise to any income.

(n64)Footnote 27. *IRC § 956(c)(2)(J)* refers to deposits of cash or securities made or received on commercial terms in the ordinary course of a US or foreign person's business as a dealer in securities or in commodities, but only to the extent the deposits are made or received as collateral or margin for (i) a securities loan, notional principal contract, options contract, forward contract, or futures contract, or (ii) any other financial transaction in which it is determined that it is customary to post collateral or margin.

(n65)Footnote 28. *IRC § 954(c)(2)(C)(i)*, *(ii)*. *IRC § 954(c)(2)(C)(ii)* applies only to the first taxable year of a foreign corporation beginning after Dec 31, 1998 and before Jan 1, 2009, and to taxable years of US shareholders with or within which the taxable year of the foreign corporation ends. *IRC § 954(h)(9)*.

See *IRC § 954(h)(7)* for anti-abuse rules regarding the application of *IRC § 954(c)(2)(C)(ii)*.

(n66)Footnote 29. *IRC § 954(c)(1)(C), (D); Treas Reg § 1.954-2(g)(2)(ii)*. Currency gain or loss arising from an interest-bearing liability must be allocated and apportioned between Subpart F income and non-Subpart F income in the same manner that interest expense associated with the liability is allocated and apportioned under *Temp Treas Reg §§ 1.861-9T and 1.861-12T. Treas Reg § 1.954-2(g)(2)(iii)*.

Transactions in dealer property that are entered into by a controlled foreign corporation that is a regular dealer in such property in its capacity as a dealer are treated as directly related to the business needs of the controlled foreign corporation. *Treas Reg § 1.954-2(g)(2)(ii)(C); Prop Treas Reg § 1.954-2(g)(2)(ii)(C)(1)*.

An interest-bearing liability incurred by a controlled foreign corporation that is denominated in (or determined by reference to) a nonfunctional currency is treated as dealer property if the liability, by being denominated in such currency, reduces the controlled foreign corporation's currency with respect to dealer property, and the liability is identified on the controlled foreign corporation's records as a liability treated as dealer property before the close of business on the day the liability is incurred. *Prop Treas Reg § 1.954-2(g)(2)(ii)(C)(2)(i)*. If the controlled foreign corporation identifies certain interest-bearing liabilities as liabilities treated as dealer property but fails to identify other interest-bearing liabilities that manage the corporation's currency risk with respect to assets that constitute dealer property, the Service may treat the other liabilities as dealer property if it determines that the failure to identify the other liabilities had as one of its principal purposes the avoidance of federal income tax. *Prop Treas Reg § 1.954-2(g)(2)(ii)(C)(2)(ii)*.

(n67)Footnote 30. *IRC § 954(c)(2)(A)*. Rents derived from leasing an aircraft or vessel in foreign commerce can be treated as derived in the active conduct of a trade or business, as determined under regulations prescribed by the Service, if the active leasing expenses are not less than 10% of the profit on the lease.

A person is a related person with respect to a controlled foreign corporation, if:

such person is an individual, corporation, partnership, estate, or trust that controls, or is controlled by, the controlled foreign corporation; or

such person is a corporation, partnership, trust, or estate that is controlled by the same persons who control the controlled foreign corporation.

Control, here, is the ownership of more 50 percent of the voting stock of a corporation. The rules for determining ownership prescribed by *IRC § 958* are applicable for this purpose. *IRC § 954(d)(3)*.

(n68)Footnote 31. *IRC § 954(c)(2)(B)*.

(n69)Footnote 32. The exception does not apply to dividends paid out of earnings and profits accumulated before the corporations were related persons. *Ltr Rul 199907022*.

(n70)Footnote 33. *IRC § 954(c)(3)*. The exception does not apply (i) in the case of any interest, rent, or royalty to the extent it reduces the payor's Subpart F income, or creates (or increases) a deficit that may reduce the Subpart F income of the payor or another controlled foreign corporation, or (ii) to a dividend if the dividend is attributable to earnings and profits accumulated by the distributing corporation during a period in which the person receiving the dividend did not hold the stock, either directly or indirectly through a chain of one or more subsidiaries (each of which is organized in the same foreign country as the controlled foreign corporation and has a substantial part of its assets used in its business located in that country).

(n71)Footnote 34. *Treas Reg § 1.954-2(a)(5)(ii)(A)*.

(n72)Footnote 35. *IRC § 954(c)(4)(A)*.

(n73)Footnote 36. *IRC § 954(c)(4)(B)*.

(n74)Footnote 37. *IRC § 954(c)(4)(B)*.

(n75)Footnote 38. The provision applies only to the taxable years of a foreign corporation beginning after Dec 31, 1998, and before Jan 1, 2007, and to taxable years of US shareholders with or within which any such taxable year of the foreign corporation ends. *IRC § 954(h)(9)*. See *IRC § 954(h)(7)* for anti-abuse rules to be used in applying *IRC § 954(h)(1)*.

IRC § 954(h)(1) does not apply to income described in *IRC § 954(c)(2)(C)(ii)* (discussed above) of an eligible controlled foreign corporation that is a dealer in securities. *IRC § 954(h)(6)*.

(n76)Footnote 39. *IRC § 954(h)(2)(A)*.

(n77)Footnote 40. A person is a related person with respect to a controlled foreign corporation if (1) the person is an individual, corporation, partnership, trust, or estate that controls or is controlled by the foreign corporation, or (2) the person is a corporation, partnership, trust, or estate that is controlled by the same person or persons that control the controlled foreign corporation. *IRC § 954(d)(3), 954(h)(5)(E)*.

(n78)Footnote 41. *IRC § 954(h)(2)(B)*. A lending or financing business is defined as the business of (a) making loans; (b) purchasing or discounting accounts receivable, notes, or installment obligations; (c) engaging in leasing (including entering into leases and purchasing, servicing, and disposing of leases and leased assets); (d) issuing letters of credit or providing guarantees; (e) providing charge and credit card services; or (f) rendering services or making facilities available in connection with the above activities carried on by the corporation (or qualified business unit) rendering the service or making the facilities available, or by an affiliated corporation (or qualified business unit of the affiliated corporation). *IRC § 954(h)(4)*.

(n79)Footnote 42. *IRC § 954(h)(3)(A)*. A qualified business unit is a separate and clearly identifiable unit of a trade or business of a taxpayer that maintains separate books and records. *IRC §§ 954(h)(5)(D), 989(a)*.

The home country of the controlled foreign corporation is the country in which the corporation was created or organized. The home country of a qualified business unit is the country in which it maintains its principal office. *IRC § 954(h)(5)(A), (B)*.

An activity will be treated as conducted directly by an eligible foreign corporation or qualified business unit in its home country if the activity is performed by employees of a related person and (i) the related person is an eligible controlled foreign corporation the home country of which is the same or the home country of the corporation or unit to which the provision is being applied, (ii) the activity is performed in the home country of the related person, and (iii) the related person is compensated on an arm's-length basis for the performance of its employees and the compensation is treated as earned by the related person in its home country for purposes of that country's tax laws. *IRC § 954(h)(3)(E)*.

(n80)Footnote 43. *IRC § 954(h)(3)(B)*.

(n81)Footnote 44. *IRC § 954(h)(3)(C)*.

(n82)Footnote 45. *IRC § 954(h)(3)(D)*.

(n83)Footnote 46. *Treas Reg § 1.954-2(a)(5)(ii)(B)*.

(n84)Footnote 47. *IRC § 954(i)(2)*.

(n85)Footnote 48. *Treas Reg § 1.954-2(a)(5)(ii)(C)*.

(n86)Footnote 49. *IRC § 954(d)(1)*. The provision also covers fees and commissions which the controlled foreign corporation receives for acting as an agent for a related person in purchasing or selling personal property.

Foreign base company sales income does not include income of a controlled foreign corporation derived in connection with the sale of personal property manufactured, produced, or constructed by it in whole or in part from personal property that it purchased. *Treas Reg § 1.954-3(a)(4)(i)*. To determine whether a controlled foreign corporation's distributive share of any item of gross income of a partnership would have been foreign base company sales income if received by the corporation directly, the property sold will be considered to be manufactured, produced, or constructed by the controlled foreign corporation only if the manufacturing exception would have applied to exclude the income from foreign base company sales income if the controlled foreign corporation had earned the income directly, taking into account only the activities of, and property owned by, the partnership. *Treas Reg § 1.954-3(a)(6)(i)*.

The term "personal property" does not include agricultural commodities that are not grown in the US in commercially marketable quantities. *Treas Reg § 1.954-3(a)* contains a list of agricultural commodities that are grown in the United States in commercially viable quantities.

See generally, Voce, "Foreign Base Company Sales Income: A Primer and an Update," 53 *Tax Lawyer* 327 (2000).

(n87)Footnote 50. S Rep No 1881, 87th Cong, 2d Sess 84 (1962).

(n88)Footnote 51. *Treas Reg § 1.954-3(a)(4)(i)*.

(n89)Footnote 52. *IRC § 954(d)(3)*. Rules similar to those contained in *IRC § 958* are used in determining ownership.

If the determination of whether an item of partnership income would be Subpart F income if received by the controlled foreign corporation directly requires a determination of whether an entity is a related person, the determination is made by reference to the controlled foreign corporation, not to the partnership. *Treas Reg § 1.954-1(g)(1)*. The same holds true for a determination of whether an activity occurred within or outside the country in which the controlled foreign corporation is organized.

(n90)Footnote 53. *Treas Reg § 1.954-3(a)(4)(ii), (iii)*.

(n91)Footnote 54. S Rep No 1881, 87th Cong, 2d Sess (1962); *Treas Reg § 1.954-3(a)(4)(iii)*, Ex (3).

(n92)Footnote 55. *IRC § 954(d)(2)*. There is no statutory or regulatory definition of "branch." The Tax Court believes that it should be given its ordinary meaning in a business or accounting sense. Hence, in *Ashland Oil, Inc v Commr*, 95 TC 348 (1990), it refused to treat a separately incorporated manufacturing entity operating pursuant to an arm's-length contract, with the controlled foreign corporation having no direct or indirect stock interest in that entity (and vice versa), as a branch. *Ashland Oil* was followed in *Vetco, Inc v Commr*, 95 TC 579 (1990).

The Service will follow the *Ashland* and *Vetco* opinions. The activities of a contract manufacturer cannot be attributed to a controlled foreign corporation for purposes of either *IRC § 954(d)(1)* or *IRC § 954(d)(2)* to determine whether the income of a controlled foreign corporation is foreign base company sales income. *Rev Rul 97-48, 1997-2 CB 89*.

(n93)Footnote 56. 1975-1 CB 244.

(n94)Footnote 57. Under the "branch rule," *IRC § 954(d)(2)*, the controlled foreign corporation would have subpart F income if the contract manufacturer/branch were located in a country other than the controlled foreign corporation's country of incorporation, and the controlled foreign corporation's profit from the sale of the manufactured product were taxed at an effective rate that was less than 90 percent of, and at least 5 percentage points less than, the effective rate in

the country in which the contract manufacturer/branch was located. See *Treas Reg* § 1.954-3(b)(1)(ii); *Rev Rul* 75-7 .

(n95)Footnote 58. See *Rev Rul* 97-48 .

(n96)Footnote 59. The regulations will apply to taxable years of controlled foreign corporations beginning after June 30, 2009, but, at their election, taxpayers may apply them retroactively to all open taxable years. *Treas Reg* § 1.954-3(a)(4)(iv)(c) and (d).

(n97)Footnote 60. *Treas Reg* § 1.954-3(a)(4)(iv), added by *TD 9438* , *73 Fed Reg* 79334 (Dec 29, 2008) . Such activities include, but are not necessarily limited to: oversight and direction of manufacturing processes; participation in manufacturing processes (though such participation fails to satisfy the regulations' physical manufacturing tests); selection of materials or vendors, or control of raw materials, work-in-process or finished goods; management of manufacturing costs or capacities; control of manufacturing related logistics; quality control; and developing or directing the use or development of product design and design specifications, trade secrets, technology or other intellectual property for the purpose of manufacturing the property.

(n98)Footnote 61. See *TD 9438* , *73 Fed Reg* at 79336.

(n99)Footnote 62. *Treas Reg* §§ 1.952-1(g) and 1.954-1(g)(1).

(n100)Footnote 63. *Treas Reg* § 1.954-1(g)(1).

(n101)Footnote 64. *Treas Reg* § 1.954-1(g)(2). The "related party" label also applies in transactions where the controlled foreign corporation sells property on behalf of the partnership to a related party (eg, on a commission basis), or sells property on behalf of a related party to the partnership. *Id.*

(n102)Footnote 65. See *Treas Reg* § 1.954-1(g)(3), Ex 2. Note that for purposes of determining whether CFC1's distributive share is foreign base company sales income, its country of organization, not that of Partnership, must be used. *Treas Reg* § 1.954-1(g)(1).

(n103)Footnote 66. *IRC* § 954(e)(1). A controlled foreign corporation's distributive share of a partnership's services income will be deemed to be derived from services performed for or on behalf of a related person if the partnership is a related person with respect to the controlled foreign corporation, and, in connection with the services performed by the partnership, the controlled foreign corporation (or a related person) provided assistance that would have constituted substantial assistance contributing to the performance of the services if furnished to the controlled foreign corporation by a related person. *Treas Reg* § 1.954-4(b)(2)(iii).

(n104)Footnote 67. S Rep No 1881, 87th Cong, 2d Sess (1962).

(n105)Footnote 68. *IRC* §§ 907(c)(2), 954(g)(1). Foreign base company oil related income does not include any dividend or interest that is passive income as defined in *IRC* § 904(d)(2)(A), discussed in § 20.02[4][e][iii]. It also does not include any income *IRC* § 954(c). See § 20.03[2][b][iii].

(n106)Footnote 69. *IRC* § 954(g)(1)(A), (B).

(n107)Footnote 70. *IRC* § 954(g)(2).

(n108)Footnote 71. *IRC* § 955(a)(1).

(n109)Footnote 72. *IRC* § 955(a)(2).

(n110)Footnote 73. *IRC* § 955(a)(2).

(n111)Footnote 74. *IRC § 955(b)(1)*.

(n112)Footnote 75. *IRC § 955(b)(5)*.

(n113)Footnote 76. *IRC § 956(a)(1)*. The amount taken into account with respect to any property is its adjusted basis as determined for purposes of computing earnings and profits, reduced by any liability to which the property is subject.

A controlled foreign corporation will be considered to hold indirectly any investment in US property held on its behalf by a trustee or nominee or, at the discretion of the District Director, investments in US property acquired by any other foreign corporation that is controlled by the foreign corporation, if one of the principal purposes for creating, organizing, or funding the other foreign corporation is to avoid application of *IRC § 956* with respect to the controlled foreign corporation. *Temp Treas Reg § 1.956-1T(b)(4)(i)*.

(n114)Footnote 77. *IRC § 956(a)(2)*.

(n115)Footnote 78. *IRC § 956(b)(1)*.

(n116)Footnote 79. *IRC § 956(b)(2)*.

(n117)Footnote 80. *IRC § 956(b)(2)*.

(n118)Footnote 81. *IRC §§ 956(b)(3), 956A(e)*.

(n119)Footnote 82. In *Schering-Plough Corp v US*, 2009 US Dist LEXIS 77467 (DNJ August 28, 2009), the Court applied the substance over form, step transaction and economic substance doctrines to recharacterize a US parent's sale to its controlled foreign corporation subsidiary as in reality a loan from the subsidiary to the parent. The US parent sold its subsidiary, in exchange for cash, the right to future income due under the "receive leg" of an interest rate swap the parent entered into with a bank in anticipation of the sale. The US parent remained obligated to the bank on the "pay leg" of the swap, and its payments to the bank funded the income "purchased" by the subsidiary. Finding that the pay and receive legs were of approximately equal value, and that as a result of related transactions both the US parent and the bank assumed no risk and had no expectation of profit from the interest rate swap (other than the bank's fee for serving as intermediary), the Court dismissed the swap as economically meaningless and treated the bank as a mere conduit for the US parent's repayment of the cash initially advanced by its subsidiary. The subsidiary's acquisition of the US parent's "obligation" constituted "US property" and triggered the recognition of subpart F income.

(n120)Footnote 83. *IRC § 956(c)(1)*. A state obligation is not an obligation of a US person, and is not to be taken into account in determining the US shareholder's pro rata share of the increase in earnings invested in US property. *Rev Rul 71-14, 1971-1 CB 218*.

The final regulations to be issued under *IRC § 956* will exclude from the definition of the term "obligation" an obligation that would constitute an investment in US property if held at the end of the controlled foreign corporation's taxable year, provided (i) the obligation is collected within 30 days from the time it is issued, and (ii) the corporation does not hold for more than 60 days during the year obligations that would constitute an investment in US property if held at the end of the taxable year. *IRS Notice 88-108, 1988-2 CB 445*.

A loan by a controlled foreign corporation is considered an investment in US property when the loan is made to a foreign corporation that is treated as a domestic subsidiary pursuant to an election by its parent under *IRC § 1504(d)*. *Rev Rul 82-171, 1982-2 CB 161*.

The Service has held that a controlled foreign corporation is deemed to have made an investment of earnings in US property when its stock is pledged as collateral by its US shareholders. The Service bases its position on *IRC § 956(c)*,

which provides that the corporation is treated as holding the obligation of a US person if it acts as a pledgor or guarantor. *Rev Rul 76-125, 1976-1 CB 204*. The Tax Court disagrees with the ruling and holds otherwise. *Ludwig v Commr, 68 TC 979 (1977)*.

A purchase of US person's debt obligations that mature and are repaid shortly before the end of the controlled foreign corporation's taxable year may constitute an investment of earnings in US property where new debt obligations issued by the same US person are purchased by the controlled foreign corporation shortly after the beginning of its next taxable year. *Rev Rul 89-73, 1989-1 CB 258*.

If a controlled foreign corporation is a partner in a partnership that owns property that would be US property if owned directly by the controlled foreign corporation, the corporation will be treated as holding an interest in the property equal to its interest in the partnership and the interest will be treated as an interest in US property. *Treas Reg § 1.956-2(a)(3)*.

(n121)Footnote 84. Vessels leased by a controlled foreign corporation and operated exclusively between ports in the US and ports in possessions of the US are not used in foreign commerce so that leasehold improvements made on the vessels are considered US property for purposes of *IRC § 956*. *Rev Rul 73-195, 1973-1 CB 349*.

(n122)Footnote 85. If an item is excluded from income because of the application of *IRC § 883(a)(1)*, *IRC § 952(b)* will not apply and the income will be treated as Subpart F income. *Rev Rul 87-15, 1987-1 CB 248*.

For purposes of *IRC § 952(b)*, any exemption (or reduction) with respect to the branch profits tax imposed by *IRC § 884* is not taken into account.

(n123)Footnote 86. In determining stock ownership for this purpose, the attribution rules of *IRC § 318* apply irrespective of the residence of the owner of the shares.

(n124)Footnote 87. *IRC § 956(c)(2)*. The term "dealer in securities" has the meaning given the term by *IRC § 475(c)(1)*, and the term "dealer in commodities" has the meaning given the term by *IRC § 475(e)*, except that the term includes a futures commission merchant. See *§ 18.05*.

(n125)Footnote 88. Tax-exempt interest received by a controlled foreign corporation is not includable currently in the income of its US shareholders. Since the purpose of *IRC § 959* is the prevention of double taxation of previously reported income, the Service takes the position that the provision does not apply to an actual distribution of earnings attributable to such interest. *Ltr Rul 8928036*.

The distribution of previously taxed income and the amount of the exclusion from income is kept in the foreign functional currency of the distributing foreign corporation for purposes of *IRC § 301*, because the distribution is not taxable as a dividend under *IRC § 301(c)(1)*. However, the distribution must be translated into U.S. dollars to determine the amount of exchange gain or loss under *IRC § 986(c)* (discussed in *§ 20.08[2]*). *TAM 200141003*.

(n126)Footnote 89. *IRC § 959(e)*. A purchaser of stock in a US corporation that is formed principally to hold the stock of a controlled foreign corporation does not receive previously taxed income treatment. Instead, that treatment is accorded to the US corporation whose stock was acquired where dividend consequences attended the sale of the stock under *IRC § 1248(e)*.

(n127)Footnote 90. *IRC § 959(f)(2)*.

(n128)Footnote 91. *IRC § 959(d)* provides that any distribution excluded from gross income under *IRC § 959(a)* "shall be treated, for purposes of this chapter, as a distribution which is not a dividend; except that such distributions shall immediately reduce earnings and profits."

Following a distribution out of earnings and profits by a controlled foreign corporation of property that has depreciated in value, the corporation's earnings and profits will be adjusted by reducing the sources of the distributions in the order set forth in *IRC § 959(c)*, to the extent thereof. *Rev Rul 86-131, 1986-2 CB 135* .

(n129)Footnote 92. *IRC § 959(f)(1)*.

(n130)Footnote 93. *IRC § 961(a)*. The increase is limited in the case of an individual shareholder who elects, under *IRC § 962*, to be subject to tax at corporate rates. See § 20.03[3][a].

(n131)Footnote 94. *IRC § 961(b)(1)*. A special rule is applied if the shareholder has made the *IRC § 962* election.

The basis reduction is permitted only if the exclusion from gross income comes under *IRC § 959(a)(1)*. There is no reduction if the governing exclusion is *IRC § 959(a)(2)*, unless the excluded amount is distributed to the US shareholder. *Rev Rul 76-539, 1976-2 CB 232* .

(n132)Footnote 95. *IRC § 961(b)(2)*.

(n133)Footnote 96. *Treas Reg §§ 1.961-1(a)(1), 1.961-2(a)(1)*.

(n134)Footnote 97. *IRC § 964(e)(1)*. See § 20.03[4]. The basis adjustments of *IRC § 961(c)* also apply to the stock of higher-tiered controlled foreign corporations in the same chain of ownership.

(n135)Footnote 98. *IRC § 961(c)*. The basis adjustments of *IRC § 961(c)* also apply to the stock of higher-tiered controlled foreign corporations in the same chain of ownership.

(n136)Footnote 99. *IRC § 960(a)(1)*. *IRC § 902* is discussed in § 20.02[4][c].

If a domestic corporation computes deemed-paid taxes under both *IRC § 902* and *IRC § 960* in the same year, *IRC § 960* is applied first. After the deemed-paid taxes are computed under *IRC § 960* with respect to a deemed income inclusion, post-1986 undistributed earnings and profits and post-1986 foreign income taxes in each separate category are reduced by the appropriate amounts before deemed-paid taxes are computed under *IRC § 902* with respect to a dividend distribution. *Treas Reg § 1.960-1(i)(2)*.

(n137)Footnote 100. *IRC § 960(a)(2)*. *IRC § 960(b)* sets forth a special rule relating to the *IRC § 904* limitation on the foreign tax credit for the year of receipt of previously taxed earnings and profits.

Ltr Rul 9023006 illustrates the proper method of computing earnings and profits for determining foreign tax credits under *IRC §§ 902* and *960* if, in the same taxable year, the US corporation includes an amount in income under *IRC § 951(a)* and also receives a cash dividend from its foreign subsidiary.

(n138)Footnote 1. *IRC § 962(a), (b)*; *Treas Reg § 1.962-2(a)*.

(n139)Footnote 2. *IRC § 962(c)*. The corporate tax rate is the sum of 15 percent of the first \$50,000 of taxable income, 25 percent of the next \$25,000, and 34 percent of taxable income in excess of \$75,000.

A corporation with taxable income in excess of \$100,000 must increase its tax by the lesser of 5 percent of such excess or \$11,750.

(n140)Footnote 3. *Treas Reg § 1.962-1(b)(1)(i) (b)*, (b)(2)(ii), (c).

(n141)Footnote 4. *IRC §§ 78, 960(a)(1)*.

(n142)Footnote 5. Each bracket amount specified in *IRC § 11(b)* would be reduced by one-half, the ratio of the

Subpart F income included in the shareholder's income (\$90,000) to the shareholder's pro rata share of the corporation's earnings and profits (60 percent of \$300,000).

(n143)Footnote 6. *IRC § 962(d)*.

(n144)Footnote 7. *Treas Reg § 1.962-2(b)*.

(n145)Footnote 8. *IRC § 962(b); Treas Reg § 1.962-2(c)*.

(n146)Footnote 9. *Treas Reg § 1.962-2(c)*.

(n147)Footnote 10. See generally Schenk & Balkin, "Subpart G Tax Incentives for Export Trade: A Technical Analysis of Tax Haven Operations," *54 Minn L Rev* 245 (1969); Brudno, "Export Trade Corporations," *5 Inst on Private Investments Abroad & Foreign Trade* 59 (1963).

(n148)Footnote 11. *IRC § 971(a)(3)*.

(n149)Footnote 12. S Rep No 1881, 87th Cong, 2d Sess 91 (1962).

(n150)Footnote 13. "Export promotion expenses" are defined by *IRC § 971(d)* as being the following expenses paid or incurred in the production of export trade income:

salaries or other compensation for personal services rendered;

rent paid for the use of property; an allowance for depreciation;

and any other ordinary and necessary expenses reasonably allocable to the receipt or production of export trade income.

No expense incurred in the United States will be treated as an export promotion expense unless 90 percent of each category of expense is incurred outside the United States.

(n151)Footnote 14. Defined as working capital necessary for the production of export trade income, inventory of export property, facilities located outside the United States for the storage, handling, transportation, or servicing of export property, and evidences of indebtedness executed by unrelated persons in connection with the purchase of export property. *IRC § 971(c)*.

A controlled foreign corporation need not take into account an excess of current liabilities over current assets (negative working capital) when determining the amount of its export trade assets. *Rev Rul 69-549, 1969-2 CB 158*.

(n152)Footnote 15. *IRC § 970(a)(1), (2)*.

(n153)Footnote 16. *IRC § 970(c)(3)*. The amount taken into account with respect to any asset is its adjusted basis reduced by any liability to which the asset is specifically subject. *IRC § 970(c)(1); Treas Reg § 1.970-1(d)(1)(iii)*.

IRC Section 970(c)(4) permits an election to determine the decrease in investment as of a day other than the last day of the taxable year and preceding taxable year.

(n154)Footnote 17. An export trade corporation transferred property having an adjusted basis equal to its untaxed Sub-part F income to a commonly owned DISC without receiving any consideration for the transfer. The transfer did not reduce the export trade corporation's investment in export trade assets for purposes of applying *IRC § 970(b)*. *Rev Rul 73-196, 1973-1 CB 354*.

(n155)Footnote 18. *Treas Reg § 1.970-1(c)(2)*.

Suppose, in a given year, a controlled foreign corporation, qualifying as an export trade corporation, has \$400 Subpart F income, of which \$300 is excluded under *IRC § 970(a)*. The corporation invests the \$400 in export trade assets. In a later year, the corporation sells \$100 of those assets and distributes \$100 to its United States shareholder. The reduction in export trade assets and the distribution to the shareholder of an amount equal to the previously included Subpart F income are treated as separate events. Thus, while the actual distribution is excluded from the shareholder's gross income under *IRC § 959(a)*, the amount of the reduction in export trade assets must be included in the shareholder's income. *Rev Rul 71-213, 1971-1 CB 219* .

(n156)Footnote 19. *IRC § 971(a)(1)*.

(n157)Footnote 20. *IRC § 971(a)(2)*.

(n158)Footnote 21. *IRC § 971(b)*. The Service has ruled that income derived by an export trade corporation from sales of export property solicited by a related foreign corporation acting merely as a commission sales agent of the export trade corporation is export trade income. *Rev Rul 71-184, 1971-1 CB 220* .

(n159)Footnote 1. *IRC § 1248* applies only if the gain realized is recognized in whole or in part. *Treas Reg § 1.1248-1(c)*.

A US person will be treated as having sold or exchanged stock if the person is treated as realizing gain from the sale or exchange of the stock. This means that redemptions and liquidations treated as exchanges are subject to *IRC § 1248(a)*.

An amount treated as a dividend under *IRC § 1248* cannot be taken into account in determining the extent to which capital losses are deductible under *IRC § 1211*. *Rev Rul 74-60, 1974-1 CB 236* .

To determine how much of a parent's gain on the sale of a controlled foreign corporation's stock is a dividend under *IRC § 1248*, the foreign corporation's earnings and profits must be reduced by presale distributions to the parent and postsale distributions to the purchaser. *TAM 199906035* .

See, generally, Friedman & Silbert, "The Ultimate U.S. Tax Burden on Foreign Operations--Section 1248," 24 *NYU Inst on Fed Tax* 1401 (1966); Irell & Stone, "Understanding Section 1248--The New Tax Law Regarding Sales or Liquidations of Foreign Corporations," 1964 *So Calif Tax Inst* 321.

(n160)Footnote 2. *IRC § 1248(h)*.

(n161)Footnote 3. *IRC § 964(e)(1)*. The provision is effective for gain recognized on transactions, including deemed sales, occurring after Aug 5, 1997.

Regulations can provide for a basis adjustment to the stock of the selling controlled foreign corporation to be made to reflect the inclusion in income by the US shareholder. *IRC § 961(c)*. The basis adjustments of *IRC § 961(c)* also apply to the stock of higher-tiered controlled foreign corporations in the same chain of ownership.

(n162)Footnote 4. *IRC § 964(e)(2)*.

(n163)Footnote 5. A finding, that the substance of a purported sale of stock in a foreign corporation was in fact a liquidation, extended the period during which the corporation qualified as a controlled foreign corporation. *Est of Weiskopf v Commr*, 64 TC 78 (1975) , *affd mem 37 AFTR2d 76-1427 (2d Cir 1976)* .

(n164)Footnote 6. *Treas Reg § 1.1248-1(d)(1)*. No additional credit is allowable if the amount of the *IRC § 1248*

dividend is actually distributed to the shareholder at a later date. *Rev Rul 90-31, 1990-1 CB 147*.

(n165)Footnote 7. *Treas Reg § 1.1248-4(b)(1)*.

(n166)Footnote 8. *IRC § 1248(b)*. The limitation applies only if the taxpayer can prove the amount of foreign taxes to be taken into account under Section 1248(b). *IRC § 1248(h)*.

The tax attributable to amounts included as dividends in the gross income of a partner in a partnership that sells stock in a controlled foreign corporation is subject to the limitation in *IRC § 1248(b)*. *Rev Rul 69-124, 1969-1 CB 203*. The same holds true for a shareholder in an S corporation. *Ltr Rul 199908044*.

(n167)Footnote 9. *IRC § 1248(c)(1)*. The computation of the amount of earnings and profits attributable to the particular block sold or exchanged is broken down into simple cases and complex cases. A simple case must meet the following conditions imposed by *Treas Reg § 1.1248-2(c)* to insure an "easy" computation: (1) on each day of the period during which the block sold or exchanged was held by the shareholder, the corporation was a controlled foreign corporation and was not a foreign personal holding company or a foreign investment company; (2) the corporation had only one class of stock and the same number of shares of such stock outstanding on each day of such period; (3) the corporation was not a less developed country corporation for any taxable year within the period; (4) during the period involved, distributions out of earnings and profits were made only out of post-1962 earnings and profits, only when the shareholder owned the block of stock and the corporation was a controlled foreign corporation. If by reason of the ownership of the block of stock sold or exchanged, the shareholder owns sufficient stock in a lower-tier corporation to require its earnings and profits to be included in the earnings and profits of the first-tier corporation to the extent prescribed by *IRC § 1248(c)(2)*, then the four previously mentioned conditions must be met with respect to the lower-tier corporation as well, and the shareholder's percentage of indirect ownership of stock in such corporation kept at a constant level throughout the period involved. If these conditions cannot be met, the case is a complex case governed by *Treas Reg § 1.1248-3*.

(n168)Footnote 10. *IRC § 1248(d)(1)*. The exclusion is permitted only to the extent that the inclusion in gross income under *IRC § 951* did not lead to the exclusion of an actual distribution under *IRC § 959*.

There is no reduction in earnings and profits when a sale or exchange of stock in the controlled foreign corporation produces an *IRC § 1248* dividend. The reduction will occur when amounts attributable to the dividend are actually distributed to the shareholder. *Rev Rul 90-31, 1990-1 CB 147*.

(n169)Footnote 11. *IRC § 1248(d)(6)*.

(n170)Footnote 12. *IRC § 1248(d)(4)*. This provision does not apply to any item of income which is exempt from taxation or is subject to a reduced rate of tax pursuant to a treaty obligation of the US.

(n171)Footnote 13. *IRC § 1248(d)(3)*.

(n172)Footnote 14. *IRC § 1248(d)(5)*.

(n173)Footnote 15. *IRC § 1248(c)(2)*.

(n174)Footnote 16. A redemption or liquidation that is treated as an exchange of stock is governed by *IRC § 1248(e)*. *IRC § 1248(a)(2)*.

The only case to address the meaning of "principally" in the context of *IRC § 1248* is *Teller v Commr, TC Memo 1992-402*. The Tax Court looked to uses of the term in other Code sections and accorded to it the everyday meaning of first importance.

(n175)Footnote 17. To the extent earnings and profits are taken into account under this subsection, they are excluded from consideration under *IRC § 1248(e)*. *IRC § 1248(f)(3)*.

(n176)Footnote 18. *IRC § 1248(f)(2)*.

(n177)Footnote 19. *IRC § 751(c), (e)*.

(n178)Footnote 20. See Ch 14.

(n179)Footnote 21. See, eg, *Rev Rul 87-47, 1987-1 CB 250*, involving gain realized on a distribution of shares of a foreign subsidiary that could not qualify as a tax-free spinoff, and *Rev Rul 75-143, 1975-1 CB 275*, treating "boot" received on the transfer of controlled foreign corporation stock to a newly formed corporation as a dividend.

(n180)Footnote 22. *IRC § 1248(g)(1), (2)*.

(n181)Footnote 1. *IRC § 965(a)(1)*. All US shareholders that are members of an affiliated group filing a consolidated return under *IRC § 1501* are treated as one US shareholder. *IRC § 965(c)(5)(A)*.

No dividends received deduction is allowed under *IRC §§ 243 or 245* for any dividend for which a deduction is allowed under *IRC § 965(a)(1)*.

(n182)Footnote 2. *IRC § 965(c)(3)*; *Notice 2005-10, 2005-1 CB 474*. Dividends resulting from liquidations of a subsidiary qualifying under *IRC § 332* to which *IRC § 367(b)* applies qualify as cash dividends to the extent the US shareholder receives cash as part of the liquidation. *IRC § 965(c)(3)*.

(n183)Footnote 3. *IRC § 965(a)(2)*.

(n184)Footnote 4. *IRC § 965(b)(1)*. The term "applicable financial statement" means the most recently audited financial statement that is certified on or before June 30, 2003, as being prepared in accordance with generally accepted accounting principles, and that is used for the purposes of a statement or report to creditors, shareholders, or any other substantial nontax purpose. If the taxpayer is required to file a financial statement with the Securities and Exchange Commission, the term means the most recent such statement filed on or before June 30, 2003. *IRC § 965(c)(1)*.

(n185)Footnote 5. *IRC § 965(b)(2)*. The amount of dividends eligible for the deduction must be reduced by any increase in related-party indebtedness of the controlled foreign corporation between Oct 3, 2004 and the close of the taxable year for which the election is made. *IRC § 965(b)(3)*. All controlled foreign corporations with respect to which the taxpayer is a US shareholder are treated as one controlled foreign corporation for this purpose.

(n186)Footnote 6. *IRC § 965(c)(2)(A)*. If the taxpayer has fewer than five taxable years ending on or before June 30, 2003, the base period years include all the taxable years of the taxpayer ending on or before June 30, 2003. *IRC § 965(c)(2)(B)*. Special rules adjust the base period to take account of mergers, acquisitions, and spin-offs. *IRC § 965(c)(2)(C)*.

(n187)Footnote 7. *Notice 2005-10, 2005-6 IRB 474*. The Notice also lists acquisition of interests in business entities and advertising and marketing expenditures as permitted investments.

(n188)Footnote 8. *IRC § 965(b)(4)*; *Notice 2005-10, 2005-6 IRB 474*.

(n189)Footnote 9. *Notice 2005-10, 2005-6 IRB 474*.

(n190)Footnote 10. *Notice 2005-10, 2005-6 IRB 474*.

(n191)Footnote 11. *IRC § 965(e)(2)(A)*. The term "nondeductible CFC dividends" means the excess of the amount

of dividends taken account under *IRC* § 965(a) over the deduction allowed under that subsection for the dividends. *IRC* § 965(e)(2)(C).

(n192)Footnote 12. *IRC* § 965(e)(2)(B).

(n193)Footnote 13. *IRC* § 965(d)(1), (2). Unless the taxpayer specifies otherwise, the deductible portion of any dividend or other amount is the amount that bears the same ratio to the amount of the dividend or other amount as the amount allowed as a deduction under *IRC* § 965(a) for the taxable year bears to the amount of dividends taken into account under *IRC* § 965(b)(2)(A). *IRC* § 965(d)(3).

(n194)Footnote 14. *IRC* § 965(f).

(n195)Footnote 15. *Notice 2005-10, 2005-6 IRB 474* .



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Taxation of Securities Transactions

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CHAPTER 20 Foreign Securities and Foreign Shareholders

2-20 Taxation of Securities Transactions § 20.04

§ 20.04 Tax Consequences of Investments in Foreign Securities by United States Citizens and Residents--Passive Foreign Investment Companies

The Tax Reform Act of 1986 added new provisions governing the treatment of United States shareholders in passive foreign investment companies. Unlike the rules discussed earlier, the provisions are applied without regard to the degree of United States ownership in the fund.

[1] Passive Foreign Investment Company Defined

Pursuant to *IRC Sections 1297(a)* and *1297(d)*, a foreign corporation is a passive foreign investment company (PFIC) if (1) 75 percent or more of its gross income for the taxable year is passive income,ⁿ¹ or (2) on average, at least 50 percent of its assets are assets that produce passive income or are held for the production of passive income.ⁿ² The determination in (2) is made on the basis of the value of the assets of a foreign corporation if the corporation is a publicly traded corporation for the taxable year.ⁿ³ A controlled foreign corporation (CFC), or any other foreign corporation that so elects, will have the determination based on the adjusted bases of its assets in lieu of their value.ⁿ⁴ The election, once made, can be revoked only with the consent of the Service. A foreign corporation that owns (directly or indirectly) at least 25 percent (by value) of the stock of another corporation must take into account a proportionate share of the assets and income of the other corporation in determining whether the foreign corporation is a PFIC.ⁿ⁵ A corporation is not treated as a PFIC for its start-up year (the first year in which it has gross income) if (1) neither the corporation nor predecessor corporation was a PFIC; (2) it is established to the satisfaction of the Service that the corporation will not be a PFIC for either of the two taxable years following the start-up year; and (3) the corporation is not a PFIC for either of those two years.ⁿ⁶ A similar rule applies to a corporation that has passive income from the disposition of an active business.ⁿ⁷

Stock of a United States corporation owned by another United States corporation in which a foreign corporation owns at least 25 percent (by value) of the stock is treated as a nonpassive asset. In determining whether a foreign corporation is a PFIC, stock of a regular domestic C corporation owned by a 25-percent domestic corporation is treated as an asset that does not produce passive income (and is not held for the production of passive income) and income derived from the stock is not passive income.ⁿ⁸ Thus, a foreign corporation, in applying the look-through rule available to 25-percent owned corporations, will be treated as owning nonpassive assets in these cases. The rule does not apply if, under a treaty obligation of the United States, the foreign corporation is not subject to the accumulated earnings tax, unless the corporation waives the benefit of the treaty. If a foreign corporation tries to use the rule to avoid the PFIC provisions, it

will be subject to the accumulated earnings tax imposed by *IRC Section 531*.

IRC Section 1298(b)(1) provides that if a shareholder owns stock in a foreign corporation that, at any time during the shareholder's holding period with respect to the stock, was a PFIC that was not a qualified electing fund, the stock will retain its character as PFIC stock, even if the corporation ceases to qualify as a PFIC under *IRC Section 1297(a)*, unless the shareholder elects to purge the PFIC taint by making either a deemed sale election or a deemed dividend election.ⁿ⁹ A shareholder making a deemed sale election with respect to a former PFIC is treated as having sold all of its stock in the former PFIC for its fair market value on the termination date--the last day of the taxable year of the foreign corporation for which it qualified as a PFIC.ⁿ¹⁰ This causes the amount of any gain to be recognized as an excess distribution on the termination date.ⁿ¹¹ Any loss realized on the deemed sale is not recognized.ⁿ¹² For purposes of applying the PFIC rules and no other purposes, the deemed sale election also causes the shareholder's holding period in the stock of the foreign corporation to begin on the day following the termination, whether or not the shareholder recognized gain on the deemed sale.ⁿ¹³

A shareholder of a former PFIC can make a deemed dividend election if the foreign corporation was a controlled foreign corporation during its last year as a PFIC, whether the shareholder is a United States shareholder of the controlled foreign corporation, as defined in *IRC Section 951(b)*.ⁿ¹⁴ A shareholder making an election with respect to a former PFIC must include in income as a dividend its pro rata share of the post-1986 earnings and profits of the PFIC attributable to all of the stock it held, directly or indirectly, on the termination date and treat the amount included as an excess distribution received on that date.ⁿ¹⁵ The excess distribution resulting from the deemed dividend election is allocated under *IRC Section 1291(a)(1)(A)* only to each day of the shareholder's holding period of the stock during which the foreign corporation qualified as a PFIC.ⁿ¹⁶ After the deemed dividend election, the shareholder's stock with respect to which the election was made is not treated as stock in a PFIC unless the foreign corporation thereafter qualifies as a PFIC.ⁿ¹⁷

The deemed dividend election is made in the same manner, within the same time periods, and on the same form as the deemed sale election.ⁿ¹⁸ In addition, similar basis adjustment and holding period rules apply.ⁿ¹⁹

The Commissioner may, in his discretion, grant consent for a late purging election.ⁿ²⁰ However, the Commissioner can grant relief only if (i) the shareholder requests the consent before a representative of the Service raises upon audit the PFIC status of the foreign corporation for any taxable year of the shareholder; (ii) the shareholder has agreed in a closing agreement with the Commissioner to eliminate any prejudice to the interests of the United States government as a consequence of the shareholder's inability to file amended returns for the taxable year in which the CFC qualification date fallsⁿ²¹ (or an earlier closed taxable year in which the shareholder has taken a position that is inconsistent with the treatment of the foreign corporation as a PFIC);ⁿ²² and (iii) the shareholder satisfies certain procedural requirements.ⁿ²³

For this purpose, passive income has the same meaning as foreign personal holding company income, as defined for Subpart F purposes. However, passive income does not include any income derived in the active conduct of a banking or insurance business in the United States, interest, dividends, rents, or royalties received or accrued from a related person (within the meaning of *IRC Section 954(d)(3)*) to the extent the amount is properly allocable to income of the related person that is not passive income, or income that is foreign trade income of a foreign sales corporation or export trade income of an export trade corporation.ⁿ²⁴

Prior to 1998, a foreign corporation that was a CFC could also be a PFIC if it met the passive income test or passive asset test. In such case, a 10-percent United States shareholder of the corporation could be subject to both the Subpart F provisions and the PFIC provisions of the Code. *IRC Section 1297(e)(1)*, added by the Taxpayer Relief Act of 1997, changes that result by providing that the corporation will not be treated as a PFIC during the "qualified portion" of a shareholder's holding period with respect to stock in the corporation. The qualified portion is the portion of the shareholder's holding period after December 31, 1997, during which the shareholder is a 10-percent United States

shareholder and the corporation is a CFC.ⁿ²⁵

The effect of *IRC Section 1297(e)(1)* is to subject a 10-percent United States shareholder to current inclusion under the Subpart F rules with respect to stock of a PFIC, but not to be subject to the PFIC provisions with respect to that stock. The PFIC provisions continue to apply to a corporation that is also a CFC with respect to shareholders who are not 10-percent United States shareholders and are not subject to the Subpart F rules.

If *IRC Section 1297(e)(1)* ceases to apply to a shareholder because the shareholder is no longer a 10-percent United States shareholder of the corporation, for purposes of the PFIC rules, the shareholder's holding period for the stock is treated as beginning immediately after such cessation.ⁿ²⁶ Thus, in applying the rules applicable to a PFIC that is not a qualified electing fund, the earnings of the corporation are not attributed to the period during which the shareholder was subject to the Subpart F rules and not to the PFIC provisions.

A further purging election is available to a shareholder of a corporation to which *IRC Section 1297(e)* applies (a Section 1297(e) corporation).ⁿ²⁷ The mechanics and consequences of the election are similar to those described above.ⁿ²⁸

[2] Taxation of Excess Distributions From and Dispositions of Stock in Passive Foreign Investment Companies

In order to eliminate the tax advantages that United States shareholders in foreign investment funds had over United States shareholders in domestic investment funds, *IRC Section 1291* eliminates the economic benefit of tax deferral by imposing United States income taxes and an interest charge based on the value of the deferral at the time that the shareholder disposes of stock in the PFIC or receives an excess distribution (unless the PFIC is a qualified electing fund).ⁿ¹ The gain recognized on the disposition or on receipt of an excess distribution is considered to be earned pro rata over the period of the taxpayer's holding period of the stock, and is treated as ordinary income.ⁿ² To the extent provided in regulations, transfers of stock in a PFIC that would normally be wholly or partly tax-free become taxable to the extent of the excess of the fair market value of the stock over its adjusted basis, with proper adjustment in the basis of the stock made to reflect the recognition of gain.ⁿ³

The United States tax due in the year of disposition or receipt of excess distribution is the sum of (1) United States tax computed using the highest rate of tax for the taxpayer (without regard to other income or expenses the taxpayer may have) on income attributed to prior years; (2) interest imposed on the deferred tax; and (3) United States tax on the gain attributable to the year of disposition or receipt and to years in which the foreign corporation was not a PFIC.ⁿ⁴ The portions of the distribution that are not characterized as excess distributions are subject to tax in the current year under normal Code provisions.

Under *IRC Section 1291(g)*, the United States investor's creditable foreign taxes for the distribution includes the amount of direct foreign taxes paid by the investor with respect to the distribution (e.g., withholding taxes) and the amount of the PFIC's foreign taxes deemed paid by the investor with respect to the distribution under *IRC Section 902* to the extent the taxes are creditable under general foreign tax credit principles and the investor chooses to claim the taxes as a credit.ⁿ⁵ The investor then determines the amount of the creditable foreign taxes that are attributable to the portion of the distribution that is an excess distribution ("excess distribution taxes") by apportioning the total amount of creditable foreign taxes between the amount of the distribution that is an excess distribution and the amount that is not on a pro rata basis. For purposes of determining the amount of the distribution from the PFIC (and the amount of the excess distribution) the gross-up under *IRC Section 78* is included in the amount of money or other property received.

The taxpayer next allocates the excess distribution taxes ratably to each day in the holding period of the stock. To the extent the taxes are allocated to days in tax years prior to the year in which the corporation became a PFIC and to the current tax year, the taxes are taken into account under general foreign tax credit rules. To the extent the taxes are allocated to days in other tax years, the foreign tax credit limitation provisions of *IRC Section 904* are applied separately

to those taxes. Under this rule, the allocable taxes can reduce the aggregate increase in tax on which interest is computed, but not below zero. If the allocable taxes are in excess of any increase in tax, no interest will be due, but no carryover will be allowed since the foreign tax credit limitations are applied with respect to excess distributions occurring within each taxable year.

IRC Section 1298(c) provides that, if a pooled income fund owns stock in a PFIC and no portion of any gain from a disposition of the stock may be allocated to income under the terms of the governing instrument, the deferred tax and interest charge rules will not apply so long as a charitable deduction would be allowable with respect to the gain, and the current inclusion rule applicable to investors in a PFIC that is a qualified electing fund will not apply with respect to the stock held. However, for distributions received from a PFIC, the deferred tax and interest rules will continue to apply to excess distributions, even when the distributions are received from a PFIC that has been a qualified electing fund for all of its life as a PFIC.

An excess distribution is a distribution in the taxable year that exceeds 125 percent of the average amount received with respect to stock in the PFIC during the three preceding taxable years (or, if shorter, the taxpayer's holding period before the taxable year).ⁿ⁶ If there are multiple distributions during the year, each distribution is an excess distribution to the extent that it represents a ratable portion of the total distributions that are excess distributions.ⁿ⁷ For example, if a calendar-year taxpayer's average distributions for the prior three years are \$100, and he receives a \$100 distribution in January and a \$50 distribution in November, the total excess distribution is \$25 (\$150 total distribution less \$125, 125 percent of the \$100 average). Two thirds of the total excess distribution is then allocated to the January distribution and one third to the November distribution for purposes of attributing the excess distribution to current and prior years to compute the amount of deferred tax and interest.

IRC Section 1291(b)(3) calls for regulations providing for the following adjustments to be made in determining excess distributions:

- (1) Determinations are to be made on a share-by-share basis, except that shares with the same holding period can be aggregated.
- (2) Proper adjustments must be made for stock splits and stock dividends.
- (3) If the taxpayer does not hold the stock during the entire taxable year, distributions must be annualized.
- (4) If the taxpayer's holding period includes periods during which the stock was held by another person, distributions received by the other person are taken into account as if received by the taxpayer.
- (5) If distributions are received in a foreign currency, determinations are made in that currency and the amount of any excess distribution is translated into dollars.
- (6) Proper adjustment is made for amounts not includable in gross income under *IRC Sections 959(a)* or *1293(c)*.
- (7) If a charitable deduction was allowable to a trust for any distribution of its income, proper adjustment must be made for the deduction to the extent allocable to distributions or gain in respect of stock in a PFIC.

IRC Section 1291(e) provides rules similar to those that applied to foreign investment companies (as in effect on the day before the enactment of the American Jobs Creation Act of 2004) for stock with a substituted basis that inherits the attributes of passive foreign investment stock, for the treatment of certain forms of indirect ownership of PFIC stock, for

information reporting by 5-percent owners of PFIC's, and to deny a step up in basis for stock acquired from a decedent other than a foreign decedent.ⁿ⁸

IRC Section 1291(d)(2) allows a taxpayer, who holds stock in a PFIC on the day that it becomes a qualified electing fund and can establish the fair market value of the stock on that day to the satisfaction of the Service, to elect to recognize gain as if the stock were sold on that day.ⁿ⁹ In such case, the adjusted basis of the stock will be increased by the amount of the recognized gain, and the taxpayer's holding period will be treated as beginning on that day. The election can be made by a shareholder who would realize a loss on the deemed sale, but the loss cannot be recognized.ⁿ¹⁰

If a PFIC becomes a qualified electing fund for a taxable year that begins after December 31, 1986, the taxpayer holds stock in the company on the first day of that taxable year, and the company is a CFC, the taxpayer can elect to include in gross income as a dividend received on that first day an amount equal to the portion of the post-1986 earnings and profits of the corporation attributable to the stock in the company held by the taxpayer on that day.ⁿ¹¹ The amount treated as a dividend is considered an excess distribution and is allocated only to days during periods taken into account in determining the post-1986 earnings and profits so attributable. In this case, the adjusted basis of the stock is increased by the amount treated as a dividend and the taxpayer's holding period begins on the day the taxpayer is deemed to have received the dividend.

[3] Qualified Electing Funds

IRC Section 1291(d)(1) causes *IRC Section 1291* to be inapplicable to any distributions paid by a PFIC, or any disposition of stock in a PFIC, if the company is a qualified electing fund with respect to the taxpayer for each of its taxable years (i) that begins after December 31, 1986, and for which the company is a PFIC, and (ii) that includes any portion of the taxpayer's holding period.

[a] Qualified Electing Fund Defined. A PFIC is a qualified electing fund if an election by the taxpayer applies to the company for the taxable year, and the company complies with such requirements as the Service will prescribe for determining the ordinary earnings and net capital gain of the company for the taxable year, and otherwise carrying out the purposes of the PFIC rules.ⁿ¹ The election can be made for any taxable year if made before the 15th day of the third month of the following taxable year, and continues in effect for subsequent taxable years for which the company is a PFIC unless revoked with the consent of the Service.ⁿ²

[b] Current Taxation of Income From Qualified Electing Funds. Every United States person who, directly or indirectly, owns stock in a qualified electing fund at any time during the taxable year of the fund must include in gross income the person's pro rata share of the ordinary earnings and net capital gain of the fund as ordinary income and long-term capital gain, respectively.ⁿ³ The inclusion is made for the taxable year of the shareholder in which or with which the taxable year of the fund ends.ⁿ⁴ Later distributions by the PFIC will not be treated as a dividend, if the shareholder can establish that the distribution is out of earnings and profits that were previously included in the gross income of the shareholder.ⁿ⁵ However, the rule stated in the last sentence will not apply to any U.S. shareholder in a PFIC that is also a CFC, and any inclusion in income under *IRC Section 1293* will be treated, for purposes of *IRC Section 959*, as an inclusion of Subpart F income.ⁿ⁶

According to *IRC Section 1293(g)*, in determining the amount includable in the gross income of any person, the ordinary earnings and net capital gain of a qualified electing fund do not include any item of income received by the fund if (1) the fund is a CFC and the person is a United States shareholder in the fund, and (2) the person establishes to the satisfaction of the Service that (a) the income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax imposed by *IRC Section 11*, or (b) the income is from sources within the United States, is effectively connected with the conduct by the qualified electing fund of a trade or business in the United States, and is not exempt from taxation (or subject to a reduced rate of tax) under a treaty

obligation of the United States. Regulations will prescribe adjustments that may be necessary to prevent the same item of income of a qualified electing fund from being included in the gross income of a United States person more than once.

The basis of the taxpayer's stock in a PFIC is increased by the amount of the fund's ordinary earnings and net capital gain included in income, and decreased by any distributions not treated as a dividend.ⁿ⁷ A similar rule applies to any property held by the taxpayer that causes the taxpayer to be treated under *IRC Section 1298(a)* as owning stock in a qualified electing fund.

For purposes of the application of *IRC Section 960*, corporate 10-percent shareholders treat any amount included currently in income as if it were included under *IRC Section 951*, and any distribution not treated as a dividend as if excluded from gross income under *IRC Section 959*.ⁿ⁸

United States shareholders of a qualified electing fund can, subject to an interest charge, elect to defer United States tax on amounts included in income for which no current distributions are received.ⁿ⁹ However, the election is not available for any amounts that must be included in income currently under *IRC Section 951*.ⁿ¹⁰

The election to defer is treated as an extension of time to pay the tax. It terminates if the shareholder receives a distribution of previously taxed earnings or transfers the stock, or if the PFIC ceases to be a qualified fund.ⁿ¹¹ It will also terminate if the Service believes that collection of any deferred amount is in jeopardy.ⁿ¹²

[4] Mark-to-Market Election

A shareholder of a PFIC (including a person who is treated as owning stock in a PFIC) is permitted to make a mark-to-market election for PFIC stock that is marketable.ⁿ¹ The election applies only to the United States person (or CFC treated as a United States person) that makes the election; it does not apply to a transferee of the stock.ⁿ² Under the election, the shareholder includes in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the taxable year over the shareholder's adjusted basis in the stock.ⁿ³ The shareholder is allowed a deduction for the lesser of the excess, if any, of the adjusted basis of the stock over its fair market value, or the "unreversed inclusions" with respect to the stock.ⁿ⁴ When a United States person is treated as owning stock through a foreign entity, mark-to-market gain or loss is determined as of the last day of the taxable year of the entity and then included in the taxable year of the United States person that includes the last day of the taxable year of the foreign entity.ⁿ⁵

PFIC stock is considered marketable if it is regularly traded on a national securities exchange that is registered with the Securities and Exchange Commission, on the national market established pursuant to the Securities and Exchange Act of 1934, or any exchange or other market that the Internal Revenue Service determines has rules adequate to ensure that the market price represents a legitimate and sound fair market value.ⁿ⁶ Any option that is considered marketable under the foregoing rules is also treated as marketable to the extent provided in regulations.ⁿ⁷ In addition, PFIC stock is treated as marketable, to the extent provided in regulations, if the PFIC offers for sale (or has outstanding) any stock of which it is the issuer and which is redeemable at its net asset value in a manner comparable to a United States regulated investment company.ⁿ⁸ Finally, any PFIC stock owned by an RIC that offers for sale (or has outstanding) stock of which it is the issuer and which is redeemable at its net asset value is marketable stock.ⁿ⁹

The shareholder's adjusted basis in the PFIC stock is adjusted to reflect the amounts included or deducted under the election.ⁿ¹⁰ In the case of stock owned indirectly by a United States person under *IRC Section 1296(g)(1)*, the basis adjustment is made to the basis of the stock in the hands of the actual owner, but only for the purposes of determining the subsequent application of the PFIC rules to the indirect United States owner.ⁿ¹¹ In addition, similar basis adjustments are made to the adjusted basis of the property actually held by the indirect United States owner by reason of which the United States person is treated as owning PFIC stock.ⁿ¹²

Any amount included in gross income pursuant to a mark-to-market election, as well as gain on the actual sale or disposition of PFIC stock, is treated as ordinary income.ⁿ¹³ Ordinary loss treatment applies to any amount allowed as a deduction under the election, and to any loss realized on the actual sale or other disposition of PFIC stock to the extent that the amount of the loss does not exceed the net mark-to-market gains previously included in income with respect to the stock.ⁿ¹⁴ The source of any amount included or deducted under the election is determined in the same manner as if the amount was gain or loss from the sale of stock in the PFIC.ⁿ¹⁵

A CFC that owns stock in a PFIC is treated as a United States person that may make the election with respect to its PFIC stock.ⁿ¹⁶ Any amount includable in the CFC's income pursuant to the election is treated as foreign personal holding company income; any deduction resulting from the election is treated as a deduction allocable to foreign personal holding company income.ⁿ¹⁷ The source of such amounts is determined by reference to the actual residence of the CFC.ⁿ¹⁸

If the mark-to-market election is made after the beginning of the taxpayer's holding period for the PFIC stock, and the PFIC is not a qualified electing fund, a coordination rule applies to ensure that the taxpayer does not avoid the interest charge imposed by *IRC Section 1291* (discussed in § 20.04[2]) with respect to amounts attributable to periods before the election.ⁿ¹⁹ If an RIC makes the mark-to-market election after the beginning of its holding period with respect to PFIC stock, the RIC's tax for the first tax year in which the election is made is increased by the interest that would have been charged under *IRC Section 1291*, unless the mark-to-market election is made on the last day of the preceding year; no deduction is allowed for the increase in tax.ⁿ²⁰

Except as provided in the coordination rules, the rules of *IRC Section 1291*, applicable to funds that are not qualified electing funds, do not apply to a shareholder for which a mark-to-market election is in effect.ⁿ²¹ In applying *IRC Section 1291* in a case where a mark-to-market election was in effect for any prior year, the shareholder's holding period for the PFIC stock is treated as beginning immediately after the last taxable year for which the election applied.ⁿ²²

If stock in a PFIC is acquired from a decedent and a mark-to-market election was in effect on the date of the decedent's death, the basis of the stock in the hands of the person acquiring the stock is the lesser of the adjusted basis of the stock in the hands of the decedent immediately before death or the date of death value.ⁿ²³ In the case of a PFIC shareholder who becomes a United States person in a taxable year beginning after December 31, 1997, the adjusted basis of any marketable stock in the PFIC owned by the individual on the first day of such taxable year is treated as being the greater of its fair market or adjusted basis on that day.ⁿ²⁴

The mark-to-market election applies to the year in which made and all subsequent years unless the PFIC stock ceases to be marketable stock, or the Service consents to the revocation of the election.ⁿ²⁵ The election must be made on or before the due date (including extensions) of the income tax return of the United States person that owns, or is treated as owning marketable stock in the PFIC.ⁿ²⁶

FOOTNOTES:

(n1)Footnote 1. The gross income test applies to the total gross income of a corporation for the taxable year determined under the principles of *IRC § 61* and Subpart F.

(n2)Footnote 2. See, eg, *Ltr Rul 9447016*, where a corporation that did not qualify as a PFIC under the asset test was held not to be such under the income test because its nonpassive losses exceeded its passive and nonpassive income.

(n3)Footnote 3. *IRC § 1297(f)(1)*. A foreign corporation is treated as publicly traded if the stock of the corporation is regularly traded on (a) a national securities exchange that is registered with the Securities and Exchange Commission or the national market system established pursuant to § 11A of the Securities and Exchange Act of 1934, or (b) any

exchange or other market that is determined to have rules sufficient to ensure that the market price represents a sound fair market value. *IRC § 1297(f)(3)*.

(n4)Footnote 4. *IRC § 1297(f)(2)*. Elimination of the overlap between a CFC and a PFIC (see the text at N 10 below) effectively means that the only persons that must use tax basis are persons who own less than 10 percent of the stock of a CFC.

Any tangible personal property leased by the foreign corporation under a lease with a term of at least 12 months is treated as an asset actually held by the corporation. The amount of the leased asset taken into account for this purpose is the unamortized portion of the present value of the payments under the lease. The rules do not apply if the lessor is a related person or a principal purpose of leasing the property was to avoid the PFIC provisions. *IRC § 1298(d)*.

The adjusted basis of the total assets of a CFC is increased by the amount of unreimbursed research or experimental expenditures paid or incurred by the corporation during the taxable year and the preceding two taxable years. If the corporation is a licensee of any intangible property and uses the asset in the active conduct of a trade or business, the adjusted basis of the corporation must be increased by an amount equal to 300 percent of the payments made during the taxable year by the corporation for the use of the property. *IRC § 1298(e)*. Again, the rules do not apply to any payments to a related foreign person and to any payments under a license if a principal purpose of entering into the license was to avoid the rules relating to passive foreign corporations or to investments by a CFC in excess passive assets.

(n5)Footnote 5. *IRC § 1297(c)*.

(n6)Footnote 6. *IRC § 1298(b)(2)*.

(n7)Footnote 7. *IRC § 1298(b)(3)*.

(n8)Footnote 8. *IRC § 1298(b)(8)*.

(n9)Footnote 9. *Treas Reg § 1.1298-3(a), (b)(1)*.

(n10)Footnote 10. *Treas Reg § 1.1298-3(b)(2), (d)*. The deemed sale election must be made in the shareholder's original or amended return for the taxable year that includes the termination date (election year). If the election is made in an amended return, the return must be filed within three years of the due date, as extended, of the original return for the election year. *Treas Reg § 1.1298-3(b)(3)*.

The deemed sale election is made by filing Form 8621 with the return for the election year, reporting the gain as an excess distribution and paying the tax and interest due thereon. *Treas Reg § 1.1298-3(b)(4)*.

(n11)Footnote 11. *Treas Reg § 1.1298-3(b)(2)*. A shareholder that makes the deemed sale election increases its adjusted basis of the stock owned by the amount of gain recognized on the deemed sale. If the shareholder makes the deemed sale election with respect to a PFIC of which it is an indirect shareholder, the shareholder's adjusted basis of the stock or other property owned directly by the shareholder, through which ownership of the PFIC is attributed to the shareholder, is increased by the amount of the gain recognized by the shareholder; the adjusted basis of the direct owner of the stock is increased as well. *Treas Reg § 1.1298-3(b)(5)*.

(n12)Footnote 12. *Treas Reg § 1.1298-3(b)(2)*. There is no adjustment to basis on account of a loss that is not recognized. *Treas Reg § 1.1298-3(b)(5)*.

(n13)Footnote 13. *Treas Reg § 1.1298-3(b)(6)*.

(n14)Footnote 14. *Treas Reg § 1.1298-3(c)(1)*.

(n15)Footnote 15. *Treas Reg § 1.1298-3(c)(2)*. Post-1986 earnings and profits are post-1986 undistributed earnings, within the meaning of *IRC § 902(c)(1)*, without regard to *IRC § 901(c)(2)*, as of the close of the taxable year that includes the termination date. *Treas Reg § 1.1298-3(c)(3)(i)*. In making the computation, only earnings and profits accumulated in taxable years during which the foreign corporation was a PFIC are taken into account.

A shareholder's pro rata share of the post-1986 earnings and profits attributable to the stock held by the shareholder on the termination date is the amount of such earnings and profits of the PFIC accumulated during any portion of the shareholder's holding period ending on the termination date and attributable to the PFIC stock held on that date. *Treas Reg § 1.1298-3(c)(3)(ii)(A)*. There is a reduction for amounts previously included in income pursuant to another provision of the Code. *Treas Reg § 1.1298-3(c)(3)(ii)(B)*.

(n16)Footnote 16. *Id.*

(n17)Footnote 17. *Id.*

(n18)Footnote 18. *Treas Reg § 1.1298-3(c)(4), (5)(i)*. The shareholder must attach a schedule to Form 8621 that demonstrates the calculation of post-1986 earnings and profits treated as distributed to the shareholder because of the election. *Treas Reg § 1.1298-3(c)(5)(ii)*.

(n19)Footnote 19. *Treas Reg § 1.1298-3(c)(6), (7)*.

(n20)Footnote 20. *Treas Reg § 1.1298-3(e)(1)*.

(n21)Footnote 21. The CFC qualification date is the first day on which the qualified portion of the shareholder's holding in a section 1297(e) PFIC begins. *Treas Reg § 1.1297-3(d)*.

(n22)Footnote 22. The interests of the US government are prejudiced if granting relief would result in the shareholder having a lower tax liability (other than by a *de minimis* amount), taking into account applicable interest charges, for the taxable year that includes the CFC qualification date (or a prior taxable year in which the taxpayer took a return position that was inconsistent with the treatment of the foreign corporation as a PFIC) that the shareholder would have had if the shareholder had made a timely purging election under *IRC § 1298(b)(1)* (or had not taken an inconsistent position on a return for a prior taxable year). The time value of money is taken into account for purposes of this computation. *Treas Reg § 1.1298-3(e)(2)*.

(n23)Footnote 23. The amount due with respect to a late purging election is determined in the same manner as if the purging election had been timely filed. However, the shareholder is also liable for interest on the amount due, determined for the period beginning on the due date (without extensions) for the taxpayer's tax return for the year in which the CFC qualification date falls and ending on the date the late purging election is filed. *Treas Reg § 1.1298-3(e)(3)*.

(n24)Footnote 24. *IRC § 1297(b)(2)*.

(n25)Footnote 25. *IRC § 1297(e)(2)*. *IRC § 1297(e)(1)* does not apply to stock treated as owned by a person pursuant to *IRC § 1298(a)(4)* (person holding option to acquire the stock treated as owning the stock) unless the person establishes that the stock is owned by a US shareholder who is not exempt from tax. *IRC § 1297(e)(4)*.

(n26)Footnote 26. *IRC § 1297(e)(3)*.

(n27)Footnote 27. A foreign corporation is a Section 1297(e) corporation with respect to a shareholder if (a) the foreign corporation qualifies as a PFIC under *IRC § 1297(a)* on the first day on which the qualified portion of the shareholder's holding period in the foreign corporation begins, as determined under *IRC § 1297(e)(2)*, and (b) the stock of the foreign corporation held by the shareholder is treated as stock of a PFIC, pursuant to *IRC § 1298(b)(1)*, because,

at any time during the shareholder's holding period of the stock, other than the qualified portion, the corporation was a PFIC that was not a qualified electing fund. *Treas Reg § 1.1291-9(j)(2)(v)*.

(n28)Footnote 28. *Treas Reg § 1.1297-3(a)-(c)*.

(n29)Footnote 1. Any amount included in the gross income of a U.S. shareholder of a CFC because of an investment in U.S. assets is treated as a distribution with respect to stock in a PFIC that is a CFC. *IRC § 1298(b)(9)*.

As a general rule, *IRC § 1291* will not apply if a mark-to-market election under *IRC § 1296* is in effect for the taxable year. *IRC § 1291(d)(1)*. The mark-to-market election is the subject of § 20.04[4]. *IRC § 1291* also does not apply to stock marked to market under *IRC § 475* or any other provision, except that rules similar to those of *IRC § 1296(j)* apply.

(n30)Footnote 2. *IRC § 1291(a)(1), (2)*. Use of passive foreign investment stock as security for a loan is treated as a disposition of the stock.

The taxpayer's holding period is determined under the rules of *IRC § 1223*, except that (1) for purposes of applying *IRC § 1291* to an excess distribution, the holding period is treated as ending on the date of the distribution, and (2) if the mark-to-market election under *IRC § 1296* applied to the stock with respect to the taxpayer for any prior taxable year, the holding period is treated as beginning on the first day of the first taxable year after the last taxable year for which the election applied. *IRC § 1291(a)(3)(A)*.

Attribution rules are applied to the extent that the effect is to treat stock of a PFIC as owned by a US person, but not to treat stock owned, directly or indirectly, by a US person as owned by any other person. *IRC § 1298(a)(1)*. Under these rules, stock owned, directly or indirectly, by or for a corporation in which a person owns at least 50 percent in value of the stock is deemed to be owned proportionately by such person, while stock owned, directly or indirectly by or for a partnership, estate, or trust is considered as owned proportionately by its partners or beneficiaries. *IRC § 1298(a)(2), (3)*. *IRC § 1297(e)* does not apply in determining whether a corporation is a PFIC for purposes of *IRC § 1298(a)(2)*.

To the extent provided in regulations, if any person has an option to acquire stock, the stock will be considered as owned by the person. An option to acquire an option, and each one of a series of such options, will be considered as an option to acquire the stock. *IRC § 1298(a)(4)*.

If a person has an option to acquire stock in a PFIC, and sells the option instead of exercising it, the sale will be treated as a disposition to which *IRC § 1291* applies. This will not be the case if the option is exercised. *Prop Treas Reg § 1.1291-1(d)*.

If a US person is treated as owning stock in a PFIC by virtue of the attribution rules, any distribution of money or other property to the actual holder of the stock is treated as a distribution to the US person. Amounts deemed distributed to the US person are not includable in gross income of the holder actually receiving those amounts for purposes of causing the US person to include the amounts in income again.

(n31)Footnote 3. *IRC § 1291(f)*.

(n32)Footnote 4. *IRC § 1291(c)*. The aggregate amount of interest on the increases in tax is treated as interest paid under *IRC § 6601* on the due date for the current year.

(n33)Footnote 5. The rules coordinating *IRC §§ 901* and *1291* also apply to any gain that, absent *IRC § 1291*, would be treated as a dividend under *IRC § 1248*.

(n34)Footnote 6. *IRC § 1291(b)(2)(A)*. Any excess distribution received during the three-year period is taken into

account only to the extent it was included in gross income under *IRC § 1291(a)(1)(B)*.

There can be no excess distributions for the taxable year in which the taxpayer's holding period for the stock begins. *IRC § 1291(b)(2)(B)*.

(n35)Footnote 7. *IRC § 1291(b)(1)*.

(n36)Footnote 8. See § 20.05[2][a].

(n37)Footnote 9. The election must be made with the filing of the electing shareholder's tax return (or amended return filed within three years of the due date, as extended) for the taxable year that includes the qualification date. *Treas Reg § 1.1291-10(c)*. The election is made on Form 8621 or on a statement containing similar information. *Treas Reg § 1.1291-10(d)*.

(n38)Footnote 10. *Treas Reg § 1.1291-10(b)*.

(n39)Footnote 11. For this purpose, post-1986 earnings and profits are earnings and profits that were accumulated in taxable years beginning after Dec 31, 1986, and during the period or periods the stock was held by the taxpayer while the company was a PFIC, but without regard to whether the earnings relate to a period during which the PFIC was a CFC. *Treas Reg § 1.1291-9* sets forth the rules regarding the time and manner of making the deemed dividend election.

For purposes of *IRC § 959(e)*, any amount included in gross income as a dividend is treated as included under *IRC § 1248(a)*.

(n40)Footnote 1. *IRC § 1295(a)*. *Treas Reg § 1.1295-1(b)* sets forth the requirements for making the election.

(n41)Footnote 2. *IRC § 1295(b)*. The election applies to all subsequent years with respect to the company unless revoked by the taxpayer with the consent of the Service.

If a US person, or the US shareholder on behalf of a CFC, makes a mark-to-market election under *IRC § 1296* with respect to stock for which a qualified electing fund election is in effect, or marks-to-market the stock under any other provision of the Code, the qualified electing fund provision is automatically terminated with respect to that stock, effective on the last day of the taxable year preceding the first taxable year for which the election under *IRC § 1296* is in effect or the stock is marked-to-market. *Treas Reg § 1.1295-1(i)(3)*. A shareholder whose qualified electing fund election is terminated cannot make a qualified electing fund election with respect to the PFIC before the sixth taxable year in which the termination became effective, unless the election under *IRC § 1296* was terminated because the PFIC stock ceased to be marketable or the stock was no longer marked-to-market. *Treas Reg § 1.1295-1(i)(5)*.

(n42)Footnote 3. *IRC § 1293(a)(1)*. The pro rata share is the amount that would have been distributed to the shareholder if, on each day during the taxable year of the fund, the fund had distributed to each shareholder a pro rata portion of that day's ratable share of its ordinary income and net capital gain for the year. *IRC § 1293(b)*. To the extent provided in regulations, if the fund establishes to the satisfaction of the Service that it uses a shorter period than the taxable year to determine shareholders' interests in the earnings of the fund, *pro rata* shares may be determined by using the shorter period.

The fund's ordinary earnings are the excess of its earnings and profits for the taxable year over its net capital gain. The fund's net capital gain for any taxable year cannot exceed its earnings and profits for the year. *IRC § 1293(e)*. Earnings and profits are determined without the LIFO inventory, installment sales, and completed contract method of accounting adjustments required by *IRC § 312(n)*, except to the extent it would increase earnings and profits by an amount that was previously distributed by the qualified electing fund.

(n43)Footnote 4. *IRC § 1293(a)(2)*.

(n44)Footnote 5. *IRC § 1293(c)*. The distribution immediately reduces earnings and profits.

(n45)Footnote 6. *IRC § 1293(c)*.

(n46)Footnote 7. *IRC § 1293(d)*.

(n47)Footnote 8. See § 20.04[2][g].

(n48)Footnote 9. *IRC § 1294(a)(1), (b)*. The election must be made by the due date, as extended, of the tax return for the shareholder's taxable year to which the election applies. The shareholder is required to file Form 8621 or a statement containing similar information. *Temp Treas Reg § 1.1294-1T(c), (d)*.

(n49)Footnote 10. *IRC § 1294(a)(2)*.

(n50)Footnote 11. *IRC § 1294(c)(1), (2)*. The extension will not terminate by reason of a transfer of stock in a nonrecognition transfer; the transferee succeeds to the treatment of the transferor.

A loan by a qualifying electing fund to a shareholder of the fund is treated as a distribution for purposes of *IRC §§ 1293 and 1294*. *IRC § 1294(f)*.

(n51)Footnote 12. *IRC § 1294(c)(3)*. The IRS has the authority to require a bond as in the case of any extension of time for payment. *IRC § 1294(e)*.

(n52)Footnote 1. *IRC § 1296(a)*. Stock owned, directly or indirectly, by or for a foreign partnership, foreign trust, or foreign estate is considered as being owned proportionately by its partners or beneficiaries. *IRC § 1296(g)(1)*. A disposition that results in a US person being treated as not owning PFIC constructively is treated as a disposition by the US person of the PFIC stock. *IRC § 1296(g)(2)*.

Under the regulations, marketable stock includes (1) a class of stock that is regularly traded on one or more qualified exchanges or other markets, in other than *de minimis* quantities, on at least 15 days during each calendar quarter; (2) stock in PFIC's that meet certain conditions that liken the PFIC to an RIC; and (3) options on stock described in (1) and (2). *Treas Reg § 1.1296-2*.

For the calendar year in which a corporation initiates a public offering trading on one or more qualified exchanges or other markets, the class of stock is treated as marketable for that year if the stock is regularly traded, other than in *de minimis* quantities, on one-sixth of the days remaining in the quarter in which the offering occurs, and on at least 15 days during each remaining quarter of the calendar year. If the public offering takes place in the last quarter of the year, the class of stock is treated as marketable if regularly traded, other than in *de minimis* quantities, on the greater of one-sixth of the days remaining in the quarter or five days. *Treas Reg § 1.1296-2(b)(2)*.

(n53)Footnote 2. *Treas Reg § 1.1296-1(b)(2)*. The election is made with respect to a single foreign corporation and, therefore, a separate election must be made for each foreign corporation that meets the requirements of *IRC § 1296*. *Treas Reg § 1.1296-1(b)(3)*.

(n54)Footnote 3. *IRC § 1296(a)(1)*.

(n55)Footnote 4. *IRC § 1296(a)(2)*. The unrecovered inclusions are the excess, if any, of the mark-to-market gains included in income by the shareholder for prior taxable years (including any amount that would have been included for any prior year, but for the interest on tax deferral imposed by *IRC § 1291*), over the mark-to-market losses for the stock that were allowed as deductions in prior years. *IRC § 1296(d)*.

If a regulated investment company (RIC) makes the mark-to-market election for its PFIC stock, the deduction for the

excess of the stock's adjusted basis over its fair market value is allowed to the extent of its mark-to-market inclusions for prior years.

(n56)Footnote 5. *Treas Reg § 1.1296-1(g)(3)*.

(n57)Footnote 6. *IRC § 1296(e)(1)(A)*. A foreign securities exchange must have trading volume, listing, financial disclosure, surveillance, and other requirements designed to prevent fraudulent and manipulative practices, to remove impediments to and perfect the mechanism of a free and open, fair and orderly market, and to protect investors; and the laws of the country in which the exchange is located and the rules of the exchange ensure that the requirements are actually enforced. In addition the rules of the exchange must effectively promote active trading of listed stocks. *Treas Reg § 1.1296(e)-1(c)(1)(ii)*.

(n58)Footnote 7. *IRC § 1296(e)(1)(C)*.

(n59)Footnote 8. *IRC § 1296(e)(1)(B)*.

(n60)Footnote 9. *IRC § 1296(e)(2)*. Except as provided in regulations, similar treatment as marketable stock applies to any PFIC stock held by any other RIC that publishes net asset valuations at least annually.

(n61)Footnote 10. *IRC § 1296(b)(1)*.

(n62)Footnote 11. *IRC § 1296(b)(2)(A)*.

(n63)Footnote 12. *IRC § 1296(b)(2)(B)*.

(n64)Footnote 13. *IRC § 1296(c)(1)(A)*. Any amount included by an RIC is treated as a dividend for the purposes of *IRC § 851(b)(2)* and (3), the income limitation provisions used in determining whether a corporation is an RIC. *IRC § 1296(h)*.

Any gain from the disposition of stock of a foreign corporation that does not qualify as a PFIC for the year of disposition will be capital gain. *Treas Reg § 1.1296-1(c)(7)*, Ex 2.

(n65)Footnote 14. *IRC § 1296(c)(1)(B)*. Any loss with respect to stock for which a mark-to-market election was made but that is recognized in a taxable year during which the foreign corporation is not a PFIC is a capital loss. *Treas Reg § 1.1296-1(c)(7)*, Ex 4.

(n66)Footnote 15. *IRC § 1296(c)(1)(C)*.

(n67)Footnote 16. *IRC § 1296(f)(1)*.

(n68)Footnote 17. *IRC § 1296(f)(2)*.

(n69)Footnote 18. *IRC § 1296(f)(2)*.

(n70)Footnote 19. *IRC § 1296(j)(1)*.

(n71)Footnote 20. *IRC § 1296(j)(2)*.

(n72)Footnote 21. *IRC § 1291(d)(1)*. For the first taxable year for which a § 1296 election is in effect with respect to stock of a PFIC, the US person making the election must (1) apply the rules of *IRC § 1291* with respect to, or disposition of, the stock; (2) apply *IRC § 1291* to the amount of the excess, if any, of the fair market value of the stock on the last day of the US person's taxable year over its adjusted basis, as if the amount were gain recognized from the disposition of stock on the last day of the taxpayer's taxable year; and (3) increase the adjusted basis of the stock by the

amount of that excess. *Treas Reg* § 1.1296-1(i)(2).

The coordination rules are applicable as well to a US person that marks-to-market its PFIC stock under a provision other than *IRC* § 1296. *Treas Reg* § 1.1291(c)(3).

(n73)Footnote 22. *IRC* § 1291(a)(3)(A)(ii).

(n74)Footnote 23. *IRC* § 1296(i).

(n75)Footnote 24. *IRC* § 1296(l).

(n76)Footnote 25. *IRC* § 1296(k).

(n77)Footnote 26. *Treas Reg* § 1.1296-1(h)(1). The election is made on Form 8621.



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Taxation of Securities Transactions

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CHAPTER 20 Foreign Securities and Foreign Shareholders

2-20 Taxation of Securities Transactions § 20.05

§ 20.05 Tax Consequences of Investments in US Securities by Nonresident Aliens and Foreign Corporations

[1] The Taxation of Passive Investment Income

The United States taxation of a foreign taxpayer's passive investment income--income not effectively connected with the conduct of a trade or business in the United States--extends only to income from sources within the United States. Whether income is from United States sources, or from foreign sources and, thus nontaxable, is a matter normally to be determined under the various source rules that are prescribed for different types of income in *IRC Sections 861, 862, and 863*. The source rules most pertinent to foreign investors--those for interest, dividends, and gains on sales of property--are discussed in greater detail below, but a few general points should be kept in mind.

First, determining the "source" of an item of income is not a matter of finding the physical source or location of the funds from which the item is paid. "[In prescribing source rules,] Congress was not referring ... to the origin of the physical means of payment, but rather to the place where the recipient's income was 'produced.'"n1 In seeking the source of interest, dividends or royalty payments, for example, the fact that the payments are made out of a foreign bank account, in which only foreign income has been deposited, does not necessarily give the payments a foreign source.n2

Second, *IRC Sections 861, 862 and 863* do not comprehensively cover all types of income, including income related to securities transactions, on which nonresident aliens may be subject to US tax. Where income is not of a kind covered by a specific statutory sourcing rule, the Internal Revenue Service and the courts will generally compare it with the kinds of income for which sourcing rules are specifically prescribed and apply by analogy the sourcing rule for the income type that is most similar to the income in question.

Thus, in *Bank of America v US*,n3 "acceptance" and "confirmation" commissions received by a US bank from foreign banks for undertaking to pay US exporters presenting commercial letters of credit and similar obligations issued by the foreign banks were deemed analogous to (though not the same as) interest because, like interest, the commissions predominately compensated the US bank for assuming the risk that the foreign banks might fail to reimburse it for amounts advanced on their behalf. On the other hand, "negotiations" commissions paid to the US bank for acting as the foreign banks' agent in determining whether the conditions of their letters of credit had been met, without obligating the US Bank to use its funds to make payments under the letters of credit if the conditions were satisfied, were deemed more in the nature of compensation for services performed by the US bank. Accordingly, the "acceptance" and "confirmation" commissions were sourced at the residence of the foreign banks by analogy to the statutory sourcing rule

for interest (residence of obligor), while "negotiating" commissions were sourced in the US, where the US banks' services were performed, by analogy to the sourcing rule applicable to compensation for services.ⁿ⁴ In another case involving income that did not fall squarely into one of *IRC Section 861*'s categories, a foreign parent company received fees from its US subsidiary as compensation for guaranteeing the US subsidiary's indebtedness to third parties, calculating the fees as a percentage (1.5 percent) of the subsidiary's outstanding guaranteed indebtedness each year. The Tax Court decided that the lack of an unconditional obligation to assume the subsidiary's outside indebtedness made it inappropriate to analogize these fees to interest. Finding that the guarantee was more akin to a service performed for the US subsidiary by the foreign parent in its home country (where the assets supporting the guarantee were located), the Tax Court held that the fees charged for that service should be sourced outside the US where it felt the service was performed.ⁿ⁵

Finally, a determination that passive investment income received by a foreign taxpayer has a US source does not necessarily mean that it will therefore be taxed by the US; it only means that the US considers such investment income to be within its jurisdiction to tax. Whether or not US source income of a foreign taxpayer is actually taxed, and at what rate, depends upon the provisions of and statutory exceptions to *IRC Sections 871* (taxation of foreign individuals) and *881* (taxation of foreign corporations). Tax rates are also governed by income tax treaties between the US and individual foreign countries which often reduce or eliminate, for the resident-beneficiaries of the US's treaty partners, US tax on various kinds of income. One example of US source income that is not taxable to any nonresident alien or foreign corporation is the statutory exception for "portfolio interest" as defined in *IRC Section 871(h)(2)*, the purpose of which is to encourage foreign investors to deposit their funds in the US. This and other rules governing the taxation of US source investment income received by foreign individuals and corporations are discussed in § 20.05 [1][b], *infra*.

[a] The Source Rules.

[i] Interest. The general rule regarding the source of interest income is that it is determined by reference to the residence of the obligor.ⁿ⁶ Thus, "interest from the United States, any Territory, and political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise," constitutes income from sources within the United States.ⁿ⁷

IRC Section 861(a) makes exceptions from the general rule in certain categories where the resident payor derives at least 80 percent of its income from an active business outside the United States, or the interest is paid on deposits in a foreign branch of a US bank. More specifically, the following four categories of interest are considered income from sources outside the US, notwithstanding that the payor is legally resident in the US.

(1) Interest paid by a resident alien individual or domestic corporation, if it is established to the satisfaction of the Service that, during the three-year period ending with the close of the payor's taxable year preceding the payment, at least 80 percent of the payor's income was "active foreign business income."ⁿ⁸ "Active foreign business income" means gross income derived from sources outside the United States attributable to the active conduct of a trade or business in a foreign country.^{n8.1} If the payor of the interest is a domestic corporation, the 80-percent test may also be satisfied by a subsidiary in which the domestic corporation owns at least 50 percent of the stock. However, if the nonresident recipient of the interest is a "related person," (eg, a corporation 10 percent or more of which is owned by the payor of the interest),ⁿ⁹ a "look-thru" rule applies under which the percentage of the interest received that is deemed sourced outside the US cannot exceed the percentage of the payor's gross income that is "active business income." Thus, if 20 percent of the payor's income is not attributable to the conduct of an active business or is not from sources without the US, no more than 80 percent of the recipient's interest payment will be regarded as sourced without the US.

(2) interest on deposits with a foreign branch of a domestic corporation or domestic partnership, provided the branch is engaged in the commercial banking business;ⁿ¹⁰

(3) interest on deposits or withdrawable accounts in foreign branches of United States savings and loan associations;ⁿ¹¹ and

(4) in the case of a foreign partnership that is predominantly engaged in the active conduct of a trade or business outside the United States, any interest paid by a trade or business engaged in by the partnership in the United States and not allocable to income that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.ⁿ¹²

However, *IRC Section 871(i)* prevents the imposition of any tax on interest on deposits, if the interest is not effectively connected with the conduct of a trade or business in the United States.ⁿ¹³

[ii] Dividends. Dividends received from domestic corporations are generally considered income from United States sources, without regard to whether or to what extent the domestic corporation earned its income from sources within or without the United States.ⁿ¹⁴

Dividends from a foreign corporation may also be considered US source income under certain circumstances described in *IRC Section 861(a)(2)*. Under *IRC Section 861(a)(2)(B)*, dividends received from a foreign corporation are deemed to be wholly or partially from US sources if, in the three-year period ending with the taxable year before the dividend is declared, at least 25 percent of the corporation's gross income from all sources was effectively connected with the conduct of a US trade or business. In this event, the portion of such foreign corporation's dividends that are deemed to be from US sources is determined by multiplying the total amount of dividends received by a fraction, the numerator of which is the gross income for the three-year period that was effectively connected with the conduct of a trade or business in the United States, and the denominator of which is the entire gross income for the period.ⁿ¹⁵ (If the corporation has no gross income from any source during the three-year period, the 25 percent test is applied with respect to its income in the year the dividend is paid.)ⁿ¹⁶

For purposes of the foreign tax credit, dividends (other than dividends for which a dividends received deduction is allowable under *IRC Section 245(b)*) from a foreign corporation are treated as income from sources without the United States to the extent (and only to the extent) they exceed the amount that is 100/70ths of the amount of the deduction allowable under *IRC Section 245* in respect of such dividends.ⁿ¹⁷ Finally, dividends paid by a foreign corporation from earnings and profits accumulated by a domestic corporation subject to federal income taxes are United States source income in their entirety.ⁿ¹⁸ Dividends received by a United States corporation from a DISC or former DISC constitute income derived from sources within the United States, except to the extent the dividends are attributable to qualified export receipts, in which case they are treated as foreign source income.ⁿ¹⁹ Dividends other than those described above are considered dividends from sources outside the United States.ⁿ²⁰

[iii] Dividend Equivalents. *IRC Section 871(l)*, added to the Code by the Hiring Incentives to Restore Employment Act (the "HIRE" Act) of 2010,ⁿ²¹ provides that, for purposes of *IRC Sections 871* and *881*, and the obligation to withhold the tax imposed by those sections from payments to nonresident aliens pursuant to §§ 1441 et seq and 1471 et seq, a "dividend equivalent" shall be treated as a dividend from sources within the United States. A dividend equivalent is defined as:ⁿ²²

(A) any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States;

(B) any payment made pursuant to a notional principal contract that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States;ⁿ²³ and

(C) any other payment determined by the Secretary [of the Treasury] to be substantially similar to a payment described in paragraphs (A) or (B) above.

Dividend equivalents treated as U.S.-source dividends under *IRC Section 877(l)* are the gross amounts used in computing any net amounts transferred to or from the foreign taxpayer.ⁿ²⁴ An example given by the Joint Committee on Taxation illustrates this rule. Under a typical total return swap referencing stock of a domestic corporation (an example of a notional principal contract to which *IRC § 877(l)* applies), a foreign investor enters into an agreement with a counterparty under which amounts due to each party are based on the returns generated by a notional investment in a specified dollar amount of the domestic corporation's stock. The investor agrees for a specified period to pay to the counterparty (1) an amount calculated by reference to a market interest rate (such as the London Interbank Offered Rate (LIBOR)) on the notional amount of the domestic corporation's stock and (2) any depreciation in the value of the stock. In return, the counterparty agrees for the specified period to pay the investor (1) any dividends paid on the stock and (2) any appreciation in the value of the stock. Amounts owed by each party under this swap typically are netted so that only one party makes an actual payment. *IRC Section 877(l)* treats any dividend-based amount under the swap as a payment even though any actual payment under the swap is a net amount determined in part by other amounts (for example, the interest amount and the amount of any appreciation or depreciation in value of the referenced stock). Accordingly, a counterparty to a total return swap may be obligated to withhold and remit tax on the gross amount of a dividend equivalent even though, as a result of a netting of payments due under the swap, the counterparty is not required to make an actual payment to the foreign investor.ⁿ²⁵

The antecedent of *IRC Section 871(l)* is the "transparency rule" promulgated by the Treasury in a set of final regulations issued in 1997.ⁿ²⁶ The 1997 regulations cover the same transactions now governed by *IRC Section 871(l)(2)(A)*; so-called "substitute dividends" paid in connection with "securities lending transactions" (a transfer of one or more securities that is described in *IRC Section 1058(a)* or a substantially similar transactionⁿ²⁷) and "sale-repurchase transactions" (an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive substantially identical securities from the transferee in the future in exchange for cash).ⁿ²⁸ Under the transparency rule, "a substitute dividend payment [paid under such agreements] shall be sourced in the same manner as the distributions with respect to the transferred security. ..."n29

The peculiar thing about the 1997 regulations, and *IRC § 877(l)*, is that, as the Treasury conceded when the 1997 regulations were promulgated, the transparency rule treats substitute payments differently for sourcing purposes than they are treated for other purposes under the Internal Revenue Code.ⁿ³⁰ The general rule with respect to such payments is stated in *Prop Treas Reg Section 1.1058-1(d)*:

"...[A] payment of amounts required to be paid by the borrower that are equivalent to all interest, dividends, and other distributions...shall be treated by the lender as a fee for the temporary use of property. Thus, for example, an amount received by the lender that is equivalent to a dividend paid during the term of the loan shall not constitute a dividend to the lender for purposes of the Internal Revenue Code, but shall be taken into account as ordinary income."

Consistent with this general rule, the IRS has held that substitute dividends are not dividends for purposes of the dividends received deduction under *IRC Section 243*,ⁿ³¹ and that substitute interest cannot be tax-exempt interest under *IRC Section 103* even though the underlying security is a tax-exempt bond.ⁿ³² Nor is the transparency or "look through" rule always applied consistently even in transactions to which it is otherwise applicable. For example, if the issue is whether a substitute interest payment to a foreign taxpayer is US or foreign source income, the focus is on the underlying security (transparency rule applies), but the underlying security is disregarded if the issue is whether the substitute payment is "effectively connected" with a US trade or business of the foreign taxpayer (transparency rule does not apply).ⁿ³³ Indeed, the term transparency rule is itself a misnomer, since under the regulations (as well as under *IRC Section 871(l)*) a substitute payment will be treated as derived from a dividend on the underlying security even

though that underlying security may no longer be owned by the borrower that is supposedly a mere conduit for dividends to the lender.ⁿ³⁴

It would appear that the justification for departing from the general rule for determining the character of substitute payments when it comes to the sourcing rules for passive income received by foreign taxpayers is that, as a practical matter, application of the general rule in such cases would make the US withholding tax on interest and dividends a dead letter.ⁿ³⁵ In the absence of a "transparency rule," foreign taxpayers holding US stocks could easily avoid the US withholding tax on their dividends by entering into securities lending or similar agreements with their US brokers, thereby transforming their taxable US-source dividends into nontaxable substitute payments that are exempt as US-source "portfolio interest."ⁿ³⁶

However, a troubling possible consequence of unhitching the sourcing rules from the reality of securities lending transactions is that the borrower might re-transfer the underlying securities to a foreign party, which might transfer them to second foreign party, and so on, so that multiple substitute payments based on the same dividend could become subject to withholding tax under the transparency rule, and the total tax collected could exceed the 30 percent rate imposed by the Internal Revenue Code.ⁿ³⁷ The IRS sought to address this potential problem in *Notice 97-66*,ⁿ³⁸ issued shortly after publication of the 1997 final regulations, which provided relief in the following terms:

"[T]he amount of U.S. withholding tax to be imposed ... with respect to a foreign-to-foreign payment will be the amount of the underlying dividend multiplied by a rate equal to the excess of the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the recipient of the substitute payment over the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the payor of the substitute payment. This amount may be reduced or eliminated to the extent that the total U.S. tax actually withheld on the underlying dividend and any previous substitute payments is greater than the amount of U.S. withholding tax that would be imposed on U.S. source dividends paid by a U.S. person directly to the payor of the substitute payment."

However, *Notice 97-66* spawned transactions in which, relying on the literal terms of *Notice 97-66*, taxpayers took the position that a foreign payor of substitute dividends to a payee which was subject to the same withholding tax rate on US source dividends as the payor could calculate the rate on the foreign-to-foreign payment as zero even though no withholding tax had ever actually been paid with respect to the dividend on the underlying US security.ⁿ³⁹

Notice 97-66 was withdrawn by the IRS in *Notice 2010-46*ⁿ⁴⁰ in light of what the IRS regarded as the misinterpretation of *Notice 97-66* and the enactment of *IRC Section 877(l)*. Section 877(l)(6) expressly authorizes the Treasury to reduce the amount of tax imposed under *IRC Sections 871* or *881* "in the case of any chain of dividend equivalents" that is subject to tax under those sections "but only to the extent that the taxpayer can establish that such tax has been paid with respect to another dividend equivalent in such chain, or is not otherwise due, or as the ... [Treasury] determines is appropriate to address the role of financial intermediaries in such chain."ⁿ⁴¹

Treasury and the IRS announced in *Notice 2010-46*, Section II, their intention to issue regulations, with an effective date of January 1, 2012, exercising the authority granted by *IRC Section 871(l)(6)*. Consistent with the provisions of the new statute, the regulations will replace the formulary approach previously adopted by *Notice 97-66* with a documentation-based system, outlined in part II of *Notice 2010-46*. Under the new system, withholding agents will be able to reduce withholding to the extent that withholding is shown to have been made on another substitute payment or dividend with respect to identical securities. Further, a withholding agent making a substitute dividend payment to a financial institution which is certified as a "Qualified Securities Lender" will not be required to withhold U.S. tax with respect to such payment provided the Qualified Securities Lender is obliged to make an offsetting substitute dividend payment with respect to identical securities and withholds and pays over to the IRS US withholding tax on such offsetting payment.ⁿ⁴²

In addition to the rules applicable until September 14, 2010 (*Notice 97-66* as modified by *Notice 2010-46*), and the regulations expected to be applicable on and after January 1, 2012, *Notice 2010-46* announced a third set of rules for avoiding multiple tax on dividend substitute payments in a chain of securities lending transactions, which will be applicable during the "transition period" between September 14, 2010 and January 1, 2012. Under the "transition period" rules, the maximum aggregate U.S. gross-basis tax due, if any, with respect to a series of Securities Lending Transactions and any related dividend payment will be the amount determined by the tax rate paid by the foreign taxpayer (other than in the case of a Qualified Securities Lender that is obligated to make an offsetting substitute dividend paymentⁿ⁴³) bearing the highest rate of U.S. gross-basis tax in the series. A withholding agent that is obligated to make a substitute dividend payment pursuant to a Securities Lending Transaction during the transition period may presume that US tax has been paid in an amount equal to the amount implied by the net payment if all of the following requirements are satisfied: (1) the withholding agent receives a substitute dividend or dividend payment with respect to identical securities that reflects a reduction for withholding of U.S. gross-basis tax; (2) the withholding agent does not know or have reason to know that tax was not withheld and deposited or paidⁿ⁴⁴; and (3) the withholding agent is a person subject to audit under *IRC § 7602*, or in the case of a Qualified Intermediaryⁿ⁴⁵, by an external auditor.

[iv] Gains and Losses From the Sale of Securities. Gains derived from the sale of investment securities by a nonresident alien or foreign corporation are foreign source income no matter where the sale takes place, unless the nonresident has an office or fixed place of business in the United States and gain from the sale is attributable to the office.ⁿ⁴⁶ However, if the securities are held by a dealer other than for investment, the applicable source rule depends on the place of purchase and sale.ⁿ⁴⁷ If the purchase of the "inventory" securities takes place outside the United States or its possessions and the sale occurs within the United States, the gains are United States source income.ⁿ⁴⁸ If the purchase occurs within the United States and the sale without, the income is from foreign sources.ⁿ⁴⁹ In other words, the gain is treated as derived entirely from the country in which the property is sold, i.e., the country in which the right, title, and interest of the seller pass to the buyer.ⁿ⁵⁰

IRC Section 306(f) sets forth a special rule for determining the source of gain from the sale of Section 306 stock.ⁿ⁵¹ To the extent that such gain is considered gain from the sale of a noncapital asset and, thus, as ordinary income, it "shall ... be treated as derived from the same source as would have been the source if money had been received from the corporation as a dividend at the time of the distribution of such stock."

Generally, loss recognized with respect to stock is allocated to, or apportioned between, United States source and foreign source income.ⁿ⁵² This can lead to different classifications for gains and losses. For example, any gain produced by a sale of stock is determined according to the residence of the taxpayer. Thus, if a nonresident sells stock in a United States corporation from which the nonresident has received dividends, and the sale produces a gain, the gain is foreign source income. However, if the sale produces a loss, the loss will be a deduction against United States source income.

[b] Imposition of the Tax on United States Source Income. *IRC Sections 871(a)(1)* and *881(a)* assess a tax of 30 percent on the interest, dividends, and other fixed or determinable annual or periodical gains, profits, and income not effectively connected with the conduct of a trade or business within the United States which are received by nonresident alien individuals and foreign corporations during the taxable year.ⁿ⁵³ However, *IRC Section 871(i)* precludes the imposition of any tax on (1) interest on deposits, if the interest is not effectively connected with the conduct of a trade or business in the United States; (2) a percentage of any dividend paid by a domestic corporation that meets the 80-percent foreign business requirement;ⁿ⁵⁴ (3) income derived by a foreign central bank of issue from bankers' acceptances; and (4) dividends paid by a foreign corporation that is treated under *IRC Section 861(a)(2)(B)* as income from sources within the United States.

Under *IRC Section 7701(b)*, a nonresident alien is an individual who is not (1) a citizen of the United States or a person

granted lawful permanent resident status; (2) has not had a substantial presence in the United States during the taxable year; and (3) has not made the first-year election.ⁿ⁵⁵ The substantial presence test is met if the person is present in the United States for 31 days during the calendar year in question and the sum of the number of days present in the United States during the current calendar year, plus one third of the days present in the preceding calendar year and one sixth of the days present in the second preceding year equals or exceeds 183 days. Exceptions are made for an individual present in the United States for less than 183 days in the current year if it is established that the person has a tax home in a foreign country and has a closer connection to the foreign country than to the United States. Foreign government-related individuals (e.g., diplomats or full-time employees of international organizations), teachers or trainees, students, and professional athletes who are temporarily in the United States to compete in certain charitable sports events are exempt from the substantial presence test. A teacher or trainee loses that exemption if it is applied for any two calendar years during the preceding six calendar years. The substantial presence test must be met for any year after the fifth year for which the person was exempt either as a teacher or trainee, or as a student, unless it is established that there is no intention to permanently reside in the United States and has substantially complied with the requirements for a student visa.

Under *IRC Section 269B*, a foreign corporation will be treated as a domestic corporation and will be taxed on its worldwide income if it and a domestic corporation are stapled entities, that is, if more than 50 percent in value of the beneficial ownership in each of the entities are stapled interests. Two or more interests are stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms and conditions, in connection with the transfer of one of such interests the other interests must also be transferred. The rule does not apply if it is established to the satisfaction of the Service that the domestic corporation and foreign corporation are foreign owned (less than 50 percent of the combined voting power of all classes of stock entitled to vote and of the total value of the stock is held, directly or indirectly, by United States persons).ⁿ⁵⁶

Foreign investors treat original issue discount (OID) somewhat differently from their domestic counterparts. OID on obligations issued before April 1, 1972, is not taxed until sale, exchange, or surrender at maturity.ⁿ⁵⁷ A foreign taxpayer acquiring an OID obligationⁿ⁵⁸ issued after March 31, 1972, treats OID in two ways. When a foreign taxpayer receives payment on an OID obligation, an amount equal to the OID accruing while the obligation was held by the nonresident alien will generally be subject to tax. However, the amount of OID is taken into account only to the extent that the tax thereon does not exceed the payment less the tax imposed on that payment.ⁿ⁵⁹ On the sale or exchange of an OID obligation, any gain not in excess of the OID accruing while the obligation was held by the foreign investor will be subject to tax to the extent not previously taken into account on a payment.ⁿ⁶⁰ The provisions of *IRC Section 1286*, relating to the treatment of stripped bonds and stripped coupons as obligations with OID, apply for purposes of determining the amount of tax due under *IRC Section 871(a)*.ⁿ⁶¹

As a general rule, the payor of periodic income to a nonresident alien or foreign corporation is required to withhold 30 percent of the amount of the payment.ⁿ⁶² However, the Code does not require the imposition of the 30-percent withholding tax on portfolio interest received by a nonresident individual or a foreign corporation from sources within the United States.ⁿ⁶³ Portfolio interest is defined as interest paid on any obligation in registered form,ⁿ⁶⁴ provided the obligor receives a statement that the beneficial owner of the obligation is not a U.S. person.ⁿ⁶⁵ Interest received by a nonresident individual is not portfolio interest if the recipient is a 10-percent shareholder--a person who owns 10 percent or more of the total combined voting power of all classes of stock of the corporation issuing the obligation, or, if the obligation is issued by a partnership, a person who owns 10 percent or more of the capital or profits interest in the partnership.ⁿ⁶⁶ For a foreign corporation, interest that would be treated as portfolio interest is not if it is received by (1) a bank on an extension of credit made in the ordinary course of business and is not interest on an obligation of the United States; (2) a 10-percent shareholder; or (3) a controlled foreign corporation from a related person.ⁿ⁶⁷

IRC Section 871(h)(4)(A) excludes from the category of portfolio interest:

(a) any amount of interest that is determined by reference to

- (i) any receipts, sales, or other cash flow of the debtor or a related person,
 - (ii) any income or profits of the debtor or a related person,
 - (iii) any change in value of any property of the debtor or a related person, or
 - (iv) any dividend, partnership distributions, or similar payments made by the debtor or a related person, and
- (b) any other type of contingent interest that is identified in regulations, where a denial of the portfolio interest exemption is necessary to prevent avoidance of federal income tax.ⁿ⁶⁸

This rule does not apply to:

- (1) any amount of interest solely by reason of the fact that the timing of any interest or principal is subject to a contingency,
- (2) any amount of interest solely by reason of the fact that the interest is paid with respect to nonrecourse or limited recourse indebtedness,
- (3) any amount of interest all or substantially all of which is determined by reference to any other interest not described in the preceding sentence (or by reference to the principal amount of indebtedness on which such other interest is paid),
- (4) any amount of interest solely by reason of the fact that the debtor or a related person enters into a hedging transaction to manage the risk of interest rate or currency fluctuations with respect to the interest,
- (5) any amount of interest determined by reference to (a) changes in the value of, or index of the value of, property (including stock that is actively traded within the meaning of *IRC Section 1092(d)*) other than a U.S. real property interest, or (b) the yield on, or index of the yield on, such property, other than a debt instrument that pays contingent interest, or stock or other property that represents a beneficial interest in the debtor or a related person, and
- (6) any other type of interest identified in regulations.ⁿ⁶⁹

IRC Section 871(h)(4)(A) also does not apply to any indebtedness with a fixed term that was issued on or before April 7, 1993, or issued after that date pursuant to a written binding contract in effect on that date and at all times thereafter until the indebtedness was issued.ⁿ⁷⁰

IRC Sections 871(a)(1) and *881* generally do not apply to any interest-related dividend received from a regulated investment company.ⁿ⁷¹ Excepted from this rule is (a) any interest-related dividend received from a regulated investment company by a person to the extent the dividend is attributable to interest (other than original issue discount on an obligation payable 183 days or less from the date of original issue or interest on deposits not effectively connected with a United States trade or business) received by the company on indebtedness issued by that person or by any corporation or partnership in which the person is a 10-percent shareholder (as defined in *IRC Section 871(h)(3)*, discussed above); (b) any interest-related dividend with respect to stock of a regulated investment company unless the

person who would otherwise be required to deduct and withhold tax from the dividend receives a statement that the beneficial owner of the stock is not a United States person; and (c) any interest-related dividend paid to any person within a foreign country (or any interest-related dividend payment addressed to, or for the account of, persons within that foreign country) during any period of time that the Service determines that the exchange of information between the United States and that country is inadequate to prevent the evasion of federal income taxes by United States persons, unless the stock was acquired on or before the date of the determination.ⁿ⁷²

An interest-related dividend is any dividend (or part thereof) that is designated by the regulated investment company as an interest-related dividend in a written notice mailed to its shareholders not later than 60 days after the close of the taxable year.ⁿ⁷³ If the aggregate amount so designated for any taxable year (including amounts designated with respect to dividends paid after the close of the taxable year according to *IRC Section 855*) is greater than the qualified net interest income (qualified interest income less deductions properly attributable thereto) of the company for the taxable year, the portion of each distribution that will be an interest-related dividend is only that portion of the designated amount that the qualified net interest income bears to the aggregate amount so designated.ⁿ⁷⁴ Qualified interest income equals the sum of the following amounts derived by the regulated investment company from sources within the United States:

- (i) any amount includable in gross income as original issue discount on an obligation payable 183 days or less from the date of original issue (without regard to the period held by the company);
- (ii) any interest includable in gross income (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount and such other amounts as regulations may provide) on an obligation in registered form, but not (a) any interest on an obligation issued by a corporation or partnership if the regulated investment company is a 10-percent shareholder thereof, or (b) any contingent interest that is treated as not being portfolio interest under *IRC Section 871(h)(4)*;
- (iii) any interest on deposits, if the interest is not effectively connected with the conduct a trade or business in the United States (without regard to the business of the regulated investment company); and
- (iv) any interest-related dividend includable in gross income with respect to stock of another regulated investment company.ⁿ⁷⁵

A nonresident alien shareholder of a regulated investment company is not subject to tax on any short-term capital gain dividend received from a regulated investment company, unless the shareholder is otherwise taxable on capital gains.ⁿ⁷⁶ A short-term capital gain dividend is any dividend (or part thereof) that is designated by the regulated investment company as a short-term capital dividend in a written notice mailed to its shareholders not later than 60 days after the close of the taxable year.ⁿ⁷⁷ If the aggregate amount so designated for any taxable year (including amounts designated with respect to dividends paid after the close of the taxable year according to *IRC Section 855*) is greater than the qualified short-term capital gain of the company for the taxable year, the portion of each distribution that will be a short-term capital gain dividend is only that portion of the designated amount that the qualified short-term capital gain bears to the aggregate amount so designated.ⁿ⁷⁸ For this purpose, qualified short-term capital gain is the excess of the net short-term capital gain of the regulated investment company for the taxable year over its net long-term capital loss (if any) for the year.ⁿ⁷⁹ The net short-term capital gain of the regulated investment company is computed by taking into account any short-term capital gain dividend received from another regulated investment company, while the excess of net short-term capital gain over net long-term capital loss is determined without regard to any net capital loss or net short-term capital loss attributable to transactions after October 31 of the taxable year; those losses are treated as arising on January 1 of the next taxable year.ⁿ⁸⁰

IRC Section 892(a) exempts from taxation any income received by a foreign government received from investments in the United States in (1) stocks, bonds, or other domestic securities, (2) financial instruments held in the execution of

governmental financial or monetary policy, or (3) interest on deposits in U.S. banks, except when the income is derived from the conduct of a commercial activity, received from or by a controlled commercial entity, or derived from the disposition of any interest in a controlled commercial entity.ⁿ⁸¹ *IRC Section 892(b)* provides a similar rule for investment income of international organizations.

Gains realized on lump-sum distributions from qualified employees' trusts are subject to tax.ⁿ⁸² On the other hand, gains from the sale of securities are not considered to be fixed or determinable income. Under *IRC Section 871(a)(2)*, a nonresident alien is taxed on net capital gains from U.S. sources (the excess of capital gains from sources within the United States over capital losses from such sources) only if present in the United States for 183 days or more during the taxable year;ⁿ⁸³ the rate imposed is, again, 30 percent. A foreign corporation not engaged in business in the United States is never present in the United States and, therefore, is never taxed on its capital gains from U.S. sources.ⁿ⁸⁴

Capital losses are taken into account in computing net capital gains only if actually incurred during the taxable year; capital loss carryovers are not available to a nonresident alien. However, if, by some chance, the gain is taxed under *IRC Section 871(a)(1)* as an item of fixed or determinable income, it is not subject to tax a second time under *IRC Section 871(a)(2)*.

[2] Income Effectively Connected With a U.S. Trade or Business

[a] The Effectively Connected Income Concept

[i] The Function of the Concept. Prior to the enactment of the Foreign Investors Tax Act in 1966, the conduct of a trade or business in the United States by a foreign taxpayer triggered "force of attraction" rules which caused income from U.S. sources--passive investment income and business income alike--to be taxed by the United States at regular rates. Present law taxes income at such rates only if effectively connected with the conduct of a trade or business in the United States;ⁿ¹ investment income is taxed separately. Thus, one function of the effectively connected income concept is to distinguish between United States source investment income, taxed at the flat rate provided by *IRC Sections 871(a)(1)* and *881(a)*, and United States source business income, taxed under the progressive rates imposed on individuals by *IRC Section 1*, *Section 55*, or *Section 402(e)(1)*, or under the corporate rates of *IRC Section 11*. But the effectively connected concept plays another role; it determines whether certain classes of foreign source income will be taxed by the United States.

[ii] Effectively Connected Income From United States Sources. The Code is almost silent when it comes to defining the effectively connected concept. However, it does set forth two principal factors to be taken into account in determining if periodic income from sources within the United States, or capital gain or loss from United States sources, is effectively connected with the conduct of a trade or business within the United States, namely, whether:

"(A) the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business, or (B) the activities of such trade or business were a material factor in the realization of the income, gain, or loss."ⁿ²

The statute goes on to say that in making this determination "due regard shall be given to whether or not [the] asset or [the] income, gain, or loss was accounted for through [the] trade or business." This may be taken as an indication that a person will be hard pressed to deny that income is effectively connected with the conduct of a trade or business if, on the business's books, the income is treated as business income.

A simple example will serve to illustrate these principles:

Example:

F Corp., a foreign corporation engaged in manufacturing operations in the United States, purchases stock in a domestic corporation in order to insure a constant source of supply of raw materials for its

operations. Dividends paid on, and gain realized from the sale of, such stock will be considered income effectively connected with the conduct of a trade or business in the United States. So would income or gain from a temporary investment of working capital, but not income or gain from securities purchased with funds not needed in the conduct of the business in the United States.ⁿ³

The content of effectively connected income is more easily determined when the income does not consist of the fixed or determinable type specified in *IRC Sections 871(a)(1)* and *881(a)*, or capital gain. By use of a "force of attraction" rule all such other income from United States sources, eg, gain from the sale of a noncapital asset in the United States, is treated as effectively connected with the conduct of the taxpayer's trade or business within the United States.ⁿ⁴

Under *IRC Section 864(c)(6)*, the determination of whether income or gain of a nonresident alien or foreign corporation taken into account in one year but attributable to a transaction in another tax year is effectively connected with a United States trade or business is made by looking to the year of the transaction, without regard to the requirement that the taxpayer be engaged in a trade or business during the year the income is taken into account. Under *IRC Section 864(c)(7)*, the determination of whether any income or gain attributable to a sale or exchange of property within 10 years after the property ceases to be used in connection with the conduct of a United States trade or business is effectively connected income is made as if the sale or exchange occurred immediately before the cessation, without regard to the requirement that the taxpayer be engaged in a United States trade or business during the taxable year in which the income is taken into account.

IRC Section 897 treats gain realized by a foreign taxpayer from the disposition of a United States real property interest as gain effectively connected with a trade or business conducted by the taxpayer within the United States.ⁿ⁵ The term "United States real property interest" is broadly defined and includes not only direct interests in real property located in the United States or the Virgin Islands, but also "any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes [in accordance with regulations to be prescribed] that such corporation was at no time a United States real property holding corporation during the shorter of [the period after June 18, 1981, during which the taxpayer held the interest or the five-year period ending on the date of disposition]."ⁿ⁶

A corporation is a United States real property holding corporation if the fair market value of its United States real property interests amount to 50 percent or more of the total value of (1) its United States real property interests, (2) its real property located outside the United States, and (3) all its other trade or business assets.ⁿ⁷ The process of determining real property holding corporation status is more complex than the simple definition would have it appear, because:

- (1) any interest in a domestic or foreign real property holding corporation must be treated as a United States real property interest;ⁿ⁸
- (2) United States real property interests held by a partnership, trust or estate are deemed to be owned proportionately by its partners or beneficiaries;ⁿ⁹
- (3) a corporation that owns 50 percent or more of the fair market value of all classes of stock of a second corporation is treated as owning that portion of each of the second corporation's assets that corresponds to the percentage of the controlling corporation's stock ownership.ⁿ¹⁰

Three exclusionary rules soften the impact of the Act. First, an interest in a domestic corporation is not a United States real property interest if, on the date of disposition, the corporation has no United States real property interests and those that it had during the specified period were disposed of in transactions in which the full amount of the corporation's gain was recognized.ⁿ¹¹ Second, stock regularly traded on an established securities market is an exempt interest, unless at some time during the designated period, the shareholder owned more than 5 percent of that class of stock.ⁿ¹² Third, interests in a real estate investment trust are excluded from the scope of the Act if, at all times during the specified

period, the REIT was domestically controlled (less than 50 percent in value of its stock was owned directly or indirectly by foreign persons).ⁿ¹³

IRC Section 897 contains a number of other far-reaching rules:

(1) Gain will be recognized by a foreign corporation on the distribution of appreciated United States real property interests.ⁿ¹⁴

(2) Other provisions which normally prescribe nonrecognition treatment will apply to an exchange of a United States real property interest only when it is exchanged for an interest "the sale of which would be subject to taxation. ..." ⁿ¹⁵ In addition, regulations can further limit the scope of nonrecognition to prevent tax avoidance.ⁿ¹⁶

(3) The amount of money and property received by a foreign person in exchange for all or part of the person's interest in a partnership, trust, or estate is, to the extent attributable to United States real property interests, considered as an amount received from the sale or exchange in the United States of such property.ⁿ¹⁷

(4) Any distribution by a qualified investment entity (a real estate investment trust or regulated investment company that is a United States real property holding corporation or that would be if the exceptions provided in *IRC Sections 897(c)(3)* and *897(h)(2)* did not apply to interests in any real estate investment trust or regulated investment company) to a nonresident alien individual, a foreign corporation, or other qualified investment entity is, to the extent attributable to gain from sales or exchanges by the entity of United States real property interests, treated as gain recognized by the foreign taxpayer or other qualified investment entity from the sale or exchange of such an interest.ⁿ¹⁸ In addition, any distribution of an appreciated United States real property interest by a domestically controlled qualified investment entity will produce gain for the entity to the extent of the entity's foreign ownership percentage.ⁿ¹⁹

(5) Gain will be recognized by a nonresident alien individual or foreign corporation on the transfer of a United States real property interest to a foreign corporation, if the transfer is made as paid-in surplus or as a contribution to capital, to the extent of the excess of the fair market value of the property transferred over the adjusted basis and any other gain recognized to the transfer at the time of the transfer.ⁿ²⁰ If an interest in a domestically controlled qualified investment entity is disposed of in an applicable wash sale transaction, the taxpayer is treated as having gain from the sale or exchange of a United States real property interest that, but for the disposition, would have been treated as gain from the sale or exchange of a United States real property interest under *IRC Section 897(h)(1)*.^{n20.1} An applicable wash sales transaction is a transaction (or series of transactions) under which a nonresident alien individual, foreign corporation or qualified investment entity (i) disposes of an interest in a domestically controlled qualified investment entity during the 30-day period preceding the ex-dividend date of a distribution that is to be made with respect to the interest and any portion of which, but for the disposition, would have been treated as gain from the sale or exchange of a United States real property interest under *IRC § 897(h)(1)*, and (ii) acquires, or enters into a contract or option to acquire, a substantially identical interest in the entity beginning with the first day of the 30-day period.^{n20.2} A transaction is not treated as an applicable wash sale transaction if the foreign taxpayer or qualified investment entity receives the distribution with respect to either the interest that was disposed of, or acquired in the transaction.^{n20.3} In addition, a transaction is not treated as an applicable wash sale transaction if it involves the disposition of any class of stock in a qualified investment entity that is regularly traded on an established securities market within the United States, but only if the nonresident alien individual, foreign corporation, or qualified investment entity did not own more than 5 percent of the class of stock at any time during the one-year

period ending on the date of distribution.^{n20.4}

Certain foreign corporations can avoid some of the burden imposed upon such corporations by *IRC Section 897* by electing to be treated as domestic corporations. A corporation is eligible to make the election only if it holds a United States real property interest, and, under any treaty obligation of the United States, is entitled to nondiscriminatory treatment with respect to that interest.ⁿ²¹ The election can be made only if all shareholders of the corporation at the time of the election consent to it and agree that any gain from the disposition of the interest, that would be taken into account under *IRC Section 897*, will be taxable notwithstanding any treaty provision to the contrary.ⁿ²² Once made, the election can be revoked only with the consent of the Secretary.ⁿ²³

The Code sets forth a system for the withholding of tax on dispositions of United States real property interests.ⁿ²⁴ Under the provision, the transferee is required to deduct and withhold 10 percent of the amount realized on the disposition or, if less, the transferor's maximum tax liability (the maximum amount of tax that could be imposed on the gain realized plus the amount of the transferor's unsatisfied withholding liability with respect to that interest). Exemptions are provided if: (1) the transferor furnishes a nonforeign affidavit, that is, an affidavit stating that he is not a foreign person; (2) the transferor is a nonpublicly traded domestic corporation and furnishes an affidavit that it is not a United States real property holding corporation; (3) the transferor receives a qualifying statement from the Service that he has reached an agreement for the payment of the tax, is exempt from tax, or has provided adequate security for the payment of the tax; (4) the transferee will use the property as a residence and the amount realized for the property does not exceed \$300,000; or (5) the property is stock regularly traded on an established securities market.ⁿ²⁵ No withholding is required on the grant or lapse of an option to acquire a United States real property interest, but is upon the sale, exchange, or exercise of the option.ⁿ²⁶ If the United States real property interest is owned by foreign and nonforeign persons, the amount subject to withholding is determined by allocating the amount realized on the transfer in proportion to the relative capital contribution to the property of each transferor.ⁿ²⁷

Withholding at the 10 percent rate is required, as well, in the following circumstances: (1) a domestic corporation makes a distribution to a foreign shareholder in redemption of stock or in liquidation of the corporation; (2) a domestic or foreign partnership, trust, or estate makes a taxable distribution to its partners or beneficiaries; or (3) the transfer consists of a partnership interest or of a beneficial interest in an estate or trust.ⁿ²⁸ If a domestic partnership, the trustee of a domestic trust, or the executor of a domestic estate disposes of a United States real property interest and the amount of the gain is includable in the income of a foreign partner or beneficiary, the withholding rate is 35 percent. A foreign corporation must also withhold 35 percent of the amount of gain recognized on a distribution governed by *IRC Section 897(d)* or *(e)*.

Under *IRC Section 6039C*, each foreign person who did not engage in a trade or business within the United States at any time during the calendar year, and who holds directly real property interests with a value of at least \$50,000, must file an annual return setting forth his name and address, a description of the property, and such other information as regulations will require. United States property interests held by a partnership, trust, or estate is treated as owned by its partners or beneficiaries. Interests held by a spouse or minor child of an individual is treated as owned by the individual.

[iii] Effectively Connected Income From Foreign Sources. Income, gain, or loss from sources outside of the United States will be treated as effectively connected with the conduct of a trade or business within the United States only when (1) the foreign taxpayer has an office or other fixed place of business in the United States to which the foreign source income, gain, or loss is attributable, and (2) such income, gain, or loss (a) consists of rents and royalties from intangible property, (b) is derived from the sale of certain inventory, (c) "consists of dividends or interest, or gain or loss from the sale or exchange of stock or notes, bonds, or other evidences of indebtedness, and either is derived in the active conduct of a banking, financing, or similar business within the United States or is received by a corporation the principal business of which is trading in stocks or securities for its own account," or (d) is an item of income or gain equivalent to any of the foregoing.ⁿ²⁹ But even such dividends and interest will not be effectively connected income if paid by a foreign corporation in which the taxpayer directly, indirectly, or constructively owns more than 50 percent of

the combined voting power of all classes of stock entitled to vote.ⁿ³⁰ Moreover, the legislative history indicates that dividends, interest, and gains from stocks or securities held for investment purposes only will not be included within the category of foreign source income which can be treated as effectively connected income, and that a corporation will not be treated as being principally in the business of trading in stock or securities because of incidental investments held by it.ⁿ³¹ Thus, a foreign corporation whose principal activity is holding stock or securities of corporations in which it owns a significant portion of the outstanding voting stock will generally not be considered to have as its principal business trading in stocks or securities.ⁿ³²

Special rules of application limit the foreign source income subject to United States taxation to income which has its economic genesis in the United States.ⁿ³³ An office or other fixed place of business of an agent is disregarded in determining whether a foreign taxpayer has an office or fixed place of business in the United States, unless the agent (1) has authority to negotiate binding contracts in the name of the nonresident alien or foreign corporation, or has a stock of merchandise from which he regularly fills orders on behalf of such foreign person, and (2) is not an independent agent acting in the ordinary course of his business.ⁿ³⁴ A second special rule does not consider income, gain, or loss as attributable to an office or other fixed place of business within the United States unless such office is a material factor in the production of such income, the office regularly carries on activities of the type from which the income is derived, and the income is properly allocable to the activities of the United States business.ⁿ³⁵ Put another way, the income must be generated in the United States, the activities of the United States office must be an essential element in the production of the income (although it need not necessarily be a major factor in the production of the income), and the income must not be derived from casual sales.ⁿ³⁶

[b] Exclusion of Certain Trading in Securities From the Classification of "Trade or Business Within the United States." Long before the Foreign Investors Tax Act, the rule had been that a foreign taxpayer was not engaged in a trade or business within the United States if the taxpayer effected transactions in stocks or securities through a resident broker, commission agent, or custodian.ⁿ³⁷ On the other hand, the foreign taxpayer was considered to be so engaged if the transactions were effected by the taxpayer while present in the United States,ⁿ³⁸ or by a resident agent who exercised discretionary authority with respect to the trading.ⁿ³⁹

IRC Section 864(b)(2)(A)(i) continues the exclusion for trading in stocks or securities through a resident broker, commission agent, custodian, or other independent agent, but only if the taxpayer does not maintain an office in the United States through which, or at the direction of which, the transactions in stock or securities are effected.ⁿ⁴⁰ Thus, a foreign dealer having no office in the United States during the taxable year can transact an unlimited number of securities transactions through independent agents without having the activities classified as a trade or business in the United States.

In addition, *IRC Section 864(b)(2)(A)(ii)* states that the term "trade or business within the United States" does not include "trading in stocks or securities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions." This exception does not apply to a dealer in securities.ⁿ⁴¹

The failure of a dealer to fit within the exception provided by *IRC Section 864(b)(2)(A)(ii)* does not lead automatically to a finding that the taxpayer is engaged in a trade or business. Whether a dealer is conducting a trade or business in the United States remains a question of fact.ⁿ⁴² Thus, while Section 864(b)(2)(A) can relieve a person from trade or business status, it cannot by itself thrust him into that status.

IRC Section 864(b)(2)(B) provides a similar safe harbor for trading in commodities "if the commodities are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind normally consummated at such place." The safe harbor does not apply in the case of a dealer in commodities.

[c] Imposition of the Tax on Effectively Connected Income. As we have seen, income effectively connected with the conduct of a trade or business in the United States by a nonresident alien or foreign corporation is taxed at the rates imposed upon the taxable income of domestic taxpayers.ⁿ⁴³ In general, the computation of the amount subject to tax is made by allowing the taxpayer to claim deductions only to the extent that they are allocable to the effectively connected income.ⁿ⁴⁴ However, the following deductions are allowed in full, whether or not they are connected with such income:

- (1) casualty or theft losses of nonresident alien individuals suffered with respect to property located in the United States, but not connected with a trade or business;ⁿ⁴⁵
- (2) the charitable deduction allowed by *IRC Section 170*;ⁿ⁴⁶ and
- (3) the personal exemption allowed individuals by *IRC Section 151*, although a nonresident alien individual who is not a resident of Canada or Mexico is allowed only one such exemption.ⁿ⁴⁷

A foreign taxpayer is allowed a credit for taxes paid or deemed paid to foreign countries and possessions of the United States on or with respect to income which is effectively connected with the conduct of a trade or business within the United States, except to the extent that the foreign tax is imposed on income from U.S. sources solely because the nonresident alien individual taxpayer is a citizen or resident of the foreign country or U.S. possession imposing the tax, or because the foreign corporation taxpayer is organized or created under its laws or domiciled there for tax purposes.ⁿ⁴⁸ The credit is allowed only against the tax on effectively connected income; no credit is allowed against the flat 30-percent tax imposed on passive investment income by *IRC Sections 871(a)* and *881(a)*.ⁿ⁴⁹

The determination of the amount of taxes deemed by *IRC Section 902* to have been paid by a foreign corporation receiving effectively connected dividends from a foreign subsidiary is made by treating the corporation as a domestic corporation.ⁿ⁵⁰ The computation of the credit limitation of *IRC Section 904* is made by considering the effectively connected income as the taxpayer's only taxable income.ⁿ⁵¹

IRC Section 884 imposes an additional 30-percent branch profits tax on a foreign corporation's effectively connected earnings and profits for the taxable year,ⁿ⁵² decreased (but not below zero) by the amount of any increase in the corporation's U.S. net equity for the year, and increased by any decrease in the corporation's U.S. net equity for the year.ⁿ⁵³ However, the increase for any taxable year cannot exceed the corporation's accumulated effectively connected earnings and profits (the excess of the aggregate effectively connected earnings and profits for preceding taxable years beginning after December 31, 1986, over the aggregate dividend equivalent amounts for those years) as of the close of the preceding taxable year.ⁿ⁵⁴ The corporation's U.S. net equity is the amount of the money and aggregate adjusted basis of property treated as connected with the conduct of a trade or business in the United States, reduced (even below zero) by the liabilities of the corporation that are treated as connected with the conduct of the U.S. trade or business.ⁿ⁵⁵

An income tax treaty between the United States and a foreign country can modify or eliminate the branch profits tax only if the foreign corporation is a "qualified resident" of the foreign country, or the treaty permits a withholding tax on dividends paid by the foreign corporation.ⁿ⁵⁶ A foreign corporation is a qualified resident if 50 percent or more (by value) of its stock is owned by nonresident aliens who are not residents of the foreign country, or if at least 50 percent of its income is used (directly or indirectly) to meet liabilities to persons who are not residents of the foreign country or citizens or residents of the United States.ⁿ⁵⁷ A special rule makes the foreign corporation a qualified resident if its stock is primarily and regularly traded on an established securities market in the foreign country, or the corporation is wholly owned (directly or indirectly) by another foreign corporation that is organized in the foreign country and whose stock is so traded or by a domestic corporation whose stock is primarily and regularly traded on an established securities market in the United States.ⁿ⁵⁸

If a foreign corporation is a qualified resident of a foreign country with which the United States has an income tax

treaty, the rate of tax is the treaty rate specified for branch profits, or if none is specified, the rate on dividends paid by a domestic corporation to a corporation resident in the foreign country that wholly owns the domestic corporation.ⁿ⁵⁹

No tax is imposed under either *IRC Section 871(a)* or *881(a)* on dividends paid to foreign taxpayers by a foreign corporation that is subject to the branch profits tax; there is also no withholding requirement under either *IRC Section 1441* or *1442* with respect to those dividends.ⁿ⁶⁰ However, the withholding tax may be imposed on dividends attributable to pre-1987 earnings and profits, and on dividends attributable to any earnings and profits when an income tax treaty bars application of the branch profits tax.

As a general rule, any interest paid by a U.S. trade or business of a foreign corporation is treated as paid by a domestic corporation,ⁿ⁶¹ and, to the extent that the allocable interest exceeds the interest treated as paid by a domestic corporation, the foreign corporation will be liable for tax under *IRC Section 881(a)* in the same manner as if the excess were interest paid to the foreign corporation by a domestic corporation on the last day of the foreign corporation's taxable year.ⁿ⁶²

Interest received by a foreign corporation may be subject to a benefit under a treaty with the country in which either the payor or recipient is a resident, provided, in each case, the foreign corporation is a qualified resident of the treaty partner.ⁿ⁶³ A similar rule applies to U.S. source dividends received by a foreign corporation from another foreign corporation that is not subject to the branch profits tax.ⁿ⁶⁴

FOOTNOTES:

(n1)Footnote 1. See *Howkins v Commr*, 49 TC 689, 693 (1968) .

(n2)Footnote 2. See, eg, *Rev Rul 71-516*, 1971-2 CB 264 , where interest on obligations of a foreign government was held have its source outside the US, in accordance with *IRC § 861(a)(1)*'s general rule sourcing interest in the US only if the obligor is a US resident, even though the interest on the foreign government's obligations was physically paid by the US underwriter, a bank, from its offices in the US.

(n3)Footnote 3. 680 F2d 142 (Ct Cl 1982) . The source of income rules can have important tax consequences for US as well as foreign taxpayers, since the amount of the foreign tax credit to which US residents are entitled depends on the percentage of their worldwide income that is sourced outside the United States. See *IRC § 904*; § 20.02[e], *supra* . US taxpayers, like nonresidents, would therefore normally prefer that income be classified as from sources outside the United States. *Bank of America* was such a case. In addition, US taxpayers may be liable to the Internal Revenue Service if they make taxable payments of US source income to foreign taxpayers and fail to withhold US taxes from such payments as required by *IRC § 1441*. See *Howkins v Commr*, 49 TC 689 (1968) .

(n4)Footnote 4. *Bank of America v US*, 680 F2d 142, 148-150 (Ct Cl 1982) .

(n5)Footnote 5. *Container Corp v Commr*, 134 TC No 5 (2010).

(n6)Footnote 6. Conversely, "interest other than that derived from sources within the United States as provided in *IRC Section 861(a)(1)*" is treated as income from sources without the United States. *IRC § 862(a)(1)*.

(n7)Footnote 7. *IRC § 861(a)(1)*. Despite the statutory reference to "bonds, notes, or other interest bearing obligations" *IRC § 861(a)(1)* is not limited to the interest on securities or other obligations issued or voluntarily assumed by a US resident. Thus, prejudgment interest that a US resident was ordered to pay to a nonresident alien individual pursuant to a judgment of a US court was held to be US source income to the nonresident under *IRC § 861(a)(1)* in *Iglesias v US*, 848 F2d 362 (2d Cir 1988) . Interest on a federal tax refund paid to a nonresident in accordance with US law is also US source income. See *Helvering v Stockholms Enskilda Bank*, 293 US 84 (1934) .

(n8)Footnote 8. *IRC § 861(a)(1)(A)*. If the payor has no gross income for the three-year period, the applicable

period is the year in which payment is made.

(n9)Footnote 8.1. *IRC § 861(c)*.

(n10)Footnote 9. The definition of "related person" in subpart F (controlled foreign corporations--see § 20.04, *supra*) applies for this purpose, see *IRC § 954(d)(3)*, except that ownership of 10 percent or more of a corporation's stock (rather than 50 percent or more) is considered a controlling interest. *IRC § 861(c)(2)*.

(n11)Footnote 10. *IRC § 861(a)(1)(B)(i)*.

(n12)Footnote 11. *IRC § 861(a)(1)(B)(ii)*.

(n13)Footnote 12. *IRC § 861(a)(1)(C)*.

(n14)Footnote 13. For this purpose the term "deposits" means (1) deposits with persons carrying on the banking business, (2) deposits or withdrawable accounts with federally and state chartered savings and loan institutions, but only to the extent that the amounts paid or credited on the accounts are deductible in determining the taxable income of the institution, and (3) amounts held by an insurance company under an agreement to pay interest. *IRC § 871(i)(3)*.

Interest received on US bank deposits by a US trust and distributed to a nonresident alien beneficiary is not taxed to the beneficiary. The trust is merely a conduit to the beneficiary, and there is no statutory reason for distinguishing between cases where interest is received by a nonresident alien directly, or indirectly through a trust or estate. *Isidro Martin-Montis Trust v Commr*, 75 TC 381 (1980), *acq* 1981-2 CB 2; *Rev Rul 81-244*, 1981-2 CB 151 . However, if the interest is received by a trust that is not required to distribute income currently, and not distributed to the beneficiary until a subsequent year, the interest is taxable to the trust in the year of receipt. *Rev Rul 86-76*, 1986-1 CB 349 .

(n15)Footnote 14. *IRC § 861(a)(2)*. *IRC § 861(a)(2)(A)* still makes an exception for dividends from domestic corporations which derive most of their income from Puerto Rico or a US possession and have an election in effect under *IRC § 936*, but since the *IRC § 936* election has been terminated (see *IRC § 936(j)*) the exception no longer applies.

(n16)Footnote 15. *IRC § 861(a)(2)(B)*. For purposes of the 25 percent test, income that is "treated as" effectively connected with the active conduct of a US trade or business by other provisions of the Internal Revenue Code is also included in the numerator of the fraction, except that the items excluded by *IRC § 884(d)(2)* from the effectively connected earnings and profits tax base subject to the *IRC § 884* branch profits tax are also excluded from the numerator of the 25 percent test. See § 20.05[2][c], fn 52 (listing items of income excluded from the branch profits tax base by *IRC § 884(d)(2)*).

(n17)Footnote 16. *IRC § 861(d)*.

(n18)Footnote 17. *IRC § 861(a)(2)(B)*. In the case of a dividend from a 20-percent owned corporation, the fraction is changed from 100/70ths to 100/80ths.

The dividends received deduction is the subject of § 4.04[2][a].

(n19)Footnote 18. *IRC § 861(a)(2)(C)*.

(n20)Footnote 19. *IRC § 861(a)(2)(D)*; *Rev Rul 73-68*, 1973-1 CB 336 .

(n21)Footnote 20. *IRC § 862(a)(2)*.

(n22)Footnote 21. See section 541 of the HIRE Act, Pub L No 111-147, 124 Stat 71 (2010). The effective date of *IRC § 871(l)* is September 14, 2010, 180 days after the date of enactment (March 18, 2010) of the HIRE Act.

(n23)Footnote 22. See *IRC § 871(l)(2)*.

(n24)Footnote 23. Until March 19, 2012, the date which is 2 years after the March 18, 2010 enactment of *IRC § 871(l)*, only payments made under certain "specified" notional principal contracts may be considered dividend equivalents; thereafter, payments under any notional principal contract, if contingent upon or determined by reference to the payment of a dividend from sources within the United States, will be considered dividend equivalents. See *IRC § 871(l)(3)(A)* and *(B)*. Specified notional principal contracts under which dividend equivalent payments may be made prior to March 19, 2012 must possess at least one of the following five characteristics: (i) any long party to the contract transfers an underlying security to any short party, (ii) in connection with the termination of the contract, any short party transfers the underlying security to any long party, (iii) the underlying security is not readily tradable on an established securities market, (iv) the underlying security is posted as collateral by any short party to the contract with any long party, or (v) the contract is identified by the Secretary of the Treasury as a "specified notional principal contract." *IRC § 871(l)(3)(A)*. For purposes of applying these tests, a "long party" means any party to the contract which is entitled to receive any payment pursuant to the contract which is contingent upon or determined with reference to the payment of a dividend from sources within the United States with respect to the underlying security; a "short party" means any party to the contract which is not a "long party," and "underlying security" means the US security the dividends on which are the predicate for determining the amount of payments under the contract, or on which such payments are contingent (for this purpose, any index or fixed basket of securities is treated as a single security). See *IRC § 871(l)(4)*. See also Ch 9A for a general description of notional principal contracts and their tax treatment.

(n25)Footnote 24. See *IRC § 877(l)(5)*.

(n26)Footnote 25. See Joint Comm on Taxation, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act," Under Consideration by the Senate (JCX-4-10), Feb 23, 2010, at 79.

(n27)Footnote 26. See TD 8735, 1997-2 CB 72, 62 FR 53498 (1997).

(n28)Footnote 27. See Ch 10 on Short Sales for a discussion of Section 1058 in the context of securities lending transactions.

(n29)Footnote 28. See *Treas Reg § 1.861-3(a)(6)*.

(n30)Footnote 29. *Treas Reg § 1.861-3(a)(6)*. The transparency rule also applies to substitute interest payments under the 1997 regulations. See *Treas Reg § 1.861-2(a)(7)*. See also *Treas Reg §§ 1.871-7(b)(2)* and *1.881-2(b)(2)*.

(n31)Footnote 30. TD 8735, 62 FR 53498, 53499 (1997).

(n32)Footnote 31. *Rev Rul 60-177*, 1960-1 CB 9 .

(n33)Footnote 32. *Rev Rul 80-135*, 1980-1 CB 18 .

(n34)Footnote 33. For example, if a foreign bank lends securities in a transaction that the facts and circumstances indicate in substance is an extension of credit pursuant to a loan agreement in the ordinary course of the bank's trade or business, the substitute payment may be characterized as interest which would not qualify as portfolio interest [exempt from withholding tax] under *IRC § 881(c)(3)(A)*. See TD 8735, 62 FR 53498, 53500 (1997).

(n35)Footnote 34. Of course, under a securities lending agreement described in *IRC § 1058*, the lender continues to have the right to receive identical securities from the borrower, but until that right is exercised neither the lender nor the borrower need have legal or beneficial ownership of either the securities originally transferred by the lender or "identical securities" of the same issuer. This is absolutely clear in the case of substitute payments under notional principal contracts, covered by *IRC § 877(l)(2)(B)*, where neither the long party nor the short party may ever actually

own the "underlying security" from which the substitute payments are supposedly derived.

(n36)Footnote 35. See Hariton, *Equity Derivatives, Inbound Capital and Outbound Withholding Tax*, 60 Tax Lawyer 313 (2007) (hereafter, "Hariton"); see also § 20.05[1][b], *supra*. As noted in § 20.05[1][b], to attract foreign capital Congress has itself largely eviscerated the withholding tax base with respect to US-source interest paid to nonresident aliens by exempting "portfolio interest" from the tax, but it chose to leave the withholding tax on US-source dividends intact.

(n37)Footnote 36. See *IRC § 871(h)*.

(n38)Footnote 37. *IRC § 871(a)*. The 30 percent rate may be, and frequently is, reduced by tax treaties between the US and treaty partners, so that it actually applies only to nonresident aliens who are not residents of countries with which the US has tax treaties.

(n39)Footnote 38. *1997-2 CB 328 (1997)*.

(n40)Footnote 39. See Staff Report of S. Permanent Subcomm on Investigations, 110th Cong, "Report on Dividend Tax Abuse: How Offshore Entities Dodge Taxes on US Stock Dividends" (Comm Print 2008). The Report on Dividend Tax Abuse described a typical transaction designed to use *Notice 97-66* as a way around the transparency rule as follows:

"The first step in the structure was that a U.S. financial institution used an offshore corporation that it owned and controlled to borrow U.S. stock from an offshore client anticipating a dividend. The offshore corporation borrowed the stock prior to the dividend, sold the stock so that it would not have to pay [tax on] the dividend itself, and simultaneously entered into a swap agreement with its affiliated financial institution. [Prior to *IRC § 871(l)*, the transparency rule did not apply to notional principal contracts such as swap agreements.] After the dividend was issued, the financial institution paid a tax-free "dividend equivalent" payment under the swap agreement to the offshore corporation which, in turn, paid the same amount (called a "substitute dividend") back to the offshore client from which it had borrowed the stock. According to the theory the financial institutions adopted, no withholding of the substitute dividend payment was required, because the substitute dividend payment was between two foreign parties located in jurisdictions subject to the same withholding rate. In short, the claim was that the substitute dividend payment, like the dividend equivalent payment under the swap agreement, was tax-free."

(n41)Footnote 40. *2010 IRB LEXIS 315*. Taxpayers may continue to rely on *Notice 97-66* until the September 14, 2010 effective date of *IRC § 871(l)*, with the following modification: "a withholding agent or foreign lender may not rely on *Notice 97-66* when the withholding agent or foreign lender knows or has reason to know that a Securities Lending Transaction, or series of such transactions, has a principal purpose of reducing or eliminating the amount of gross-basis tax that would have been due in the absence of such transaction or transactions. For example, a person may not rely on *Notice 97-66* to reduce or eliminate the amount of U.S. tax on the substitute dividend it is obligated to pay the foreign lender when it structures or participates in an arrangement whereby it: (1) borrows shares of a domestic corporation from a foreign person in a transaction described in *IRC § 1058* after a dividend declaration; (2) sells that stock to a related U.S. person before the ex-dividend date; and (3) enters into a total return swap agreement with that related person in order to hedge its risk." No inference is intended by the IRS that the transactions prohibited by this modification of *Notice 97-66* were not previously prohibited by the Notice, or by existing judicial doctrines, prior to the modification. *Notice 2010-46*, § I.B.

(n42)Footnote 41. For purposes of this provision, an actual dividend is also treated as a dividend equivalent. *IRC § 871(l)(6)*,

(n43)Footnote 42. *2010 IRB LEXIS 315*, *Notice 2010-46*, Section IIA. A "Qualified Securities Lender" is defined as a foreign financial institution, such as a bank, custodian or broker-dealer, that is regularly engaged in a trade or

business that includes the borrowing and lending of securities of US corporations with unrelated clients, is subject to audit by the IRS, and files an annual statement with the IRS certifying that it meets the conditions necessary to be a Qualified Securities Lender.

(n44)Footnote 43. During the transition period, withholding agents may adopt a system that reasonably implements the principles of the Qualified Securities Lender system described in Part II of *Notice 2010-46*. In particular, during the transition period, a withholding agent is not required to withhold on a substitute dividend payment made to a Qualified Securities Lender if the withholding agent receives, at least annually, a statement from its counterparty that substantially complies with the certification requirement that will have to be met once regulations under *IRC § 871(l)(6)* become final. A financial institution may make such a certification only if it reasonably determines that it meets the requirements to qualify as a Qualified Securities Lender described in part II of *Notice 2010-46*, see fn 34, *supra*, without regard to the requirement that a Qualified Securities Lender file an annual statement with the Service. It is anticipated, however, that future guidance will provide that all Qualified Securities Lenders taking advantage of transition relief may be required to identify themselves to the Service (in a manner to be specified) before the end of calendar year 2010. *2010 IRB LEXIS 315, Notice 2010-46*, (Part III).

(n45)Footnote 44. For this purpose, a withholding agent has a reason to know that tax was not withheld if, for example, the amount of any lending fee or similar fee is increased directly or indirectly, in whole or in part, by the difference between the gross amount of the substitute dividend and the net amount received.

(n46)Footnote 45. In general, a Qualified Intermediary is a foreign financial institution that has entered into a withholding and reporting agreement (a QI agreement) with the IRS. See *Treas Reg § 1.1441-1(e)(5)(ii)*.

(n47)Footnote 46. *IRC § 865(a)(2), (e)(2)(A)*. A nonresident alien is any person other than a US person. *IRC § 865(g)(1)(B)*. For this purpose, a US resident is a US citizen or resident alien who does not have a tax home in a foreign country, a nonresident alien who has a tax home in the US, and any corporation, trust, or estate that is a US person. *IRC § 865(g)(1)(A)*. A US person or resident alien cannot be treated as a nonresident with respect to any sale of personal property unless an income tax equal to at least 10% of the gain derived is actually paid to a foreign country with respect to that gain. *IRC § 865(g)(2)*. *IRC § 865(g)(2)* does not apply to a sale by a *bona fide* resident of Puerto Rico of stock in a corporation that is engaged in the active conduct of a trade or business in Puerto Rico and derived more than 50% of its gross income in the three-year period preceding the sale from that trade or business. *IRC § 865(g)(3)*.

(n48)Footnote 47. *IRC § 865(b)*.

(n49)Footnote 48. *IRC § 861(a)(6)*.

Income derived from the purchase of inventory property within a possession of the US and its sale within the US is treated as derived partly from sources within and partly from sources without the US. *IRC § 863(b)(3); Treas Reg § 1.861-7(b)*.

(n50)Footnote 49. *IRC § 862(a)(6)*.

(n51)Footnote 50. *Treas Reg § 1.861-7(a), (c)*. If bare legal title is retained by the seller, the sale is deemed to have occurred when beneficial interest and the risk of loss passed to the buyer. *Ronrico Corp v Commr*, 44 BTA 1130 (1941). A "substance of the transaction" test will be applied if the transaction is arranged in a particular manner for the primary purpose of tax avoidance. *Treas Reg § 1.861-7(c)*; See *Kaspore Cohn Co v Commr*, 35 BTA 646 (1937), where the separate identity of a foreign subsidiary was disregarded and the US parent treated as the seller.

Gains, profits and income from the disposition of a US real property interest are treated as foreign source income when the real property is located in the Virgin Islands. *IRC § 862(a)(8)*.

(n52)Footnote 51. The subject of Section 306 stock is covered in Ch 7.

(n53)Footnote 52. *Treas Reg § 1.865-2(a)(1)*. The provision applies to property that is marked-to-market. It does not apply to stock constituting inventory. *Treas Reg § 1.865-2(b)(2)*.

Loss with respect to personal property other than stock is allocated in the same manner as gain on the sale of the property would be sourced. *Treas Reg § 1.865-1(a)(1)*. The provision does not apply to foreign currency losses or loss recognized with respect to options contracts or derivative financial instruments. *Treas Reg § 1.865-1(c)(1)*.

(n54)Footnote 53. There is no deduction for expenses incurred in connection with the production of this income. *IRC § 873(a)*.

A substitute interest payment received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction has the same character as interest income paid or accrued with respect to the terms of the transferred security. A substitute dividend payment received by a foreign person in such a transaction has the same character as a distribution received with respect to the transferred security. *Treas Reg §§ 1.871-7(b)(2), 1.881-2(b)(2)*.

Income excluded from gross income by treaty will be exempt from taxation under *IRC §§ 871(a)(1) and 881(a)*. *IRC § 894(a)*. The same holds true for items excluded from gross income by other Code provisions. A treaty may also require the imposition of a lesser rate of tax.

The tax rate applied to nonresident aliens and foreign corporations will be doubled if the President finds that, under the laws of any foreign country, US citizens or corporations are subjected to discriminatory or extraterritorial taxes. *IRC § 891*.

No tax is imposed on the proceeds from a wager placed in a blackjack, baccarat, craps, roulette, or big-6 wheel game, unless the Service determines by regulation that collection of the tax is administratively feasible. *IRC § 871(j)*.

(n55)Footnote 54. The percentage is equal to the percentage that the gross income of the corporation from foreign sources for the three-year period preceding the dividend payment is of the corporation's total gross income. If the corporation has no gross income during the three-year period, the percentage is based on the income in the year of payment.

(n56)Footnote 55. An alien who has not established a taxable year for any prior period is placed on a calendar year taxable year. *IRC § 7701(b)(8)(A)*.

An alien can make the first-year election and be treated as a resident for the election year if the person (1) was not a resident for the year prior to the election; (2) has a substantial presence in the US for the year following the election; and (3) is present in the US for at least 31 consecutive days in the election year. *IRC § 7701(b)(4)*.

The Service will not rule whether an alien individual is a nonresident of the US, including whether the individual has met the requirements of the substantial presence test or exceptions to the test. However, the Service may rule regarding the legal interpretation of a particular provision of *IRC § 7701(b)* or the regulations thereunder. *Rev Proc 2007-7, 2007-1 CB 227*.

(n57)Footnote 56. *IRC § 269B(e)*. Indirect ownership is determined under the stock ownership rules applicable to controlled foreign corporations (*IRC § 958(a)*) and the option attribution rule of *IRC § 318(a)(4)*.

(n58)Footnote 57. *IRC §§ 871(a)(1)(C)(i), 881(a)(3)(A)*, prior to amendment by the Tax Reform Act of 1984. The obligations had to be issued after Sept 28, 1965. It is unclear whether the enactment of specific provisions prevents the taxation of OID where the bonds were issued before September 28, 1965. Such OID might be considered fixed or determinable income under the rationale of *US v Midland-Ross Corp*, 381 US 54 (1965).

(n59)Footnote 58. An OID obligation is any bond or evidence of indebtedness having OID, other than an obligation payable 183 days or less from the date of original issue or a tax-exempt obligation. *IRC § 871(g)(1)(B)(i), (ii)*.

The IRS will not rule whether a debt instrument having OID within the meaning of *IRC § 1273* is an OID obligation under *IRC § 871(g)(1)(B)(i)* when the instrument is payable within 183 days or less from the date of issue (without regard to the period held by the taxpayer). *Rev Proc 2007-7, 2007-1 CB 227*.

(n60)Footnote 59. *IRC §§ 871(a)(1)(C)(ii), 881(a)(3)(B)*. The determination of the amount of OID accruing during a period is made under the rules of *IRC § 1272* (see ch 17), without regard to any exception for short-term obligations. *IRC § 871(g)(2)*. The determination of the source of the OID is made at the time of the payment as if the payment were of interest. *IRC § 871(g)(3)*.

(n61)Footnote 60. *IRC §§ 871(a)(1)(C)(i), 881(a)(3)(A)*. The determination of the source of the OID is made at the time of the sale or exchange as if the sale or exchange involved the payment of interest. *IRC § 871(g)(3)*.

(n62)Footnote 61. *IRC § 871(g)(4)*. See Ch 17 for a discussion of *IRC § 1286*.

(n63)Footnote 62. *IRC §§ 1441, 1442*. A treaty can reduce the amount required to be withheld.

A deemed dividend resulting from the application of *IRC § 304(a)(1)* will be subject to withholding if paid to a foreign corporation from sources within the US. *Rev Rul 92-85, 1992-2 CB 69*. The consequences of *IRC § 304* in international transactions are explored in Staffaroni, "The International Boundaries of Section 304," 46 *Tax Lawyer* 125 (1992).

Dividends that are designated by a regulated investment company as capital gain dividends under *IRC § 852(b)(3)(C)* do not constitute fixed or determinable annual or periodical income for purposes of *IRC § 1441*, and are not subject to withholding at the source when paid to nonresident aliens and nonresident foreign corporations. *Rev Rul 69-244, 1969-1 CB 215*.

(n64)Footnote 63. *IRC §§ 871(h)(1), 881(c)(1)*.

Where, pursuant to a securities lending transaction or a sale-repurchase transaction, a foreign person transfers to another person a security the interest on which would qualify as portfolio interest in the hands of the lender, substitute interest payments made with respect to the transferred security will be treated as portfolio interest unless one of the exceptions to the portfolio interest exemption applies. *Treas Reg § 1.871-7(b)(2)*.

(n65)Footnote 64. *IRC §§ 871(h)(2), 881(c)(2)*. Interest on obligations not in registered form issued prior to March 19, 2012 will be treated as portfolio interest if it the obligation is described in *IRC § 163(f)(2)(B)*; viz, (1) there are arrangements reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person; (2) interest is payable only outside the United States and its possessions, and (3) the face of the obligation contains a statement that any United States person who holds the obligation will be subject to limitations under the United States income tax laws. *IRC §§ 871(h)(2)(A) and 881(c)(2)(A)*. These exceptions to the requirement that exempt "portfolio interest" must be paid with respect to an obligation in registered form are repealed for obligations issued after March 18, 2012. See Section 502(b) and 502(f) of the Hiring Incentives to Restore Employment Act of 2010, Pub L No 111-147, 124 *Stat* 71 (2010) (the "HIRE Act of 2010"). See also Ch 17.02[1], fn 17.

(n66)Footnote 65. The Treasury has discretion to waive the requirement of a statement identifying the beneficial owner as a non-US person if it determines that such statement is not required in order to carry out the purposes of the provision; for example, if the Treasury were to determine that there is a low risk of tax evasion and adequate

documentation standards within the country of tax residency of the beneficial owner of the obligations in question. See *IRC § 881(c)(2)*; Joint Comm on Taxation, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act," Under Consideration by the Senate (JCX-4-10), Feb 23, 2010, 53.

(n67)Footnote 66. *IRC § 871(h)(3)*. The attribution rules of *IRC § 318(a)* are applicable in determining ownership with three modifications. Stock owned by a corporation is attributed to a shareholder without regard to the 50 percent limitation normally required. Stock owned by a shareholder is attributed to a corporation without regard to the 50 percent threshold, but if the shareholder owns less than 50 percent of the stock, the corporation is deemed to own an amount of stock in the proportion that the value of the shareholder's stock in the corporation bears to the value of all of the corporation's stock. Stock treated as owned by a person under the option attribution rules is not deemed owned by that person for purposes of entity-individual and individual-entity attribution.

(n68)Footnote 67. *IRC § 881(c)(3)*. A number of special rules apply if portfolio interest is received by a controlled foreign corporation. *IRC § 881(c)(5)(A)*. The rules also apply to certain interest-related dividends received from a regulated investment company by a controlled foreign corporation. *IRC § 881(e)(1)(C)*.

Whether interest paid to a partnership and included in the distributive share of a foreign partner is received by a 10-percent shareholder is determined at the partner level. *Treas Reg § 1.871-14(g)(3)(i)*. A similar rule governs interest paid to a simple trust or grantor trust and distributed to or included in the gross income of a foreign taxpayer that is a beneficiary or owner of the trust; the determination is made at the beneficiary or owner level. *Treas Reg § 1.871-14(g)(4)*.

(n69)Footnote 68. A related person is any person related to the debtor within the meaning of *IRC § 267(b)* or *707(b)(1)*, or who is a party to any arrangement undertaken for a purpose of avoiding the application of *IRC § 871(h)(4)(A)*. *IRC § 871(h)(4)(B)*.

The provisions of *IRC § 871(h)(4)* are made applicable to foreign corporations by *IRC § 881(c)(4)*.

(n70)Footnote 69. *IRC § 871(h)(4)(C)*.

(n71)Footnote 70. *IRC § 871(h)(4)(D)*.

(n72)Footnote 71. *IRC §§ 871(k)(1)(A), 881(e)(1)(A)*. Excepted from this general rule is any interest described in *IRC § 871(k)(1)(B)*, and any interest-related dividend received by a controlled foreign corporation to the extent the dividend is attributable to interest received by the regulated investment company from a person who is a related person (within the meaning of *IRC § 864(d)(4)*) with respect to the controlled foreign corporation. *IRC § 881(e)(1)(B)*.

(n73)Footnote 72. *IRC § 871(k)(1)(B), (E)(i), (iii), (F)*.

(n74)Footnote 73. *IRC § 871(k)(1)(C)*. No dividend with respect to any taxable year beginning after Dec 31, 2007, can be an interest-related dividend.

(n75)Footnote 74. *IRC § 871(k)(1)(C), (D)*. In making the designations, permitted by *IRC §§ 852(b)(3)(C), 852(b)(5)(A), 854(b)(1), 871(k)(1)(C), and 871(k)(2)(C)*, the RIC may designate the maximum amount permitted under each provision even if the aggregate of all the amounts so designated exceeds the total amount of the RIC's dividend distribution. *Rev Rul 2005-31, 2005-1 CB 1084*.

(n76)Footnote 75. *IRC § 871(k)(1)(E)*.

(n77)Footnote 76. *IRC §§ 871(k)(2)(A), (B); 881(e)(2)*.

Under *IRC § 897(h)(1)*, a distribution by a regulated investment company to a foreign taxpayer with respect to any class of stock that is regularly traded on an established securities market located in the US is not treated as gain recognized from the sale or exchange of a US real property interest if the foreign taxpayer did not own more than 5% of the class of stock at any time during the one-year period ending on the date of distribution. The amount that would otherwise be treated as short-term capital gain is, instead, included in the shareholder's gross income as a dividend from the regulated investment company. *IRC § 871(k)(2)(E)*.

(n78)Footnote 77. *IRC § 871(k)(2)(C)*. No dividend with respect to any taxable year of the company beginning after Dec 31, 2007, can be a short-term capital gain dividend. In making the designations, permitted by *IRC §§ 852(b)(3)(C), 852(b)(5)(A), 854(b)(1), 871(k)(1)(C), and 871(k)(2)(C)*, the RIC may designate the maximum amount permitted under each provision even if the aggregate of all the amounts so designated exceeds the total amount of the RIC's dividend distribution. *Rev Rul 2005-31, 2005-1 CB 1084*.

(n79)Footnote 78. *IRC § 871(k)(2)(C), (D)*.

(n80)Footnote 79. *IRC § 871(k)(2)(C), (D)*.

(n81)Footnote 80. *IRC § 871(k)(2)(C), (D)*. The treatment of post-Oct 31 losses assumes that an election under *IRC § 4982(e)(4)* does not apply. See *§ 12.03[7]* for a discussion of that provision.

(n82)Footnote 81. A controlled commercial entity is one engaged in commercial activities if the foreign government holds (directly or indirectly) either a 50 percent or greater voting or value interest in the entity, or an interest that gives it effective control of the entity. *IRC § 892(a)(2)(B)*.

A foreign government is treated as a resident of its country for federal tax purposes. It is also treated as such for the purposes of any income tax treaty obligation of the US if it grants equivalent treatment to the US government. *IRC § 892(a)(3)*.

Income earned from a US real property interest described in *IRC § 897(c)(1)(A)(i)*, or from the disposition of such an interest, is not exempt from tax under *IRC § 892*. *Temp Treas Reg § 1.892-3T(a)(1)(iii)*.

(n83)Footnote 82. *IRC § 871(a)(1)(B)*. Certain other items of income unrelated to transactions in securities are also taxed.

(n84)Footnote 83. Capital gain dividends of a regulated investment company are taxable to a nonresident alien shareholder under *IRC § 871(a)(2)* only if the taxpayer meets the physical presence test. *Rev Rul 69-235, 1969-1 CB 190*. This ruling extends to undistributed capital gain dividends as well.

(n85)Footnote 84. The gains and losses of a nonresident alien individual are determined without regard to the exclusion permitted by *IRC § 1202*. See *§ 2.06[2][a][ii]* for a discussion of *IRC § 1202*.

A domestically controlled qualified investment entity is one in which at all times during the testing period less than 50% in value of the stock was held directly or indirectly by foreign persons. *IRC § 897(h)(4)(B)*.

(n86)Footnote 1. The Service will not ordinarily rule whether a taxpayer is engaged in a trade or business in the US, and whether income is effectively connected with the conduct of a trade or business in the US. *Rev Proc 2010-7, 2010-1 CB 231, 232*.

(n87)Footnote 2. *IRC § 864(c)(2)*.

(n88)Footnote 3. Other examples can be found in HR Rep No 1450, 89th Cong, 2d Sess 59-61 (1966).

(n89)Footnote 4. *IRC § 864(c)(3)*. If the taxpayer is not engaged in a trade or business within the US, he is not taxed on such income since it is not periodic and since a person not engaged in a trade or business cannot have any effectively connected income. *IRC § 864(c)(1)(B)*.

(n90)Footnote 5. See generally Feder & Parker, "The Foreign Investment in Real Property Tax Act of 1980," 34 *Tax Law* 545 (1981).

A foreign government is treated as a person with respect to US real property interests. *Temp Treas Reg § 1.897-9T(e)*. This means that income earned from, or gain derived from the disposition of, a US real property interest is not exempt from tax under *IRC § 892*. *Temp Treas Reg § 1.892-3T(a)(1)(iii)*.

(n91)Footnote 6. *IRC § 897(c)(1)(A)(ii)*.

A recent ruling, however, has identified a potential loophole in this otherwise broad rule. In Rev Rul 2008-31, 2008-26 *IRB* 1180, a foreign corporation entered into a notational principal contract with an unrelated domestic corporation. The return on the contract was based on an index that measured appreciation and depreciation of real estate within wide geographic areas, an index that was not maintained by either of the two corporations. The ruling determined that the contract was not a United States real property interest for purposes of *IRC Section 897(c)(1)*.

(n92)Footnote 7. *IRC § 897(c)(2)*.

(n93)Footnote 8. *IRC § 897(c)(1)(A)(ii), (c)(4)(A)*.

(n94)Footnote 9. *IRC § 897(c)(4)(B)*. Assets used or held for use in a trade or business by the partnership, trust, or estate are deemed to be so held by the partners or beneficiaries.

Any asset deemed held by a partner or beneficiary is so treated for purposes of applying ownership to partnerships, trusts, or estate that are above in a chain of partnerships, trusts, or estates.

(n95)Footnote 10. *IRC § 897(c)(5)*. The attribution rules of *IRC § 318(a)* are made applicable, but are modified to the extent that the entity-individual attribution rules become operative when a shareholder owns 5 percent of the corporation's stock. *IRC § 897(c)(6)(C)*.

"Ownership" of assets by the controlling corporation can be reattributed to corporations that are higher in a chain of corporations. *IRC § 897(c)(5)(A)*.

(n96)Footnote 11. *IRC § 897(c)(1)(B)*.

(n97)Footnote 12. *IRC § 897(c)(3)*. The attribution rules of *IRC § 318(a)* apply, with the entity-individual rules triggered when a shareholder owns 5 percent of the corporation's stock. *IRC § 897(c)(6)(C)*.

(n98)Footnote 13. *IRC § 897(h)(2)*.

(n99)Footnote 14. *IRC § 897(d)(1)*. See Chs 4, 5 and 6.

No gain will be recognized if carryover basis rules would normally apply and, at the time of receipt of the distributed property, the distribution would be subject to tax on a later disposition by the recipient. A second-tier foreign subsidiary owned a parcel of US real property. A liquidating distribution of the property to its parent, another foreign corporation was subject to nonrecognition treatment under *IRC § 332* and did not require the recognition of gain under *IRC § 897*; a later distribution by the first-tier subsidiary to its domestic parent did. *Rev Rul 90-76, 1990-2 CB 176*.

(n100)Footnote 15. *IRC § 897(e)(1)*. The purpose of *IRC § 897(e)* is to preserve otherwise available

nonrecognition treatment to cases where it is clear that the gain inherent in a US real property interest will remain subject to federal income tax. Therefore, a foreign corporation was entitled to nonrecognition under *IRC § 351* when it transferred stock of a domestic subsidiary that constituted a US real property interest to a new domestic subsidiary in exchange for the latter's stock. *Rev Rul 84-160, 1984-2 CB 125*. See also *Rev Rul 87-66, 1987-2 CB 168*.

(n101)Footnote 16. *IRC § 897(e)(2)*; *Temp Treas Reg §§ 1.897-5T, 1.897-6T*. New final regulations will revise *Temp Treas Reg § 1.897-5T* and *Temp Treas Reg § 1.897-6T* to reflect recently issued regulations under *IRC § 368(a)(1)(A)*. *Notice 2006-46, 2006-1 CB 1044*.

(n102)Footnote 17. *IRC § 897(g)*.

(n103)Footnote 18. *IRC § 897(h)(1), 4(A)(i)*. However, any distribution by a qualified investment entity to a nonresident alien individual or a foreign corporation with respect to any class of stock that is regularly traded on an established securities market located in the US will not be treated as gain recognized from the sale or exchange of a US real property interest if the shareholder did not own more than 5% of the class of stock at any time during the one-year period ending on the date of the distribution.

A regulated investment company will not be a qualified investment entity after Dec 31, 2007. *IRC § 897(h)(4)(A)(ii)*. Nonetheless, a real estate investment trust will be treated as a qualified investment entity with respect to any distribution by the entity to a nonresident alien individual or a foreign corporation that is attributable directly or indirectly to a distribution to the entity from a real estate investment trust.

The term "United States real property interest" does not include any interest in a domestically controlled qualified investment entity. *IRC § 897(h)(2)*.

(n104)Footnote 19. *IRC § 897(d)(1), (h)(3)*. The "foreign ownership percentage" of a qualified investment entity is the greatest percentage of stock held by foreign persons during whichever of the following periods (testing period) is the shortest: (1) the period beginning on June 18, 1980 and ending on the date of distribution, (ii) the five-year period ending on the date of distribution, or (iii) the period during which the entity was in existence. *IRC § 897(h)(4)(C), (D)*.

A domestically controlled qualified investment entity is one in which at all times during the testing period less than 50% in value of the stock was held directly or indirectly by foreign persons. *IRC § 897(h)(4)(B)*.

If any portion of a distribution from a qualified investment entity to a nonresident alien individual or a foreign corporation is treated as gain realized by the individual or corporation from the sale or exchange of a US real property interest, the qualified investment entity must deduct and withhold a tax equal to 35% (or, to the extent provided in regulations 15% (20% in the case of taxable years beginning after Dec 31, 2010)) of the amount so treated. *IRC § 1445(e)(6)*.

(n105)Footnote 20. *IRC § 897(j)*.

(n106)Footnote 20.1. *IRC § 897(h)(5)(A)*. The provision applies to any substitute dividend payment as defined in *IRC § 861*, or any other similar payment that the Service determines necessary to prevent avoidance of the purposes of the applicable wash sales transaction rule. *IRC § 897(h)(5)(B)(ii)*. The portion of any payment treated as gain from the sale or exchange of a United States real property interest in this case is equal to the portion of the distribution the payment is in lieu of that would have been so treated but for the transaction giving rise to the payment.

No deduction or withholding of any tax is required in the case of an applicable wash sale transaction. *IRC § 1445(b)(8)*.

(n107)Footnote 20.2. *IRC § 897(h)(5)(B)(i)*.

(n108)Footnote 20.3. *IRC § 897(h)(5)(B)(iii).*

(n109)Footnote 20.4. *IRC § 897(h)(5)(B)(iv).*

(n110)Footnote 21. *IRC § 897(i)(1).*

(n111)Footnote 22. *IRC § 897(i)(3).* If a class of interest is traded on an established securities market, the consent need only be made by a person who held more than 5 percent of that interest. The constructive ownership rules of *IRC § 897(c)(6)(C)* apply in determining the extent of ownership of a class of interest.

(n112)Footnote 23. *IRC § 897(i)(2).*

(n113)Footnote 24. *IRC § 1445.*

(n114)Footnote 25. *Rev Proc 88-23, 1988-1 CB 787*, sets forth the procedure for obtaining a withholding certificate to reduce or dispense with the 10 percent withholding tax.

(n115)Footnote 26. *Treas Reg § 1.1445-1(b)(3).* The amount of withholding in the case of the exercise of an option is based on the amount paid for the option.

(n116)Footnote 27. *Treas Reg § 1.1445-1(b)(2).* A husband and wife are each deemed to have contributed 50 percent of the aggregate capital contributed by them.

(n117)Footnote 28. *Treas Reg § 1.1445-5* contains special rules concerning distributions and other transactions by corporations, partnerships, and trusts. *Treas Reg § 1.445-8* contains the rules for publicly traded partnerships and trusts, including real estate investment trusts.

(n118)Footnote 29. *IRC § 864(c)(4)(B).* *IRC § 864(c)(4)(A)* sets forth the general rule that foreign source income is not effectively connected income.

(n119)Footnote 30. *IRC § 864(c)(4)(D)(i).* A second exclusion covers subpart F income. *IRC § 864(c)(4)(D)(ii).*

(n120)Footnote 31. HR Rep No 1450, 89th Cong, 2d Sess 59, 65 (1966).

(n121)Footnote 32. HR Rep No 1450, 89th Cong, 2d Sess 66 (1966). A corporation whose principal activity is trading in securities for its own account will not be one whose foreign source income can be effectively connected income, if its trading activities are excluded from the definition of the term "trade or business within the United States" by *IRC § 864(b)(2)(A)*. HR Rep No 1450, 89th Cong, 2d Sess 65 (1966).

(n122)Footnote 33. S Rep No 1707, N 5, *supra*, at 21 .

(n123)Footnote 34. *IRC § 864(c)(5)(A).*

(n124)Footnote 35. *IRC § 864(c)(5)(B), (C).*

(n125)Footnote 36. S Rep No 1707, N 5, *supra*, at 21 .

(n126)Footnote 37. *IRC § 871(c)* prior to amendment by the Foreign Investors Tax Act.

(n127)Footnote 38. *Commr v Nubar*, 185 F2d 584 (4th Cir 1950) (alternate holding), *cert denied* 341 US 925 .

(n128)Footnote 39. *Adda v Commr*, 10 TC 273 , *affd* 171 F2d 457 (4th Cir 1948), *cert denied* 336 US 952 .

(n129)Footnote 40. *IRC § 864(b)(2)(C).*

(n130)Footnote 41. A person who is a dealer in securities by reason of his transactions outside the US is considered a dealer in securities for purpose of *IRC § 864(b)(2)(A)(ii)*, even though the person's transactions in securities conducted in the US would not constitute the person a dealer. HR Rep No 1450, 89th Cong, 2d Sess 57 (1966).

(n131)Footnote 42. HR Rep No 1450, 89th Cong, 2d Sess 13-14 (1966); see, eg, *Abegg v Commr*, 50 TC 145 (1968) , *affd on other grounds*, 429 F2d 1209 (2d Cir 1970) , *cert denied* 400 US 1008 .

(n132)Footnote 43. *IRC §§ 871(b)(1), 882(a)(1)*.

(n133)Footnote 44. *IRC §§ 873(a) 882(c)(1)*. A foreign corporation engaged in real estate activities in the US may elect to treat such activities as a US trade or business and thus deduct the expenses connected with the "effectively connected income" for such activities. *IRC § 882(d)*. Under *Treas Reg § 1.882-4(a)(3)(i)*, however, unless a foreign corporation files its return for the year within 18 months of the due date prescribed in *IRC § 6072*, it forfeits its right to claim "effectively connected" deductions in that year. In *Swallows Holding Ltd v Comm'r*, 515 F3d 162 (2008) , *vacating* 126 TC 96 (2006) , the Court of Appeals for the Third Circuit, held that this timing restriction was a reasonable interpretation of the statute and that the regulations were therefore valid.

(n134)Footnote 45. *IRC § 873(b)(1)*.

(n135)Footnote 46. *IRC §§ 873(b)(2), 882(c)(2)*.

(n136)Footnote 47. *IRC § 873(b)(3)*.

(n137)Footnote 48. *IRC § 906(a), (b)(1)*.

(n138)Footnote 49. *IRC § 906(b)(3)*.

(n139)Footnote 50. *IRC § 906(b)(4)*.

(n140)Footnote 51. *IRC § 906(b)(2)*.

(n141)Footnote 52. The following earnings and profits are excluded for the amount of effectively connected earnings and profits: (1) exempt foreign trade income and distributions from a foreign sales corporation; (2) earnings derived by foreign transportation carriers that are exempt from US tax pursuant to treaty or reciprocal exemption; (3) earnings derived from the sale of any interest in US real property holding corporations; (4) interest on US obligations received by banks organized in US possessions; and (5) earnings derived by certain captive insurance companies that elect to treat their income as effectively connected with a US trade or business. *IRC § 884(d)(2)*.

A foreign government taxed on its US commercial activities under *IRC § 892(a)(3)* is subject to the branch tax; an international organization is not. *Treas Reg § 1.884-0(a)*.

(n142)Footnote 53. No credit is allowed against the branch profits tax. *IRC § 906(b)(7)*.

(n143)Footnote 54. *IRC § 884(b)(2)(B)*.

(n144)Footnote 55. *IRC § 884(c)*. *Treas Reg § 1.884-1(c)* contains rules relating to the determination of US net equity.

Nonincome producing assets owned by a foreign corporation doing business in the United States are not always US assets even if located in the United States. See *Treas Reg § 1.884-1(d)*.

(n145)Footnote 56. *IRC § 884(e)(1)*.

(n146)Footnote 57. *IRC § 884(e)(4)(A)*. In determining ownership, stock owned directly or indirectly by or for a corporation, partnership, trust, or estate is treated as being owned proportionately by its shareholders, partners, or beneficiaries.

Treas Reg § 1.884-5 sets forth the documentation required if a foreign corporation seeks to be classified as a qualified resident by satisfying the stock ownership test.

(n147)Footnote 58. *IRC § 884(e)(4)(B), (C)*.

(n148)Footnote 59. *IRC § 884(e)(2)*.

(n149)Footnote 60. *IRC § 884(e)(3)(A)*.

(n150)Footnote 61. *IRC § 884(f)(1)(A)*. This rule does not apply to interest reasonably expected to be allocable interest.

(n151)Footnote 62. *IRC § 884(f)(1)(B)*. Allocable interest is any interest that is allocable to income that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the US. *IRC § 884(f)(2)*.

(n152)Footnote 63. *IRC § 884(f)(3)*.

(n153)Footnote 64. *IRC § 884(e)(3)(B)*.



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Taxation of Securities Transactions

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CHAPTER 20 Foreign Securities and Foreign Shareholders

2-20 Taxation of Securities Transactions § 20.06

§ 20.06 Expatriation by United States Citizens and Residents--The Alternative Tax Regime Under Section 877A

As discussed in the previous section, individual foreign investors in US securities and other US investments are taxed differently from and in many cases more favorably than individual US investors. The tax regime applicable to "nonresident aliens" does not tax income from sources outside the United States, and investment income from US sources is taxed at a flat rate of 30 percent (without deductions), withheld at the source, that may be reduced (to zero in some cases) by statute or one of the many tax treaties in force between the US and various foreign countries. The differences between individual foreign and US investor tax regimes--income, estate and gift--may be sufficiently great to tempt some US citizens and permanent residents ("green card" holders) to relinquish their US citizenship or abandon their green card status, move to another country (if not already resident there) and thereafter become subject to US tax only under a more favorable nonresident alien tax regime.

The Internal Revenue Code, from 1966, sought to discourage this rather extreme tax saving strategy by denying nonresident alien tax status to certain expatriates, imposing instead an alternative tax regime somewhere between nonresident alien and US citizen or resident status. Although originally aimed at expatriates whose principal purpose for expatriation was the avoidance of US taxes, since 2004 the application of the alternative tax regime no longer depends on intent but is determined by objective tests targeting wealthy individuals and those that have not complied with their US tax obligations prior to expatriation. Until 2008, the alternative tax system, then imposed by *IRC Section 877*, taxed such expatriates at the same rates of tax applicable to US citizens and permanent residents on all of their US income, whether or not effectively connected to a US trade or business, over a 10-year period following expatriation.

Effective with respect to expatriations occurring on or after June 17, 2008, the alternative tax regime has been changed. Although the expatriate is now taxed as a nonresident alien after relinquishing US citizenship or giving up permanent resident status, new *IRC Section 877A* where applicable, treats expatriation as a tax realization event. A mark-to-market tax is imposed as though all of the covered expatriate's property were sold at fair market value on the day before expatriation. Deferred compensation also becomes subject to immediate taxation (at present value) unless the expatriate agrees to accept a 30 percent withholding tax on future payments of such compensation. These and other provisions of the new legislation are covered in this section (§ 20.06), which affects not only the expatriates themselves but also those making payments to such expatriates (such as present or former employers, and trustees or administrators of trusts and accounts in which they have or had an interest).ⁿ¹ Details regarding the alternative tax regime that remains applicable to expatriates who relinquished their citizenship or permanent residence status before June 17, 2008 are discussed in the following section, § 20.06A.

[1] Covered Expatriates Under Section 877A

The rules that identify individuals covered by the alternative tax regime under *IRC Section 877A*, referred to as "covered expatriates," are basically the same as the coverage rules under *IRC Section 877*.ⁿ² An "expatriate" is defined in *IRC Section 877A(g)(2)* as either (1) a citizen who relinquishes his US citizenshipⁿ³ or (2) a "long-term resident"ⁿ⁴ of the United States who ceases to be a "lawful permanent resident" of the United States within the meaning of *IRC Section 7701(b)(6)*.ⁿ⁵ The process may be voluntary or involuntary. A "covered expatriate"--an individual subject to the alternative tax regime--is defined as an expatriate who meets any one or more of the following three objective criteria.ⁿ⁶

(A) An average annual net income tax liability greater than \$149,000 for the five years preceding the year in which the individual's "expatriation date"ⁿ⁷ occurs;ⁿ⁸ or

(B) A net worth of \$2 million or more as of the expatriation date;ⁿ⁹ or

(C) Failure to certify, under penalty of perjury, compliance with all Federal tax obligations for the 5 years preceding the year in which the individual's "expatriation date" occurs, or failure to submit such evidence of such compliance as the IRS may require.ⁿ¹⁰

A former US citizen will not be subject to the alternative tax regime under *IRC Section 877A* even though the individual meets the tax liability and/or net worth tests if he or she qualifies under the "dual citizen" exception or the "minors" exception.ⁿ¹¹ Under the "dual citizen" exception a former citizen is exempt from the alternative tax regime if (1) the individual was at birth a citizen of both the United States and another country, (2) as of the expatriation date, the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (3) the individual has been a resident of the United States (as defined in *IRC Section 7701(b)(1)(A)(ii)*) for not more than 10 taxable years during the 15-taxable year period ending with the taxable year in which his expatriation date falls.ⁿ¹² The "minors" exception exempts from the alternative tax regime a former citizen who (1) relinquished US citizenship before attaining age 18½, and (2) was a resident of the United States for not more than 10 taxable years before the date of relinquishment.ⁿ¹³

In addition, if a covered expatriate reacquires US citizenship or permanent resident status, during the period such status is retained he or she will be taxable as a US citizen or resident and will not be treated as a "covered expatriate" for purposes of *IRC Section 877A(d)(1)* or *IRC Section 877A(f)*.ⁿ¹⁴

Congress changed prior law by making expatriation effective for US tax purposes (and, for covered expatriates, making the alternative tax regime effective in its stead) on the date citizenship is relinquished or permanent resident status is abandoned or revoked.ⁿ¹⁵ Under prior law, *Section 7701(n) of the Internal Revenue Code* provided that a former US citizen or resident who relinquished US citizenship or abandoned or otherwise lost permanent residence status retained the status of a US citizen or resident for federal tax purposes until notification of such expatriation was provided to the IRS,ⁿ¹⁶ as well as the Secretary of State (in the case of a former citizen) or the Secretary of Homeland Security (in the case of a former permanent resident), *IRC Section 7701(n)* was repealed by Section 301 of Pub Law 110-245.ⁿ¹⁷ However, *IRC Section 7701(n)* continues to apply to individuals who relinquished their citizenship or permanent resident status prior to June 17, 2008; that is, such individuals will continue to be taxable as US citizens or residents until the notices required by *IRC Section 7701(n)* are provided, and after that time such individuals will be subject to the alternative tax regime in *IRC Section 877* rather than the regime provided in *IRC Section 877A*.ⁿ¹⁸

[2] The Alternative Tax Regime for Covered Expatriates

[a] The Mark-to-Market Exit Tax.

Under the new alternative tax regime imposed by *IRC Section 877A*, covered expatriates must now pay an exit tax as the price of expatriation. All of the covered expatriate's propertiesⁿ¹⁹ are treated as though they were sold on the day before the expatriation date for fair market value.ⁿ²⁰ To the extent the fair market value of any property exceeds the taxpayer's basis,ⁿ²¹ gain must be recognized in the year of "sale" notwithstanding any other provision of the Internal Revenue Code.ⁿ²² Any loss arising from the deemed "sale" of a property is also allowed to the extent otherwise provided in the Code,ⁿ²³ except that the "wash sale" loss disallowance and other rules in *IRC § 1091* will not be applied.ⁿ²⁴ There is an exclusion amount of \$600,000, to be adjusted annually for inflation; gains "realized" by reason of *IRC Section 877A(a)(1)* are includible in gross income only to the extent the total of such gains exceeds the exclusion amount.ⁿ²⁵

IRC Section 877A(a)(1) only outlines the parameters of the new mark-to-market tax. Until regulations are issued, the *IRS Guidance for Expatriates* fills in the gaps. The *Guidance* provides that the mark-to-market tax covers any interest in property that would be includible in the covered expatriate's gross estate for Federal estate tax purposes if he or she had died on the day before the expatriation date as a citizen or resident of the United States.ⁿ²⁶ The fair market value of each such interest is similarly determined under applicable estate tax principles.ⁿ²⁷ The exclusion amount is allocated pro-rata to each property on which gain is recognized under *IRC Section 877A(a)(2)(A)* ("gain asset") by multiplying the exclusion amount by a fraction, the numerator of which is the built-in gain with respect to the gain asset and the denominator of which is the total built-in gain of all gain assets. If the total gain of all the gain assets is less than the exclusion amount, the exclusion amount allocable to the gain assets is limited to the total *IRC Section 877A(a)(2)(A)* gain.ⁿ²⁸

Example:

A, a covered expatriate, relinquished his citizenship on November 1, 2010. On October 31, 2010, A owned three assets: Asset X had a fair market value of \$2,000,000 and an adjusted basis in A's hands of \$200,000; it thus had a built-in gain of \$1,800,000; Asset Y had a fair market value of \$1,000,000 and an adjusted basis of \$800,000 for a built-in gain of \$200,000; and Asset Z with a fair market value of \$500,000 and an adjusted basis of \$800,000, had a built-in loss of \$300,000. The exclusion amount (\$627,000 for 2010) is allocated between Assets X and Y (no part of the exclusion is allocated to Asset Z since it had a built-in loss) in accordance with the ratios of the built-in gain on each asset to the \$2 million total gain on both assets. Accordingly, 90% (1.8/2.0) of the \$627,000 exclusion amount, or \$564,300, is allocated to Asset X, and 10% of the exclusion amount or \$62,700 is allocated to Asset Y. The amounts of gain includible in income under *IRC Section 877A(a)* are therefore \$1,235,700 for Asset X (\$1,800,000-\$564,300) and \$137,300 for Asset Y (\$200,000-\$62,700). The loss of \$300,000 on Asset Z is also allowable subject to *IRC Section 1211(b)* and other loss limitation provisions of the Code (other than *IRC Section 1091*).ⁿ²⁹

IRC Section 877A(a) provides that the basis of any property deemed sold for purposes of the mark-to-market tax is to be adjusted by the amount of gain or loss realized under that section, without regard to whether all or a portion of the gain was excluded from income by *IRC Section 877A(a)(3)*.ⁿ³⁰ Thus, if in the above example Assets X, Y and Z were US real property interests and were subsequently sold by A at a time when A was a nonresident alien, the basis of Assets X and Y would be increased by \$1.8 million and \$200,000, respectively, without reduction by the portion of the exclusion amounts allocated to those assets. The basis of Asset Z would be reduced by \$300,000, from \$800,000 to \$500,000. Even though A is a nonresident alien, any gain realized (after taking account these adjustments to basis) would be taxable to A under *IRC Section 897*.ⁿ³¹

A covered expatriate may irrevocably electⁿ³² to defer payment of all or part of the mark-to-market tax imposed by *IRC Section 877A(a)* on a property-by-property basis. The amount of the mark-to-market tax attributable to a particular property (when more than one property is deemed sold under *IRC Section 877A(a)*) is determined in a two-step process.

First, compare the covered expatriate's tax liability for the portion of the taxable year that includes the day before the expropriation date after taking all deemed sales triggered by *IRC Section 877A(a)* into account with the tax liability for the same period without taking such deemed sales into account. The difference is the covered expatriate's total tax liability attributable to *Section 877A(a)*. Second, determine the portion of the *IRC Section 877A(a)* tax liability attributable to each property by multiplying the total *IRC Section 877A(a)* tax liability by a fraction, the numerator of which is the gain (if any) included in gross income with respect to the deemed sale of that property (*i.e.* the gain realized reduced by the exclusion amount, but not offset by losses realized in *IRC Section 877A(a)* deemed sales of other properties) and the denominator is the sum of the amounts includible in income with respect to all gain properties. In the example given above, assuming that A's total tax liability for the relevant taxable year is \$500,000, but would have been \$300,000 had the gains and losses from *IRC Section 877A(a)* deemed sales not been taken into account, 90 percent of the \$200,000 *IRC Section 877A(a)* tax liability, or \$180,000 would be deemed attributable to Asset X, and 10 percent of such liability, or \$20,000 to Asset Y, calculated as follows;

Gain recognized on deemed sale of Asset X	\$1,235,700
Gain recognized on deemed sale of Asset Y	\$137,300
Gain recognized on deemed sale of Asset Z	- 0 -
Total gain recognized on all deemed sales	\$1,373,000

IRC Section 877A(a) tax attributable to Asset X: $\$200,000 \times 1,235,700/1,373,000 [.9] = \$180,000$

IRC Section 877A(a) tax attributable to Asset Y: $\$200,000 \times \$137,300/1,373,000 [.1] = \$20,000$

IRC Section 877A tax imposed with respect to gain property may be deferred until the due date (without extensions) of the covered expatriate's return (1) for the taxable year in which the property is sold or otherwise disposed of (including a transfer by gift or in a "tax-free" exchange in which gain or loss is not recognized),ⁿ³³ or (2) for the taxable year that includes the date of death of the covered expatriate, whichever is earlier. Interest on the deferred tax begins to accrue on the due date of the covered expatriate's taxable return (without extensions) for the taxable year that includes the day before the expatriation date,ⁿ³⁴ is calculated at the underpayment rate established under *IRC Section 6621*, and compounds daily under *IRC Section 6622* until the date the tax is paid.

Deferral of the mark-to-market tax requires that the covered expatriate provide "adequate security" for payment of the deferred tax, including a bond or letter of credit.ⁿ³⁵ In addition, the covered expatriate must make an irrevocable waiver of any right under any treaty of the United States which would preclude assessment or collection of any tax imposed by reason of *IRC Section 877A*.ⁿ³⁶ The *IRS Guidance for Expatriates* further provides that the covered expatriate must enter into a "tax deferral agreement" with the IRS, in the form attached as Appendix A to the *IRS Guidance*, and enter a written agreement with a US person to act as the covered expatriate's limited agent, in the form attached to the *IRS Guidance* as Appendix B, to receive communications from the IRS and otherwise act on behalf of the covered expatriate under the provisions of the tax deferral agreement and relevant procedural provisions of the Code.ⁿ³⁷

[b] Taxation of Deferred Compensation Items.

Deferred compensation items are exempt from the mark-to-market tax, but a covered expatriate must make a choice as to whether to include such items in income at their present value as of the day before the expatriation date,ⁿ³⁸ or have the payor of the deferred compensation withhold US tax at a 30 percent rate from subsequent payments.ⁿ³⁹ If the withholding option is chosen, the payor of the deferred compensation must be notified of the covered expatriate's tax status under *IRC Section 877A*, and the covered expatriate must execute an irrevocable waiver of the right to claim any reduction in the 30 percent withholding rate to which he or she may be entitled under any applicable treaty between the United States and the country in which the covered expatriate is or becomes a resident.ⁿ⁴⁰

A deferred compensation item is defined comprehensively for purposes of *IRC Section 877A(d)* to include any interest in a retirement or other type of deferred compensation plan or arrangement permitted under the Internal Revenue Code,ⁿ⁴¹ an interest in a foreign pension plan or similar retirement arrangement or programⁿ⁴², any property or right to property which the covered expatriate has a right to receive in connection with the performance of services to the extent not previously taken into account under or in accordance with *IRC Section 83*.ⁿ⁴³ and a catch-all category, any "item of deferred compensation," which includes any other legally binding right to compensation held by the covered expatriate as of the expatriation date which has not been actually or constructively received but which is payable to the covered expatriate on or after the expatriation date.ⁿ⁴⁴ A deferred compensation item does not, however, include any deferred compensation item to the extent such item is attributable to services performed by the covered expatriate outside the United States at a time when he or she was not a citizen or resident of the United States.ⁿ⁴⁵

A taxable payment of deferred compensation as to which the covered expatriate has validly elected the withholding option, referred to in the statute as an "eligible deferred compensation item,"ⁿ⁴⁶ is taxable to the extent and at the time it would be includible in the gross income of the covered expatriate if such expatriate continued to be subject to tax as a citizen or resident of the United States.ⁿ⁴⁷ If the withholding option is not elected, and the item is not an eligible deferred compensation item (or, as the *IRS Guidance for Expatriates* puts it, is an "ineligible deferred compensation item"), the item becomes taxable as of the day before the expatriation date, in accordance with the following rules (pending the issuance of regulations or further guidance from the IRS):

(1) In the case of any plan or arrangement described in *IRC Section 877A(d)(4)(A), (B) or (C)*, (i.e., all items of deferred compensation other than the receipt of property or the right to receive property as to which *IRC Section 83* applies), an amount equal to the present value of the covered expatriate's accrued benefit is treated as having been received by the covered expatriate on the day before the expatriation date as a distribution under the plan.ⁿ⁴⁸ For this purpose, present value is calculated as follows--

(A) In the case of a defined contribution plan described in *IRC Section 219(g)(5)(A)(i)*, the present value of the covered expatriate's accrued benefit is the account balance.

(B) In the case of a defined benefit plan described in *IRC Section 219(g)(5)(A)(i)*, the present value of the covered expatriate's accrued benefit is determined using the method set forth in section 4.02 of *Rev Proc 2004-37, 2004-1 CB 1099*, determined as of the day before the expatriation date.

(C) In the case of any other deferred compensation item not described above or in *IRC Section 877A(d)(4)(D)*, the present value of the covered expatriate's accrued benefit is determined by applying the principles in Proposed *Treasury Regulation Section 1.409A-4*, except that where the proposed regulations provide for a determination to be made as of the end of the taxable year, such determination shall be made as of the day before the expatriation date, and the present value of the covered expatriate's accrued benefit is determined without regard to any substantial risk of forfeiture.ⁿ⁴⁹

(2) In the case of any propertyⁿ⁵⁰ which the covered expatriate is entitled to receive in connection with the performance of services as described in *IRC Section 877A(d)(4)(D)*, the rights of the covered expatriate to such item will be treated as becoming transferable (within the meaning of *Treasury Regulation Section 1.83-3(d)*) and not subject to a substantial risk of forfeiture (within the meaning of *Treasury Regulation Section 1.83-3(c)*) on the day before the expatriation date; accordingly, the fair market value of the property (determined without regard to any lapse restriction as defined in *Treasury Regulation Section 1.83-3(i)*), reduced by any amount paid for the property, will be includible in income as of such date.ⁿ⁵¹

(3) In the case of any right to receive property in the future which the covered expatriate is entitled to receive in connection with the performance of services as described in *IRC Section 877A(d)(4)(D)*, such as a stock-settled appreciation right or a stock-settled restricted stock unit,ⁿ⁵² such right will be treated as substantially vested as of the day before the expatriation date and, under the cash-equivalency doctrine (see *Cowden v Commissioner*, 289 F2d 20 (5th Cir 1961)), the value of such right generally will be includible in the income of the covered expatriate as of such date. The value of such right is determined by applying principles similar to *Proposed Treasury Regulation Section 1.409A-4*, except that where such proposed regulations provide for a determination to be made as of the end of the taxable year, that determination is to be made as of the day before the expatriation date.ⁿ⁵³

Where the amount of an ineligible item of deferred compensation is included in income under *IRC Section 877A(d)(2)*, an appropriate adjustment should be made to subsequent distributions from the plan to the covered expatriate to prevent the same income from being taxed twice.ⁿ⁵⁴ Further, no early distribution tax is to be imposed with respect to income triggered by reason of *IRC Section 877A(d)(2)*.ⁿ⁵⁵

[c] Taxation of Specified Tax Deferred Accounts.

Like items of deferred compensation, specified tax deferred accounts are not subject to the mark-to-market tax regime. Instead, *IRC Section 877A(e)(1)* provides that the covered expatriate shall be treated as receiving his entire interest in such accounts on the day before the expatriation date. As with items of deferred compensation, appropriate adjustment is made to subsequent distributions from the tax deferred account to take into account the previously taxed income, and no early distribution tax applies by reason of the early recognition of income.ⁿ⁵⁶

The types of tax deferred accounts to which *IRC Section 877A(e)(1)* applies are: an individual retirement plan as defined in *IRC Section 7701(a)(37)*, other than any arrangement described in subsection (k) or (p) of *IRC Section 408* ("simplified employee pensions" and "simple retirement accounts"); a qualified tuition program as defined in *IRC Section 529*; a Coverdell education savings account as defined in *IRC Section 530*; a health savings account as defined in *IRC Section 223*, and an Archer MSA as defined in *IRC Section 220*.ⁿ⁵⁷

[d] Special Rules for Nongrantor Trusts.

A covered expatriate's interest in a trust, other than a trust of which the covered expatriate is considered an owner under *IRC Section 671 et seq.*, is not subject to the mark-to-market tax.ⁿ⁵⁸ However, if the covered expatriate was a beneficiary of such a trust on the day before the expatriation date,ⁿ⁵⁹ two special rules apply to a subsequent distribution of property (including cash) from the trust to the covered expatriate: First, the trustee is required to deduct and withhold 30 percent of that portion of the distribution (referred to as the "taxable portion") that would be includible in the covered expatriate's gross income if he or she were still a citizen or resident of the United States.ⁿ⁶⁰ Second, if the fair market value of such property exceeds its adjusted basis in the hands of the trust, the trust must recognize gain as if the property had been sold to the covered expatriate at its fair market value.ⁿ⁶¹

Example 1:

The Trustee of a complex, nongrantor trust, distributes a painting to A, a covered expatriate who was a beneficiary of the trust on the day before A's expatriation date. The painting is a capital asset and has a basis of \$100,000 and a fair market value of \$400,000. The trust is a domestic trust that excludes gains from the sale or exchange of capital assets from its distributable net income (DNI) under *IRC Section 643(a)(3)*. The trust must include the \$300,000 of capital gain in its gross income and may not deduct that amount under *IRC Section 661* in computing its taxable income under *IRC Section 641*. However, in these circumstances the trust is not required to deduct and withhold tax pursuant to *IRC Section 877A(f)(1)(A)*, nor is A taxable on the \$300,000 capital gain.ⁿ⁶²

Example 2:

The facts are the same as in Example 1, except that the trust is a foreign trust that includes capital gain in DNI pursuant to *IRC Section 643(a)(6)(C)*. Although the trust must include the \$300,000 of capital gain in its gross income, it may deduct that amount under *IRC Section 661* in computing its taxable income under *IRC Section 641*. If A, who is now a nonresident alien, had continued to be subject to tax as a citizen or resident of the United States, the capital gain of \$300,000 would have been includible in A's gross income pursuant to *IRC Section 662*. Therefore, the taxable portion of the trust's distribution to A is \$300,000, and in accordance with *IRC Section 877A(f)(1)(A)*, the trust is required to deduct and withhold 30 percent of \$300,000, or \$90,000, from the distribution to A.ⁿ⁶³

Under *IRC Section 877A(f)(4)(B)*, a covered expatriate is treated as having waived any right to claim any reduction under any treaty with the United States in withholding on any distribution to which *IRC Section 877A(f)(1)(A)* applies unless the covered expatriate agrees to such other treatment as the IRS deems appropriate. In the *IRS Guidance for Expatriates*, a covered expatriate is given the option of avoiding withholding, and preserving his or her right to claim treaty benefits with respect to distributions from the trust, by agreeing to be treated as having received the value of his or her interest in the trust on the day before the expatriation date. To elect this treatment, the covered expatriate must obtain a letter ruling from the IRS as to the value, if ascertainable, of the interest in the trust as of the day before the expatriation date, following the procedures set out in *Rev Proc 2009-4n64* (or a successor publication).ⁿ⁶⁵ Once the ruling is obtained, the covered expatriate has reported and paid tax on the income deemed received as of the day before the expatriation date,ⁿ⁶⁶ and the trustee has received a copy of the letter ruling and a certification that the tax has been paid, no subsequent distributions from the trust to the covered expatriate will be subject to 30 percent withholding and the covered expatriate will not be precluded from claiming treaty benefits with respect to any distributions from the trust.ⁿ⁶⁷

[3] Information Reporting Requirements

Pending the issuance of regulations under *IRC Section 877A*, the Internal Revenue Service has announced that the following requirements apply to covered expatriates that relinquish citizenship or lose permanent resident status on or after June 17, 2008.ⁿ⁶⁸

[a] Tax Returns.

Unless the covered expatriate's expatriation date is January 1, he or she must file a dual status return for the year in which expatriation occurs. This requires that the covered expatriate file Form 1040R (nonresident alien return) with Form 1040 attached as a schedule covering the period from the beginning of the taxable year through the day before the expatriation date.ⁿ⁶⁹ Thereafter, a covered expatriate files only Form 1040NR, except that there is no obligation to file a return for a taxable year if the covered expatriate is fully withheld upon at the source and has no income effectively connected with a trade or business in the United States for that year.ⁿ⁷⁰

[b] Form 8854.

All U.S. citizens who relinquish their U.S. citizenship and all long-term residents who cease to be lawful permanent residents of the United States, whether or not they otherwise qualify as covered expatriates for purposes of *IRC Section 877A*, must file Form 8854 by the due date (including extensions) of the Federal tax return for the taxable year which includes the day before their expatriation date in order to certify, under penalties of perjury, that they have been in compliance with all federal tax laws during the five years preceding the year of expatriation. Individuals who fail to make such certification will be treated as covered expatriates within the meaning of *IRC Section 877A(g)* even though they do not meet the tax liability test or the net worth test.ⁿ⁷¹

Individuals who meet the tax liability or net worth test, and are therefore considered covered expatriates for purposes of *IRC Section 877A*, must also include the following on their Form 8454 for the taxable year which includes the day before their expatriation date:

- Identification of all properties as to which the covered expatriate elects to defer the mark-to-market tax, the amount of tax attributable to each such property, and an irrevocable election to waive any right under any US treaty that would preclude assessment or collection of such tax.
- Identification of any property held by the covered expatriate on the date he or she first became a resident of the United States, as well as on the day before the expatriation date, as to which the covered expatriate elects not to apply the step-up in basis rule in *IRC Section 877A(h)(2)* for purposes of the mark-to-market tax imposed by reason of *IRC Section 877A(a)*.
- Identification of each item of deferred compensation as to which the covered expatriate elects 30 percent withholding rather than immediate taxation and an irrevocable waiver of any right to claim a reduction in the 30 percent withholding rate with respect to each such item.ⁿ⁷²

A covered expatriate who had an interest in one or more nongrantor trusts on the day before the expatriation date must also file Form 8454 annually to report any distributions received from such trust(s) or to certify that no distributions were received. However, if the covered expatriate makes an election on Form 8454 to be treated as having received the value of his or her entire interest in the trust on the day before the expatriation date, and follows the procedures required by the Internal Revenue Service to implement such an election, the covered expatriate will thereafter be relieved of this reporting obligation.ⁿ⁷³

[c] Form W-8CE.

A covered expatriate who has a deferred compensation item, a specified tax deferred account, or an interest in a nongrantor trust must file Form W-8CE with the relevant payor on the earlier of (1) the day prior to the first distribution on or after the expatriation date or (2) 30 days after the covered expatriate's expatriation date.ⁿ⁷⁴

In the case of an eligible deferred compensation item, Form W-8CE provides notice to the payor that the individual is a covered expatriate who has waived treaty benefits and that taxable payments are therefore subject to 30 percent withholding. In the case of an ineligible deferred compensation item, Form W-8CE provides notice to the payor that the individual is a covered expatriate who is treated as having received an amount equal to the present value of his or her accrued benefit on the day before the expatriation date. Receipt of Form W-8CE requires the payor to provide a written statement to the covered expatriate within 60 days setting forth the present value of the covered expatriate's accrued benefit on the day before the expatriation date.ⁿ⁷⁵

Similarly, in the case of a specified tax deferred account, Form W-8CE provides notice to the payor that the individual is a covered expatriate who is treated as having received a distribution of his or her entire interest in the account on the day before his or her expatriation date. Just as in the case of an ineligible deferred compensation item, the payor must provide a written statement to the covered expatriate within 60 days of receiving Form W-8CE setting forth the amount of the covered expatriate's account balance on the day before the expatriation date.ⁿ⁷⁶

Finally, in the case of an interest in a nongrantor trust of which the covered expatriate was a beneficiary on the day before the expatriation date, Form W-8CE provides notice to the trustee that the individual is a covered expatriate. The covered expatriate is deemed to have waived treaty benefits with respect to future distributions from the trust unless the covered expatriate checks a box on Form W-8CE certifying that he or she will elect on Form 8854 to pay tax currently on the value of his or her interest in the trust. If the box is checked, the trustee must, within 60 days of receipt of Form W-8CE, provide the covered expatriate with the information needed to calculate the value of his or her interest in the

trust as of the day before the expatriation date. The covered expatriate is subject to 30 percent withholding on the taxable portion of each distribution from the trust on or after the expatriation date until such time as the trustee receives a copy of the letter ruling and the covered expatriate's certification in writing under penalties of perjury that the tax owed on the value of the interest in the trust has been paid to the IRS.ⁿ⁷⁷

FOOTNOTES:

(n1)Footnote 1. See also *Notice 2009-85, 2009-45 IRB 598* ("Guidance for Expatriates Under Section 877A"), hereafter referred to as "*IRS Guidance for Expatriates*."

(n2)Footnote 2. In fact, *IRC § 877A(g)(1)(A)* incorporates the rules in *IRC § 877(a)(2)* by reference.

(n3)Footnote 3. *IRC Section 877A(g)(4)* recognizes four types of events that will result in relinquishment of citizenship in a manner that is effective for US tax purposes. These are:

(A) Renouncing US nationality before a diplomatic or consular officer of the United States pursuant to paragraph (5) of *section 349(a) of the Immigration and Nationality Act (8 USC 1481(a)(5))*,

(B) Furnishing the United States Department of State with a signed statement of voluntary relinquishment of United States nationality confirming the performance of an act of expatriation specified in paragraph (1), (2), (3), or (4) of *section 349(a) of the Immigration and Nationality Act (8 USC 1481(a)(1)-(4))*,

(C) Issuance by the United States Department of State of a certificate of loss of nationality, or

(D) Cancellation by a court of the United States of a naturalized citizen's certificate of naturalization.

A renunciation or voluntary relinquishment under (A) or (B) must be subsequently approved by the issuance of a certificate of loss of nationality by the United States Department of State, but is effective for tax purposes as of the date the individual's renunciation or voluntary relinquishment of citizenship is made.

(n4)Footnote 4. A "long-term resident" is any individual (other than a citizen of the United States) who is a lawful permanent resident of the United States in at least 8 taxable years during the period of 15 taxable years ending with the taxable year in which such individual ceases to be a lawful permanent resident. See *IRC § 877A(g)(5)*, incorporating by reference *IRC § 877(e)(2)*. A "lawful permanent resident" of the US is defined in *IRC § 7701(b)(6)*, discussed in n 5 below.

(n5)Footnote 5. Under *IRC § 7701(b)(6)*, an individual is a lawful permanent resident of the United States for any year in which such individual has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with US immigration laws (*i.e.*, has a "green card") provided such status is not revoked or abandoned in that year. In addition, an individual ceases to be a lawful permanent resident in any year in which such individual is treated as a resident of a foreign country under the tie-breaker provisions of a tax treaty between the US and such foreign country, does not waive the benefits of the treaty, and notifies the IRS of the commencement of such treatment. Notification is to be made on IRS Forms 8833 and 8854. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 599* .

(n6)Footnote 6. See *IRC § 877A(g)(1)*, which references the provisions of *IRC §§ 877(a)(2)(A), (B), and (C)*.

(n7)Footnote 7. For purposes of this and the other two criteria, as well as the other provisions of *IRC § 877A*, an individual's "expatriation date" is the date on which such individual relinquishes citizenship (the earliest to occur of the events referred to in note 3, *supra*) or the date on which a long-term resident other than a citizen ceases to be a lawful

permanent resident of the United States. *IRC § 877A(g)(3)*.

(n8)Footnote 8. *IRC § 877(a)(2)(A)*. The figure satisfying the tax liability test is adjusted for inflation each year, rounded to the nearest multiple of \$1,000. *IRC § 877(a)(2)* (flush language). \$149,000 is the adjusted amount for 2010. See Rev Proc 2009-50, 2009-45 *IRB* 617, 624 (Nov 9, 2009) , § 3.26. The figure for 2009 was \$145,000. *Rev Proc 2008-66*, 2008 *IRB* 1107 § 3.26. The individual's income tax liability is determined under *IRC § 38(c)(1)*, and in the case of an individual filing a joint return must take into account the entire net income tax reflected on such return. *Notice 97-19*, 1997-1 *CB* 394, 1997 *IRB LEXIS* 89, *10 .

(n9)Footnote 9. *IRC § 877(a)(2)(B)*. The provisions of *Notice 97-19* , may be used for guidance in applying the net worth as well as the tax liability test. *IRS Guidance for Expatriates*, *Notice 2009-85*, 2009-45 *IRB* at 599 . Pursuant to *Notice 97-19* , for purposes of the net worth test, an individual is considered to own any interest in property that would be taxable as a gift under Chapter 12 of the Code if the individual were a citizen or resident of the US and transferred the interest immediately prior to the expatriation date (without regard, however, to the various gift tax deductions and exclusions in *IRC §§ 2503(b) through (g)*, the spousal gift-splitting provisions in *IRC § 2513*, or the charitable and spousal deductions in *IRC §§ 2522-2524*). Further, the individual's interests in property are to be valued using the valuation principles of *IRC Section 2512* and the regulations thereunder without regard to any prohibitions or restrictions on such interest. An individual's net worth includes beneficial interests in trusts, and *Notice 97-19* provides special rules for valuing such interests. *Notice 97-19* , § III.

(n10)Footnote 10. *IRC § 877(a)(2)(C)*. Federal tax obligations include but are not limited to obligations to file income tax, employment tax, gift tax and information returns, if applicable, and obligations to pay all relevant tax liabilities, interest, and penalties. The certification must be made on IRS Form 8854, which is to be filed by the due date for the taxpayer's return for the taxable year that includes the day before his expatriation date. *Notice 2009-85*, 2009-45 *IRB* at 599 .

(n11)Footnote 11. *IRC 877A(g)(1)(B)*. Both exceptions have been modified and liberalized somewhat as compared with the "dual citizen" and "certain minors" exceptions under prior law. See *IRC § 877(c)* and § 20.07A[1] below. As under prior law, however, the individual must still certify compliance with all federal tax obligations; failure to do so will result in the individual's meeting the non-compliance test of *IRC § 877(a)(2)(C)*, which makes the individual subject to the alternative tax regime notwithstanding the "dual citizen" and "minors" exceptions.

(n12)Footnote 12. *IRC § 877A(g)(1)(B)(i)*.

(n13)Footnote 13. *IRC § 877A(g)(1)(B)(ii)*.

(n14)Footnote 14. *IRC § 877A(g)(1)(C)*, *IRC § 877A(d)(1)* subjects certain payments of deferred compensation to covered expatriates to withholding tax, while *IRC § 877A(f)* does the same for certain distributions to expatriates from nongrantor trusts. See §§ 20.07[2][b] and 20.07[2][d] below.

(n15)Footnote 15. See *IRC § 877A(g)(3)* and (4); *IRC § 7701(a)(50)*.

(n16)Footnote 16. See *IRC § 6039G*.

(n17)Footnote 17. 122 *Stat* 1638 (2008). Section 301 of Pub Law 110-245, also known as the Heroes Earnings Assistance and Relief Tax Act of 2008 (or "HEART") also added section *IRC § 877A*.

(n18)Footnote 18. See *IRS Guidance for Expatriates*, *Notice 2009-85*, 2009-45 *IRB* at 604-605 .

(n19)Footnote 19. With the exception of deferred compensation items, specified tax deferred accounts, and interests in nongrantor trusts. *IRC § 877A(c)*. All of these items are dealt with elsewhere in *IRC § 877A*. See §§ 20.07[2][b], [c], and [d] below.

(n20)Footnote 20. *IRC § 877A(a)(1)*.

(n21)Footnote 21. *IRC § 877A(h)(2)* provides that, solely for purposes of the mark-to-market tax, unless the taxpayer irrevocably elects otherwise, property which was held by an individual on the date the individual first became a resident of the United States (within the meaning of *IRC § 7701(b)*) is treated as having a basis not less than the fair market value of such property on such date. In the *IRS Guide for Expatriates*, the IRS and Treasury Department announced that they intend to exercise their regulatory authority to exclude from this step-up-in-basis rule United States real property interests within the meaning of *IRC § 897(c)* ("USRPIs"), and property used or held for use in connection with the conduct of a trade or business within the United States, unless such trade or business was not carried on through a "permanent establishment" in the United States within the meaning of an income tax treaty between the US and the country in which the taxpayer resided before becoming a resident of the United States. *IRS Guide for Expatriates, Notice 2009-85, 2009-45 IRB at 602* .

(n22)Footnote 22. *IRC § 877A(a)(2)(A)*.

(n23)Footnote 23. For example, a net capital loss is subject to the limitations on the deductibility of capital losses in *IRC § 1211(b)*. See Chapter 2, § 2.05[2][b].

(n24)Footnote 24. *IRC § 877A(a)(2)(B)*. The wash sale provisions are discussed in § 2.07[3].

(n25)Footnote 25. *IRC § 877A(a)(3)*. The exclusion amount is \$626,000 in 2009, *Rev Proc 2008-66* , § 3.27, and \$627,000 in 2010. *Rev Proc 2009-50, 2009-45 IRB 617* , § 3.27.

(n26)Footnote 26. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 599-600* , § 3A. Credits allowed against the estate tax in *IRC § 2010-2016*, inclusive, are disregarded. In addition, a beneficial interest in a trust which is not includible in the covered expatriate's gross estate is considered a property "sold" for purposes of the mark-to-market tax, and is to be valued in accordance with the special rules in *Notice 97-19* .

(n27)Footnote 27. Specifically, (a) the special valuation rules in *IRC § 2701-2704*, applicable to certain interests in corporations, partnerships and trusts, apply for purposes of *IRC § 877A* as if the covered expatriate's interests subject to those provisions were being transferred to family members; (b) the covered expatriate's tax liability as a result of *IRC § 877A* or otherwise, is not taken into account; and (c) *IRC §§ 2055, 2056, 2056A, and 2057* (concerning charitable contributions, bequests to a surviving spouse, special treatment of qualified domestic trusts and special deductions for interests in a family-owned business) are not be taken into account. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 600-601* , § 3B.

(n28)Footnote 28. *Id.*

(n29)Footnote 29. See *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 600-601* .

(n30)Footnote 30. *IRC § 877A(a)(2)* (flush language).

(n31)Footnote 31. See § 20.06[2][a], *supra*.

(n32)Footnote 32. Although *IRC § 877A(b)(6)* provides that an election to defer payment of *IRC § 877A* tax with respect to a property, once made, is irrevocable, the *IRS Guide for Expatriates* states that a covered expatriate may pay any tax deferred under *IRC § 877A(b)*, together with accrued interest, at any time. See *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 602* .

(n33)Footnote 33. The IRS has, but so far has not exercised, authority to allow deferral to continue when property is disposed of in a transaction in which gain is not recognized in whole or in part. *IRC § 877A(b)(1)*.

(n34)Footnote 34. See *IRC § 877A(b)(7)* (date on which interest begins to accrue to be determined without regard

to the deferral allowed by *IRC § 877A(b)*.

(n35)Footnote 35. *IRC § 877A(b)(4)*.

(n36)Footnote 36. *IRC § 877A(b)(5)*.

(n37)Footnote 37. See *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 603, 614-617*.

(n38)Footnote 38. See *IRC § 877A(d)(2)*.

(n39)Footnote 39. See *IRC § 877A(d)(1)*. If the payor of the deferred compensation item is not a US person, such person must elect to be treated as a US person for purposes of assuming the withholding obligation and meet such other requirements as the IRS may provide to ensure that the withholding obligation is met. *IRC § 877A(d)(3)(A)(ii)*. The payor of the deferred compensation, as well as the covered expatriate, becomes liable for payment of the tax under the withholding option. See *IRC § 1461; IRC § 877A(d)(6)(A); IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 607*. An item of deferred compensation subject to withholding under *IRC § 877A(d)(1)* is not also subject to withholding under *IRC § 1441* (applicable to US payors of certain types of income (including wages) from US sources paid to nonresident aliens). *IRC § 877A(d)(6)(C)*.

(n40)Footnote 40. See *IRC § 877A(d)(3)(B)*. The decision whether to recognize deferred compensation immediately or accept 30 percent withholding on subsequent payments is made on an item-by-item basis, so that some deferred compensation items may be includible in income immediately while others are subject to withholding. The IRS must be notified on Form 8854 of each deferred compensation item with respect to which the withholding option is elected, which must be filed with the covered expatriate's tax return for the taxable year which includes the day before the expatriation date.

(n41)Footnote 41. *IRC § 877A(d)(4)(A)* refers to "any interest in a plan or arrangement described in *IRC § 219(g)(5)*," which includes (i) a plan described in *IRC § 401(a)* that includes a trust exempt from tax under *IRC § 501(a)*; (ii) an annuity plan described in *IRC § 403(a)*; (iii) an employee plan established by the United States or by a State or political subdivision, or a federal or State agency or instrumentality, but excluding an eligible deferred compensation plan within the meaning of *IRC § 457(b)*; (iv) an annuity contract described in *IRC § 403(b)*; (v) a simplified employee pension within the meaning of *IRC § 408(k)*; (vi) a simplified retirement account within the meaning of *IRC § 408(p)*; and a trust described in *IRC § 501(c)(18)*. See *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 605*.

(n42)Footnote 42. *IRC § 877A(d)(4)(B)*.

(n43)Footnote 43. *IRC § 877A(d)(4)(D)*. Property is taken into account under or in accordance with *IRC § 83* to the extent that, on or before the expatriation date, property transferred to the covered expatriate in connection with the performance of services has become substantially vested or the covered expatriate has made a valid election under *IRC § 83(b)* to include the value of such property in income, and the covered expatriate has in fact accurately reported the value of such property in his federal income tax return and paid all taxes due in respect of such return (or, if the return is due after the expatriation date, the income has been subject to appropriate tax withholding. See *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 605*.

(n44)Footnote 44. See *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 605-606*. "An item of deferred compensation generally includes an amount,...whether or not substantially vested, that constitutes nonqualified deferred compensation for purposes of *section 404(a)(5)* (determined without regard to *§ 1.404 (b)-1T, Q&A 2*), including a cash-settled stock appreciation right, a phantom stock arrangement, a cash-settled restricted stock unit, an unfunded and unsecured promise to pay money or other compensation in the future (other than such a promise to transfer property in the future), and an interest in a trust described in *section 402(b)(1)* or *(4)* (commonly referred to as a secular trust)." *Id.*

(n45)Footnote 45. *IRC § 877A(d)(5)*. Pending further guidance from the IRS, taxpayers may use any reasonable method to determine the portion of a deferred compensation item that is attributable to services performed outside the United States while the covered expatriate was not a citizen or resident of the United States provided it is consistent with existing guidance (including *Treas Reg § 1.861-4 (b) (2)*, *Revenue Ruling 79-388*, and *Revenue Procedure 2004-37*) and based upon a reasonable, good faith interpretation of *IRC § 877A (d) (5)*. See *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 607*.

(n46)Footnote 46. See *IRC § 877A(d)(3)*.

(n47)Footnote 47. *IRC § 877A(d)(1)(B)*. However, the tax is deemed imposed under *IRC § 871* (tax on US source income of nonresident alien individuals). *IRC § 877A(d)(6)(B)*. Any amount due under *IRC § 871* that is not paid by means of withholding must be reported by the covered expatriate on the income tax return for the relevant taxable year. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 607*.

(n48)Footnote 48. *IRC § 877A(d)(A)(i)*; *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 606*.

(n49)Footnote 49. *Id.*

(n50)Footnote 50. Property is to be given the meaning set out in *Treas Reg § 1.83-3(e)*. See *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 606*.

(n51)Footnote 51. *IRC § 877A(d)(A)(ii)*; *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 606-607*.

(n52)Footnote 52. A stock appreciation right is a right to compensation based on the appreciation in value of a specified number of shares of stock or other property during a specified period (such as a period beginning on the date of grant or some other specified date and the date of exercise of such right). A stock appreciation right is a stock-settled stock appreciation right to the extent that the compensation payable under such right is in the form of a transfer of shares of stock or other property or a right to receive property in the future. A restricted stock unit is a right to receive compensation in cash, shares of stock, or other property following the satisfaction of a specified vesting condition. A restricted stock unit is a stock-settled restricted stock unit to the extent that the compensation payable under such restricted stock unit is in the form of a transfer following the satisfaction of such vesting condition of shares of stock or other property or a right to receive property in the future. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 606*.

(n53)Footnote 53. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 607*.

(n54)Footnote 54. *IRC § 877A(d)(2)(C)*. Amounts included in gross income should be treated as investments in the contract in the case of distributions to which *IRC § 72* applies, or, where distributions are received pursuant to deferred compensation items to which *Prop Treas Reg § 1.409A-4* would apply, the adjustment should be made pursuant to principles similar to those of *Prop Treas Reg § 1.409A-4*. In other cases, any reasonable method may be used to determine the amount of the adjustment so long as it is consistently applied to all such ineligible deferred compensation items with respect to the covered expatriate; does not reduce the amount includible in the covered expatriate's income below zero; and does not result in an aggregate amount of such adjustment that, when combined with amounts treated as an investment in the contract or determined pursuant to principles similar to those in *Prop Treas Reg § 1.409A-4* exceeds the amount included in the covered expatriate's income pursuant to *IRC § 877A(d)(2)(A)*. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 607*.

(n55)Footnote 55. *IRC § 877A(d)(2)(B)*. An early distribution tax includes the taxes imposed by *IRC §§ 72(t), 220(e)(4), 223(f)(4), 409A(a)(1)(B), 529(c)(6), or 530(d)(4)*. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 607*.

(n56)Footnote 56. *IRC § 877A(e)(1)(B) and (C)*.

(n57)Footnote 57. *IRC § 877A(e)(2).*

(n58)Footnote 58. *See IRC § 877A(c)(3) and 877A(f)(3)*

(n59)Footnote 59. As required by *IRC § 877A(f)(5)*. A beneficiary is defined by the *IRS Guidance for Expatriates* as "a person (a) who is entitled or permitted, under the terms of the trust instrument or applicable local law, to receive a direct or indirect distribution of trust income or corpus (including, for example, a distribution in discharge of an obligation of that person), (b) with the power to apply trust income or corpus for his or her own benefit, or (c) to whom the trust income or corpus could be paid if the trust or the current interests in the trust were then terminated." *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 610 .*

(n60)Footnote 60. *IRC § 877A(f)(1)(A).*

(n61)Footnote 61. *IRC § 877A(f)(1)(B)*. If a nongrantor trust becomes a grantor trust on or after the expatriation date, the conversion will be deemed to be a taxable distribution to the covered expatriate subject to *IRC § 877A(f)(1)* to the extent of the portion of the trust of which the covered expatriate is treated as the owner. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 610 .*

(n62)Footnote 62. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 610 (Ex 20).*

(n63)Footnote 63. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 610 (Ex 21).*

(n64)Footnote 64. *2009-1 IRB 118 .*

(n65)Footnote 65. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 610 .* The covered expatriate will not be able to make the election if the IRS concludes that the value of the interest in the trust did not have an ascertainable value as of the day before the expatriation date.

(n66)Footnote 66. Any tax withheld from trust distributions under *IRC § 877A(f)(1)(A)* prior to receipt of the letter ruling will be deducted from the tax due on the value of the covered expatriate's interest in the trust as of the day before the expatriation date. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 610-611 .*

(N67)Footnote 67. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 611 .*

(n68)Footnote 68. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 611-612 .*

(n69)Footnote 69. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 611 ; Treas Reg § 1.6012-1(b)(2)(ii)(b).*

(n70)Footnote 70. *Treas Reg § 1.6012-1(b)(1) and (2).*

(n71)Footnote 71. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 611 .*

(n72)Footnote 72. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 611-612 .*

(n73)Footnote 73. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 611 .*

(n74)Footnote 74. *IRS Guidance for Expatriates, Notice 2009-85, 2009-45 IRB at 612 .*

(n75)Footnote 75. *Id.*

(n76)Footnote 76. *Id.*

(n77)Footnote 77. *Id.*



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Taxation of Securities Transactions

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CHAPTER 20 Foreign Securities and Foreign Shareholders

2-20 Taxation of Securities Transactions § 20.06A

§ 20.06A Expatriation by United States Citizens and Residents Before June 17, 2008--The Alternative Tax Regime Under IRC Section 877

Prior to the enactment of legislation passed in 1996, an individual who relinquished his or her United States citizenship with a principal purpose of avoiding United States taxes was subject to tax on his or her United States source income at the rates applicable to United States citizens, rather than the rates applicable to other nonresident aliens, if the result was a higher United States tax liability. In addition, the scope of items treated as United States source income was broader than those items normally considered to be United States source income.

The rules were amended in 2004, in part, to replace the subjective determination that tax avoidance was a principal purpose for expatriation with one that is more objective. The new test applies to individuals who relinquish their United States citizenship or terminate long-term residency after June 3, 2004.

[1] Persons Covered by the Expatriation Rules

Prior to the 1996 legislation, the expatriation rules applied only to United States citizens who lost their citizenship. Under *IRC Section 877(e)(1)*, the expatriation rules are extended to any long-term resident who ceases to be a lawful permanent resident of the United States (loses green-card status) or is treated as a resident of a foreign country under a tie-breaker provision in a tax treaty with the United States (and the long-term resident does not waive the benefits of the treaty applicable to residents of the foreign country). A long-term resident under the 1996 legislation is any individual (other than a citizen of the United States) who is a lawful permanent resident of the United States in at least eight taxable years during the period of 15 taxable years ending with the year of termination of residence.ⁿ¹ However, an individual is not treated as a lawful permanent resident for any taxable year during the 15 year period if the individual is treated as a resident of another country under a tie-breaker provision of a treaty and does not waive the benefits of the treaty.

The expatriation rules of *IRC Section 877(a)(1)* applied to any individual, who within the ten-year period immediately preceding the close of the taxable year, lost United States citizenship, if (a) the average annual net income tax of the individual for the five-year period ending before the date of loss of United States citizenship was greater than \$124,000, (b) the net worth of the individual as of that date was \$2 million or more, or (c) the individual failed to certify under penalties of perjury that he had met the requirements of the tax laws for the five preceding taxable years or failed to submit such evidence of compliance as the Service required.ⁿ²

The expatriation rules of *IRC Section 877* did not apply to an individual if the individual was born with dual citizenship.ⁿ³ A second exception applied (1) to any individual who became a citizen of the United States at birth, (2) if neither parent of the individual was a citizen of the United States at the time of the individual's birth, (3) if the loss of United States citizenship occurred before the individual attained the age of 18, and (4) if the individual was not present in the United States for more than 30 days during any calendar year that is one of the ten calendar years preceding the individual's loss of citizenship.ⁿ⁴

[2] Tax Consequences of Expatriation

Under *IRC Section 877(a)(1)*, a person who came within the ambit of the expatriation rules prior to June 17, 2008 is subject to tax on United States source income and gains at the rates applicable to United States citizens for the ten-year period following the close of the taxable year in which expatriation occurs, if this results in a tax liability greater than the tax that would normally be imposed on the nonresident alien under *IRC Section 871*.ⁿ¹ For this purpose, gross income includes both income from United States sources that is not effectively connected with the conduct of a trade or business within the United States and income that is so connected.ⁿ² In computing taxable income, the following deductions are allowed: (1) deductions connected with includable gross income, (2) deductions for casualty losses suffered on property located within the United States, (3) charitable deductions, (4) personal exemptions, except that only one exemption is allowed unless the taxpayer is a resident of a contiguous country, and (5) deductions for losses not connected with a trade or business if incurred in a transaction entered into for profit, but only if any profit that might have resulted from the transaction would have been included in gross income; no capital loss carryover is allowed.ⁿ³

Example:

On December 31, 2004, A, a former United States citizen, expatriated under circumstances that made A subject to the rules of *IRC Section 877(a)(1)*. In 2005, A earns \$200,000 of United States source dividends and \$100,000 of United States source interest income that qualifies as portfolio interest under *IRC Section 871(h)*. Under *IRC Section 871*, the tax that normally is imposed on a nonresident alien having the same amount of income as A is \$60,000, or 30 percent of the dividend income of \$200,000; no tax is due on the portfolio interest.

Because A is subject to *IRC Section 877(a)(1)*, a second computation has to be made using the rates applicable to United States citizens. Assume that A is entitled to claim deductions of \$40,000 under *IRC Section 877(b)(2)*, and that A is a single taxpayer. The tax due on an unmarried United States taxpayer with net income of \$260,000 (\$300,000 of gross income less \$40,000 of allowable deductions) is \$83,732. A must pay this higher tax because it exceeds the amount computed under *IRC Section 871*.

A special source rule, contained in *IRC Section 877(d)(1)*, treats the following items of gross income as United States source income: (a) gains on the sale or exchange of property (other than stock or debt obligations) located within the United States, (b) gain on the sale or exchange of stock issued by a domestic corporation or debt obligations of United States persons or of the United States, a state or political subdivision thereof, or of the District of Columbia, and (c) income or gain derived from stock in a controlled foreign corporation (a corporation in which the expatriate owned, or is considered as owning, at any time during the two-year period ending on the date of loss of citizenship more than 50 percent of the total combined voting power or total value of the stock of the corporation) to the extent the income or gain does not exceed the earnings and profits attributable to the stock that were earned or accumulated before the loss of citizenship and during periods that the stock ownership requirements were met.

In addition to the special source rules of *IRC Section 877(d)(1)*, *IRC Section 877(d)(2)* provides that any exchange that normally would be treated as a nonrecognition exchange is transformed into a taxable transaction taking place in the year of exchange if the income derived from the property transferred was or would have been United States source

income and the income derived from the property acquired would be foreign source income; the amount realized on the transaction is the fair market value of the transferred property. However, immediate gain recognition is not required if the expatriate enters into an agreement with the Service that specifies any income or gain derived from the property acquired in the exchange (or any property that has a basis determined in whole or part by reference to that property) during the ten-year period will be treated as from United States sources.ⁿ⁴ If the property transferred in the exchange is disposed of by the transferee, the agreement will terminate and any gain that was not recognized because of the agreement must be recognized as of the date of the disposition.ⁿ⁵ Regulations may require the removal of appreciated tangible property from the United States, and any other occurrence that (without recognition of gain) results in a change in the source of income or gain from sources within the United States to foreign sources to be treated as an exchange on which gain is recognized immediately.ⁿ⁶

*Notice 97-19*ⁿ⁷ provides that *IRC Section 877(d)(2)* must be applied using a 15-year period beginning five years prior to expatriation. In addition, removal of appreciated tangible personal property with an aggregate fair market value in excess of \$250,000 must be treated as an exchange to which *IRC Section 877(d)(2)* applies. Any gain derived from removal of property with an aggregate fair market value of \$250,000 or less during the 15-year period will not be taxable under *IRC Section 877*. If an individual removes property with an aggregate fair market value in excess of \$250,000 during the 15-year period, the individual must recognize a pro rata portion of the gain attributable to the value in excess of \$250,000 unless the individual enters into a gain recognition agreement. A pro rata portion of the gain must be calculated by multiplying the total gain on the removed property by a fraction, the numerator of which is the excess of the aggregate fair market value of all removed property over \$250,000 and the denominator of which is the aggregate fair market values of all removed property. Removal of appreciated intangible property during the five-year period prior to expatriation will not be treated as an exchange if the removal occurred prior to February 6, 1995.

If an expatriate contributes property during the 10-year period beginning on the date of loss of United States citizenship to a corporation that would be a controlled foreign corporation in which the individual would be a United States shareholder if still a citizen, and income derived from the property immediately before the contribution was or would have been from sources within the United States, any income or gain from the property (or any other property that has a basis determined in whole or part by reference to the contributed property) received or accrued by the corporation is treated as received or accrued by the expatriate rather than the corporation.ⁿ⁸ The foregoing rule does not apply to the extent that the property is treated as sold by the corporation for purposes of gain recognition pursuant to the gain deferral agreement mentioned above. If stock in the corporation to which property has been contributed (or any other stock that has a basis determined in whole or part by reference to such stock) is disposed of during the ten-year period and while the contributed property is held by the corporation, a pro rata share of the property (determined on the basis of the value of the stock) is treated as sold by the corporation immediately before the disposition.ⁿ⁹

An expatriated individual, who normally would be subject to the rules of *IRC Section 877(a)(1)*, will be subject to the rules governing citizens and residents of the United States for any taxable year during the ten-year period prior to the close of the taxable year in which the individual is present in the United States for more than 30 days.ⁿ¹⁰ There are three exceptions to this physical presence rule. First, up to 30 days of physical presence in the United States in any taxable year can be disregarded if the individual is performing services in the United States on that day for an employer, unless the employer is related, or the employer fails to meet such requirements as the Service may prescribe by regulations to prevent avoidance of the physical presence rule.ⁿ¹¹ Second, the physical presence rule does not apply to an expatriated individual if (a) the individual becomes a citizen or resident of the country in which the individual, the individual's spouse, or either of the individual's parents were born, and (b) the individual becomes fully liable for income tax in that country.ⁿ¹² Third, an individual is not subject to the physical presence rule if, for each year in the ten-year period ending on the date of loss of United States citizenship or termination of residence, the individual was present in the United States for 30 days or less.ⁿ¹³ It should be noted that the general rule applies even though the individual could meet one of the exceptions for days of physical presence under *IRC Section 7701(b)*.

[3] Information Reporting Requirements

Any person who loses United States citizenship and becomes subject to *IRC Section 877* must provide a statement that contains the following information: (1) the taxpayer's taxpayer identification number, (2) the mailing address of the individual's principal foreign residence, (3) the foreign country in which the individual resides, (4) the foreign country of which the individual is a citizen, (5) information detailing the income, assets, and liabilities of the individual, (6) the number of days during any portion of which the individual was physically present in the United States during the taxable year, and (7) such other information as may be prescribed in regulations.ⁿ¹

An expatriate who fails to provide the required statement, fails to include all of the required information, or includes incorrect information is subject to a penalty for each year (of the ten-year period beginning on the date of loss of United States citizenship) during any portion of which such failure continues of \$10,000, unless the failure is due to reasonable cause and not to willful neglect.ⁿ²

The person or court to whom the statement must be furnished is required to provide the Service with a copy of the statement or the name (and other identifying information) of any individual who fails to furnish the required statement.ⁿ³ The names of individuals who lose United States citizenship and become subject to *IRC Section 877(a)* or *Section 877A* in each calendar quarter must be published in the Federal Register not later than 30 days after the close of the quarter.ⁿ⁴

FOOTNOTES:

(n1)Footnote 1. *IRC § 877(e)(2)*.

(n2)Footnote 2. *IRC § 877(a)(1), (2)*. If the loss of citizenship occurs in any calendar year after 2004, the \$124,000 amount will be increased by the cost-of-living adjustment determined under *IRC § 1(f)(3)*, using 2003 as the base year.

An individual's net income tax is the sum of the individual's regular tax liability and alternative minimum tax liability reduced by certain nonrefundable personal credits and the foreign tax credit. *IRC § 38(c)(1)*.

For purposes of the net worth test, an individual is considered to own any interest in property that would be taxable as a gift for federal gift tax purposes if the individual were a citizen or resident of the US who transferred the interest immediately before expatriation. In determining the values of interests in property for purposes of the net worth test, individuals must use the valuation principles of *IRC § 2512* and the regulations thereunder without regard to any prohibitions or restrictions on the interest. *Notice 97-19, 1997-1 CB 394*.

(n3)Footnote 3. *IRC § 877(c)(1), (2)(A)*. An individual has dual citizenship if (i) the individual was born a citizen of the US and a citizen of another country, and continues to be a citizen of the other country, and (ii) the individual has had no substantial contacts with the US. An individual is treated as having no substantial contacts with the US only if the individual was never a resident of the US (as defined in *IRC § 7701(b)*, discussed in § 20.06[1][b]), has never held a US passport, and was not present in the US for more than 30 days during any calendar year that is one of the ten calendar years preceding the individual's loss of US citizenship. *IRC § 877(c)(2)(B)*.

(n4)Footnote 4. *IRC § 877(c)(1), (3)*.

(n5)Footnote 1. In determining whether any gain from the sale or exchange of property is US source income, the running of the ten-year period is suspended for any period during which the expatriate's risk of loss with respect to the property is substantially diminished by the holding of a "put" with respect to the property (or similar property), the holding by another person of a right to acquire the property, a short sale, or any other transaction. *IRC § 877(d)(3)*.

The taxpayer is entitled to a credit for any income, war profits, and excess profits taxes paid to any foreign country or possession of the US on any income of the taxpayer on which tax is imposed solely by reason of *IRC § 877(a)*. *IRC § 877(b)*.

(n6)Footnote 2. *IRC §§ 877(b)(1), 872(a).*

(n7)Footnote 3. *IRC §§ 877(b)(2), 873(b).*

(n8)Footnote 4. Guidance on gain recognition agreements can be found in *Notice 97-19, 1997-1 CB 394* .

(n9)Footnote 5. To the extent provided in regulations, the ten-year period can be extended to a 15-year period beginning five years before the loss of US citizenship. In the case of any exchange occurring during the additional five-year period, any gain recognized under *IRC § 877(d)(2)* must be recognized immediately after the loss of citizenship. *IRC § 877(d)(2)(D).*

(n10)Footnote 6. *IRC § 877(d)(2)(E).*

(n11)Footnote 7. *1997-1 CB 394* .

(n12)Footnote 8. *IRC § 877(d)(4)(A), (B).* *Notice 97-19, 1997-11 CB 394* , has extended the ten-year period to a 15-year period beginning five years prior to expatriation. The notice also sets forth the information that must be filed by an individual making the contribution.

(n13)Footnote 9. *IRC § 877(d)(4)(C).*

(n14)Footnote 10. *IRC § 877(g)(1).*

(n15)Footnote 11. *IRC § 877(g)(2)(A).* An employer is related within the meaning of *IRC §§ 267 and 707*.

(n16)Footnote 12. *IRC § 877(g)(2)(B).*

(n17)Footnote 13. *IRC § 877(g)(2)(C).*

(n18)Footnote 1. *IRC § 6039G(a), (b).*

(n19)Footnote 2. *IRC § 6039G(c).*

(n20)Footnote 3. *IRC § 6039G(d).*

(n21)Footnote 4. *IRC § 6039G(d)* (flush language).



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CHAPTER 20 Foreign Securities and Foreign Shareholders

2-20 Taxation of Securities Transactions § 20.07

§ 20.07 Expatriation By US Entities

[1] Section 7874: Background and Operation

Section 7874 of the Internal Revenue Code, added in 2004, is the Congressional response to tax-motivated "corporate inversions" in which US-based multinationals remove their foreign operations from US tax jurisdiction and often lower the tax burden on their US operations as well.ⁿ¹ In a typical tax-motivated corporate inversion, the US parent of a multinational group reincorporates or otherwise relocates its legal residence from the US to a foreign country, often a tax haven with little or no connection to the group's business activities, without changing substantially either the location of the group's business activities or the owners of the parent company's stock. Prior to section 7874, corporate inversions were attractive to US-based multinationals because a multinational group with a foreign parent is not subject to US tax on income from its (or its subsidiaries') business operations outside the US, either currently or in the future. Moreover, by subsequently leveraging its US operations through intercompany debt held by related foreign entities or transferring its intangibles outside the US, the group could employ tax-reduction strategies available to other foreign based multinationals.ⁿ²

In general, *IRC Section 7874* applies to the direct or indirect acquisition by a foreign corporation of substantially all the properties of a domestic (*i.e.*, US) corporation, or substantially all the properties constituting a trade or business of a domestic partnership,ⁿ³ if, after the acquisition: (1) at least 60 percent of the stock of the foreign corporation (by vote or value) is held by (a) former shareholders of the domestic corporation "by reason of holding stock in the domestic corporation," or, (b) if the foreign corporation acquired properties from a domestic partnership, is held by former partners of that partnership "by reason of holding a capital or profits interest in the domestic partnership"),ⁿ⁴ and (2) the "expanded affiliated group" that includes the acquiring foreign corporation does not have substantial business activities in the country in which the acquiring foreign corporation is organized, compared to the total business activities of that expanded affiliated group throughout the world.ⁿ⁵

If these requirements are met, *IRC Section 7874* provides two alternative sets of tax consequences. Which set of tax consequences applies depends on the percentage of the acquiring foreign corporation owned by the domestic entity's former shareholders or partners after the inversion transaction. If former shareholders or partners of the domestic entity hold 80 percent or more of the foreign corporation's stock, the foreign corporation is thereafter treated for tax purposes as though it were a domestic corporation, wholly defeating the tax avoidance purpose of the inversion transaction.ⁿ⁶ If the domestic entity's former owners hold at least 60 percent, but less than 80 percent, of the acquiring foreign

corporation's stock, the latter's tax status as a foreign corporation will be respected (though it is now referred to as a "surrogate foreign corporation"), but the domestic entity and all of its US affiliates (each of which is now referred to as an "expatriated entity") will lose the right to use net operating losses or tax credits to offset the income from or tax on any "inversion gain."ⁿ⁷

Inversion gain includes any gain or income recognized by the expatriated entity (including its US affiliates) by reason of a transfer of stock or other property in connection with the inversion transaction or a transfer or license of property to the surrogate foreign corporation or any other foreign related person at any time within a roughly 10 year period (the "applicable period" as defined below).ⁿ⁸ Any gain or income that falls within the definition of "inversion gain" may not be offset by an expatriated entity's net operating losses, if any, nor may the tax deemed attributable to inversion gain be reduced by the expatriated entity's tax credits.ⁿ⁹ Inversion gain remains tainted in this manner throughout the "applicable period;" the period beginning on the first date properties are acquired as part of the acquisition triggering *IRC Section 7874* and ending 10 years after the last date properties are acquired as part of that acquisition.ⁿ¹⁰

[2] *Treasury Regulation Section 1.7874-1: Administrative Exceptions to Section 7874*

Congress expressly granted the Treasury broad authority to "provide such regulations as are necessary to carry out...section [7874], including regulations... necessary to prevent the avoidance of the purposes of this section..."ⁿ¹ Regulations promulgated pursuant to such authority are "legislative regulations" to which courts must accord "controlling weight unless... arbitrary, capricious, or manifestly contrary to the statute."ⁿ²

However, the principal intention of the first set of regulations to be finalized under *IRC Section 7874*, *Treas Reg 1.7874-1*, was not to prevent the avoidance of *IRC Section 7874* but to prevent the application of that section to certain transactions that might technically be covered but did not raise the tax avoidance concerns targeted by Congress.ⁿ³ Thus, *IRC Section 7874* does not apply to an "internal group restructuring," as defined in the regulations, because unlike a corporate inversion, the same corporate parent that owns the domestic entity prior to the acquisition of its properties owns the foreign corporation that acquires those properties.ⁿ⁴ Furthermore, an acquisition of substantially all the properties of a US entity in which the former owners of the domestic entity suffer a "loss of control" resembles a sale or joint venture more than a corporate inversion, and so are excluded from the operation of section 7874.ⁿ⁵ In transactions which qualify as an "internal group restructuring" or a "loss of control," the regulations override the general rule that affiliate-owned stock is not taken into account at all in calculating the post-acquisition percentage of the acquiring foreign corporation's stock held by the former owners of the acquired domestic entity.ⁿ⁶ Instead, affiliate-owned stock is included in the denominator of the ownership fraction (the total number of foreign corporation shares outstanding, post-acquisition), but *not* in the numerator (the number of those shares held by the former owners of the domestic entity).ⁿ⁷ As demonstrated in the following examples, this effectively removes internal group restructuring and loss of control transactions from the scope of *IRC Section 7874*.

Example 1:

P Corp owns all the stock of USS, a domestic corporation. P forms FS, a foreign corporation, and exchanges all of USS's stock for all 100 shares of FS's stock. The transaction literally satisfies the ownership test for a surrogate foreign corporation (see *IRC Section 7874(a)(2)(B)(ii)*) since all the stock of FS (the indirect owner of 100% of USS's properties) is owned by P Corp, the former owner of all of the stock of USS. However, the transaction also qualifies as an internal group restructuring as defined in *Treasury Regulation Section 1.7874-1(c)(2)*, since P Corp owned at least 80 percent of USS before the acquisition and owns at least 80 percent of FS after the acquisition. Applying the special rule of *Treasury Regulation Section 1.7874-1(c)(1)*, the FS stock owned by P Corp is included in the denominator but not in the numerator of the ownership fraction. The ownership fraction thus becomes 0/100 instead of 100/100, and the transaction fails the 60 percent or more ownership test.ⁿ⁸

Example 2:

P Corp owns all the stock of USS, a domestic corporation. B, a corporation unrelated to P, holds all 60 outstanding shares of FS, a foreign corporation. P transfers all the outstanding stock of USS to FS in exchange for 40 newly issued shares of FS. After the acquisition, B, FS and USS (but not P Corp, which owns less than 50 percent of FS's stock) are members of an expanded affiliated group or "EAG" that includes FS. The ownership test is literally met because P Corp, the former owner of USS, is deemed to own 100 percent of FS's stock. The 40 shares P Corp acquired in the transaction are the only shares counted because *Code Section 7874(c)(2)* requires that the remaining 60 shares of FS stock owned by B, a member of FS's EAG, be disregarded for purposes of computing the ownership test. However, P has suffered a loss of control within the meaning of *Treasury Regulation Section 1.7874-1(c)(3)* since after the acquisition P does not own directly or indirectly more than 50 percent of the stock of any member of FS's EAG. The ownership fraction under *Treasury Regulation Section 1.7874-1(c)(1)* is recalculated by including the stock owned by B, a member of the EAG, in the denominator but not the numerator of the ownership fraction. The ownership fraction therefore falls from 100 percent (40/40) to 40 percent (40/100), and the transaction is not subject to *Code Section 7874(c)(2)*.ⁿ⁹

[3] 2009 Temporary Regulations: Closing Loopholes in Section 7874

Treasury did flex its regulatory muscles in temporary regulations issued in June, 2006, which were withdrawn and reissued in modified form in June, 2009.ⁿ¹ The temporary regulations interpret the provisions of *IRC Section 7874(a)(2)(B)*, defining a "surrogate foreign corporation," with the aid of the Treasury's "legislative" authority, so as to tighten the rules in a number of significant ways.

[a] Publicly Held Foreign Partnerships Treated as Foreign Corporations.

IRC Section 7874(a)(2)(B) provides that "a foreign corporation shall be treated as a surrogate foreign corporation if..." certain tests are met. (Emphasis added.) *IRC section 7704* treats publicly traded partnerships (generally, partnerships the interests in which are either traded on an established securities market or are "readily tradable" on a secondary market) as corporations, with the exception, prescribed by *IRC section 7704(c)*, of publicly traded partnerships in which 90 percent or more of the partnership's gross income is passive-type income. Concluding that the passive income exception could open a door to avoidance of *IRC Section 7874* that was not intended by Congress, and that making publicly traded partnerships subject to *IRC Section 7874* regardless of the nature of their gross income was not inconsistent with the Congressional purpose behind the passive income exception,ⁿ² the temporary regulations provide that a publicly traded partnership that would be treated as a corporation but for *IRC Section 7704(c)* must be treated as a corporation for purposes of *IRC Section 7874*.ⁿ³ Further, in a modification of the withdrawn temporary regulations, the 2009 version provides that even if the interests in a partnership are not publicly traded when the partnership completes the acquisition of substantially all the properties of a domestic entity, the partnership will be treated as a corporation as of such time if, but for *IRC Section 7704(c)*, it would have been treated as a corporation under *IRC Section 7704* at any time thereafter, provided that its interests subsequently become publicly traded pursuant to a plan in existence at the time of the acquisition.ⁿ⁴

If the regulations deem a partnership to be a corporation under the rule stated above, the partnership is treated as a corporation organized in the foreign country in which, or under the laws of which, the partnership was created or organized, and interests in the partnership are treated as stock in the corporation.ⁿ⁵ If 80 percent or more of the partnership's post-acquisition "stock" is owned by the former owners of the acquired domestic entity, the partnership is treated as a domestic corporation regardless of its actual place of organization.ⁿ⁶ In that case, the following events are deemed to have occurred immediately before the first date that properties are acquired as part of the acquisition in question: the partnership is treated as having transferred all of its assets and liabilities to a newly formed domestic corporation in exchange solely for stock of the domestic corporation and then distributing that stock to its partners in

proportion to their partnership interests in liquidation of the partnership, with tax consequences determined under the provisions of the Internal Revenue Code and "general tax principles."ⁿ⁷

If the post-acquisition ownership of the partnership *qua* corporation by the former owners of the acquired domestic entity falls into the 60-80 percent range, which ordinarily would make it a "surrogate foreign corporation," its tax status instead reverts to a partnership; since *IRC Section 7874* prescribes no tax consequences for an entity classified as a surrogate foreign corporation, there is no longer any reason to treat it as a corporation for *IRC Section 7874* purposes.ⁿ⁸ However, the domestic entity the properties of which were acquired by the partnership becomes an "expatriated entity" (together with all related US persons) subject to the tax regime with respect to inversion gains for 10 years.ⁿ⁹ Similarly, if it is established that the partnership is not a surrogate foreign corporation because, for example, less than 60 percent of its "stock" is owned by former owners of the domestic entity, its status as a partnership under *IRC section 7704(c)* will be unaffected by *IRC Section 7874*.ⁿ¹⁰

[b] Special Rules for Applying the "Substantially All of the Properties" Test.

IRC section 7874(a)(2)(B)(i) defines a surrogate foreign corporation as a foreign corporation that, *inter alia*, "makes a direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership." The temporary regulations give meaning to the term "indirect acquisition" in this context, and additionally prescribe a special rule to prevent taxpayers from using multiple entities to avoid meeting the "substantially all" test.

A foreign corporation makes an "indirect acquisition" of a domestic entity's properties if the domestic entity is a corporation and the foreign corporation acquires stock in that corporation.ⁿ¹¹ If less than all of the domestic corporation's stock is acquired, a proportionate amount of the corporation's properties are indirectly acquired based on the relative values of the stock acquired compared to all outstanding stock of the corporation.ⁿ¹² Similarly, the acquisition of an interest in a partnership results in an indirect acquisition of a proportionate amount of the partnership's properties based on the relative values of the interest acquired compared to all interests in the partnership.ⁿ¹³ Thus, for example, the acquisition by a foreign corporation of a 40 percent interest in a domestic partnership that owns 100 percent of a domestic corporation would constitute an indirect acquisition by the foreign corporation of both 40 percent of the stock of the domestic corporation and 40 percent of the properties held by the domestic corporation.ⁿ¹⁴

Suppose a corporation or partnership (the "acquiring entity") acquires stock or properties of a domestic entity in exchange for stock of a related foreign corporation (the "foreign issuing corporation")? The temporary regulations treat both the foreign issuing corporation, and the actual acquiring entity, as having made the acquisition, provided the foreign issuing corporation is a member of the acquiring entity's expanded affiliated group after the acquisition.ⁿ¹⁵

Note, however, that an acquisition of stock in a foreign corporation that owns stock of a domestic corporation (or an interest in a domestic partnership) does not constitute an indirect acquisition of any properties held by the domestic corporation (or the partnership) under the temporary regulations.ⁿ¹⁶ Accordingly, if a foreign corporation owns all the stock of a domestic corporation, and its (*i.e.*, the foreign corporation's) stock is acquired by a second foreign corporation, the second foreign corporation will not be considered to have thereby made an indirect acquisition of any of the underlying properties of the domestic corporation for purposes of *IRC Section 7874*.

The 2009 version of the temporary regulations includes a special rule to prevent two or more foreign corporations from directly or indirectly acquiring, in the aggregate, substantially all of the properties of a domestic entity pursuant to a single plan but arguing that *IRC Section 7874* does not apply because no single acquiring corporation obtained "substantially all" the properties of the target. In such cases, each of the acquiring corporations will be treated as completing an acquisition of substantially all the domestic entity's properties.ⁿ¹⁷

[c] Special Rules for Applying the Ownership Test.

Under *IRC section 7874(a)(2)(B)(ii)*, an acquiring foreign corporation cannot be a surrogate foreign corporation unless at least 60 percent of the stock of the acquiring foreign corporation is held, after the acquisition, by the former stockholders of the acquired domestic corporation (or the former partners of the acquired partnership), who hold their foreign corporation stock "by reason of" having held stock, or a capital or profits partnership interest, in the acquired domestic corporation or partnership. The temporary regulations address four types of problems that may arise in applying this ownership test: (1) when do former stockholders or partners acquire their foreign corporation stock "by reason of" holding stock or partnership interests in the acquired domestic entity; (2) how should holders of stock options and similar interests be treated; (3) how should the ownership test be applied if the former owners of an acquired domestic entity do not receive stock in the acquiring foreign corporation for their interests but receive other interests that are "economically equivalent" to stock; and (4) how should the ownership test be applied if the acquiring foreign corporation acquires properties from multiple domestic entities pursuant to a common plan. In addition, *Notice 2009-78*ⁿ¹⁸ announced that Treasury and the Internal Revenue Service intend to issue regulations covering a fifth problem: (5) when will stock issued by the acquiring foreign corporation in an offering related to the acquisition of the domestic entity be disregarded in applying the ownership test.

[i] The "By Reason Of" Standard.

The 2009 temporary regulations clarify that stock in the acquiring foreign corporation is received "by reason of" the stock or partnership interests held by the former stockholders or partners of the acquired domestic entity whether such stock is received "in exchange for" or "with respect to" their domestic stock or partnership interests.ⁿ¹⁹ Thus, if a foreign corporation acquires the properties of a domestic corporation by purchasing the properties directly from the domestic corporation in exchange for its stock, and the domestic corporation's shareholders acquire the foreign corporation's stock in a distribution from the domestic corporation, the shareholders are treated as having received the foreign corporation's stock "by reason of" holding stock in the domestic corporation even though their receipt resulted from a distribution with respect to their domestic corporation stock rather than in an exchange for their stock.ⁿ²⁰ A similar result obtains if the foreign corporation acquires substantially all of the properties of a domestic partnership directly from the partnership in exchange for its stock, in which case its partners are deemed to hold their proportionate shares of the foreign corporation stock by reason of holding their respective interests in the partnership.ⁿ²¹ However, as illustrated in the following example, if the former shareholders or partners of the domestic entity acquire their foreign corporation stock in exchange for both their domestic corporation stock (or partnership interest) and for other property, a proportionate part of their foreign corporation stock will not be held "by reason of" their ownership of their domestic corporation stock or partnership interests and will not count in calculating the ownership test.ⁿ²²

Example

A, an individual, owns all the stock of X and Y. X is a domestic corporation with a value of \$40x, and Y is a foreign corporation with a value of \$60x. A transfers all of the stock in both X and Y to F, a newly-formed foreign corporation, in exchange solely for all of F's stock. A's stock ownership in F does not satisfy the ownership test with respect to F's acquisition of the properties of domestic corporation X because, after the acquisition, A holds only 40 percent (40x/100x) of F's stock "by reason of" having held stock in X.ⁿ²³

[ii] Options and Similar Interests.

In granting the Treasury authority to prescribe regulations implementing the definition of a "surrogate foreign corporation," *IRC section 7874(c)(6)* specifically refers to rules prescribing the treatment of "warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock." The 2006 temporary regulations provided that an option or similar interest giving the holder the right to acquire stock in a domestic corporation, or to acquire a capital or profits interest in a partnership, should be treated as exercised for purposes of

determining whether the former owners of the domestic entity own 60 percent or more of the acquiring foreign corporation's stock, but only if such treatment resulted in the acquiring foreign corporation being classified as a surrogate foreign corporation.ⁿ²⁴ The 2009 temporary regulations take a somewhat different approach, and apply not only to options to acquire stock or a partnership interest in a domestic entity, but also to options to purchase stock in the acquiring foreign corporation.

An option to acquire stock in a corporation (including a "similar interest" as defined below) is treated as stock in that corporation, with a value equal to the option holder's claim on the equity of the corporation,ⁿ²⁵ not including the value of any property the holder of the option would be required to provide to the corporation if the option were exercised.ⁿ²⁶ In two situations, however, an option will not be treated as the equivalent of stock. First, an option to acquire stock in a foreign corporation will be disregarded if a principal purpose of the issuance or acquisition of the option was to avoid the foreign corporation's being classified as a surrogate foreign corporation.ⁿ²⁷ Second, any option to acquire stock (or a partnership interest) will be disregarded if the result of treating the option as stock (or a partnership interest) would be to duplicate the claim on the equity of the corporation (or partnership) of an actual stockholder (or partner).ⁿ²⁸ The above rules apply not only to options but also to interests similar to an option ("similar interests"), including, but not limited to, "a warrant, a convertible debt instrument, an instrument other than debt that is convertible into stock, a put, stock subject to risk of forfeiture, a contract to acquire or sell stock, and an exchangeable share (as well as similar partnership interests).ⁿ²⁹

Example

A, an individual, owns all the stock of D, a domestic corporation. B, an individual unrelated to A, owns all the outstanding stock of F, a foreign corporation. C, an individual unrelated to A or B, holds a warrant to acquire F stock from F for \$20x. A transfers all D's stock to F. Immediately after the transfer, the F stock which C has a right to purchase has a value of \$70x. For purposes of determining whether A holds at least 60 percent of F's stock, C is deemed to hold stock in F with a \$50x value (C's claim on the equity of F is the \$70x current value of the stock less its \$20x option price, without taking into account the \$20x to be received by F). Note, however, that if instead of holding F's warrant C holds an option to purchase issued and outstanding F stock held by B with a value of \$70x for an option price of \$20x, C's option would be disregarded for purposes of the ownership test, because taking into account the stock subject to C's option would partially duplicate F stock held by B. In these circumstances, only the F stock actually held by B is counted for purposes of calculating A's percentage interest in F.ⁿ³⁰

[iii] Economically Equivalent Interests.

Perhaps the most controversial use of the Treasury's loophole-closing authority has been its treatment of "economically equivalent interests." These are defined as interests held by the former owners of a domestic entity that are not stock in the acquiring foreign corporation (indeed are not necessarily interests in that corporation of any kind), but give the former owners "distribution rights that are substantially similar in all material respects" to the distribution rights provided by stock in the foreign corporation.ⁿ³¹ If classifying such interests as stock in the foreign corporation would cause that corporation to be a "surrogate foreign corporation," the temporary regulations provide that they will be so treated.ⁿ³² The type of transaction that concerns the Treasury is illustrated in the following example.

Example

A privately held domestic corporation, USC, intends to make an initial public offering of stock for cash. First, however, it forms FC, a foreign corporation, which issues its shares to the public in exchange for cash and then contributes the cash to a newly formed US subsidiary, S. S merges with and into USC. Pursuant to the merger agreement, FC exchanges its stock in S for new Class A stock of UST, while the shareholders of UST exchange their stock for UST's new Class B stock. The Class B stock gives former

UST shareholders the right to dividend distributions approximately equal to any dividend distributions FC makes with respect to its publicly traded stock and also permits the UST shareholders to require, under certain circumstances, that UST redeem the Class B stock at fair market value. Since FC has few assets other than its Class A shares in UST, the Class A shares and the Class B shares are of approximately equal value. The Class B stock does not, however, confer any voting rights with respect to FC. According to the Treasury, "these transactions are contrary to the policies underlying section 7874,"ⁿ³³ and if treating the Class B stock of UST as stock in FC would make FC a surrogate foreign corporation, the class B stock will be treated as stock in FC for purposes of section 7874.ⁿ³⁴

The temporary regulations also treat the claims of creditors of a domestic entity as stock (or a partnership interest) in the domestic entity if, immediately prior to the first date on which the entity's properties are acquired as part of an acquisition of substantially all its properties, the entity is in a Title 11 or similar case (as defined in *IRC section 368(a)(3)*) or its liabilities exceed the value of its assets.ⁿ³⁵ The rationale of this provision is that the creditors of an insolvent corporation succeed to the proprietary interests of its shareholders, and are so treated, for example, in determining whether a reorganization of an insolvent corporation satisfies the continuity of interest test.ⁿ³⁶

[iv] Acquisitions of Multiple Domestic Entities.

Suppose the shareholders of two domestic corporations agree to merge their businesses by having a single foreign corporation acquire the properties of both corporations in exchange for the foreign corporation's stock, and that each group of shareholders receives 50 percent of the foreign corporation's stock in connection with the reorganization. May each shareholder group argue that since neither group acquired at least 60 percent of the foreign corporation's stock, the ownership test has not been met? The temporary regulations say no: the multiple acquisitions must be treated as a single acquisition, with the domestic entities treated as a single domestic entity. The shares of stock (or partnership interests) held by former shareholders (or partners) in the domestic entities, as well as the shares of stock they receive in the foreign corporation, are aggregated for purposes of determining whether the ownership test is met.ⁿ³⁷

[v] Stock Issued in a Related Public or Private Offering.

IRC Section 7874(c)(2)(B) provides that in calculating the post-acquisition fraction of the acquiring foreign corporation's stock held by the former owners of the acquired domestic entity, shares of the foreign corporation's stock "sold in a public offering related to the acquisition" are excluded from the denominator of the fraction. In Notice 2009-78, *supra*, the Internal Revenue Service and the Treasury announced that they intend to issue regulations that will disregard any stock issued by a foreign corporation in a transaction related to the acquisition, whether issued in a public or a private offering, if the stock is issued in exchange for "nonqualified property." Nonqualified property is defined as (i) cash or cash equivalents; (ii) marketable securities (except that stock in any member of the foreign corporation's expanded affiliated group, even if a "marketable security," is not included in the definition of "nonqualified property"); and (iii) any other property acquired by the foreign corporation in a transaction with a principal purpose of avoiding the purposes of section 7874.ⁿ³⁸ Accordingly, if the acquiring foreign corporation issues its stock for cash in a transaction related to its acquisition of a domestic entity, thereby diluting the interest held by former owners of that entity from 100 percent to 79 percent, the interest of the former owners will remain at 100 percent for purposes of Section 7874 whether the offering is made to the public (in which case section 7874(c)(2)(B) will apply) or to a private investor (in which case the new regulation will apply).ⁿ³⁹

By making clear that foreign corporation stock issued for property other than "nonqualified property" will not be disregarded, even if the stock is issued in a "public offering," *Notice 2009-78* also addressed a taxpayer concern best illustrated by an example from *Notice 2009-78*.

Example

Foreign corporation FT, a publicly held foreign corporation, wishes to merge with publicly held domestic corporation DT. FT forms foreign subsidiary FA which forms foreign subsidiary FMS and US subsidiary DMS. FMS merges into FT with FT surviving the merger, and the shareholders of FT surrender their FT stock solely in exchange for FA stock. DMS then merges with and into DT with DT surviving the merger and shareholders of DT surrendering their DT stock solely in exchange for FA stock. After completion of the plan, FA is owned by the former shareholders of FT and DT and now owns those companies as its subsidiaries. Supposing that the former stockholders of FT and DT each own a 50% interest in FA after the mergers are completed, the question is whether the FA shares acquired by the former FT shareholders will be disregarded under *IRC § 7874(c)(2)(B)* for purposes of the ownership test because they were "sold in a public offering related to the acquisition of" DT. If so, DT's shareholders would be treated as the owners of 100 percent of FA's stock for purposes of the ownership test, with the consequences prescribed by *IRC Section 7874*. The new regulations would prevent this result by allowing stock sold by the acquiring foreign corporation to be taken into account for purposes of the ownership test, whether or not the stock was sold in a "public offering" (*IRC Section 7874(c)(2)(B)* notwithstanding), as long as the stock was not sold in exchange for "nonqualified property," defined to exclude stock in the acquiring foreign corporation's expanded affiliated group (whether or not such stock falls into the category of "marketable securities").ⁿ⁴⁰

[d] Rules for Applying the Substantial Business Activities Test.

The 2009 temporary regulations adopt a facts and circumstances test with no bright line rules for determining whether or not, after the acquisition, the expanded affiliated group which includes the acquiring foreign corporation (hereafter, the "EAG") is carrying on "substantial business activities" in the foreign corporation's legal domicile, as compared with the worldwide business activities of the group.ⁿ⁴¹ In this respect the approach is quite different from the 2006 version of the temporary regulations, which contained a safe harbor that assured taxpayers they could avoid *IRC Section 7874* if at least 10 percent of the EAG's employees (by headcount and compensation), assets (by value) and sales were located in the acquiring foreign corporation's legal domicile.ⁿ⁴² The safe harbor and illustrative examples in the 2006 version were dropped from the 2009 temporary regulations as well after Treasury concluded that they might protect "transactions that are inconsistent with the purposes of section 7874;" taxpayers may no longer rely on the safe harbor or the examples.ⁿ⁴³ Instead, taxpayers are left with the following limited guidance.

The following items are considered relevant in the application of the substantial business activities test: (i) the historical conduct of continuous business activities in the foreign country which is the acquiring foreign corporation's legal domicile (hereafter, the "foreign country"); (ii) whether the EAG carries on an active trade or business in the foreign country involving EAG-owned property or employees located in the foreign country, or sales within the foreign country; (iii) whether EAG officers or employees based in the foreign country perform substantial managerial activities; (iv) whether a substantial degree of ownership of the EAG is held by persons resident in the foreign country; (v) whether the business activities carried on by the EAG in the foreign country are material to the achievement of the overall business objectives of the EAG.ⁿ⁴⁴ A proportionate share of the business activities, assets, income and sales of any partnership in which the EAG holds at least a 10 percent capital and profits interest must be taken into account for purposes of applying the substantial business activities test, whether within or outside the foreign country.ⁿ⁴⁵

Business activities, as well as assets or employees, will not be considered for purposes of the substantial business activities test if they were transferred to or located in the foreign country for the purpose of avoiding *IRC Section 7874*, or if, some time after the acquisition, they are transferred out of the foreign country pursuant to a plan that existed at the time of the acquisition.ⁿ⁴⁶

FOOTNOTES:

(n1)Footnote 1. See HR Rep No 108-755, 108th Cong 2d Sess (2004) (Conference Report to Accompany H.R. 4520 ("American Jobs Creation Act of 2004"), at 567-574 (hereafter, "Conf Rep on § 7874"). The Treasury described the

problem in a 2002 white paper. See Office of Tax Policy, Dept of the Treasury, "Corporate Inversion Transactions: Tax Policy Implications," (May, 2002). (hereafter, "2002 White Paper").

(n2)Footnote 2. The Treasury's White Paper noted the "prevalent use of foreign related-party debt in inversion transactions." Treasury White Paper at 22. Treasury viewed this as evidence that the anti-earnings stripping rules in *IRC* § 163(j) need tightening, a view Treasury continues to hold. See General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (May 2009) at pp 33-34 (proposal to tighten the earnings-stripping rules applicable to all US entities defined as "expatriated entities" for purposes of *IRC* § 7874 as well as entities that would be so defined had the provisions of *IRC* § 7874 gone into effect for taxable years beginning after July 10, 1989 (instead of taxable years ending after March 4, 2003, the actual effective date of *IRC* § 7874)). See also § 19.05[1][h], n 100, *supra*.

(n3)Footnote 3. *IRC* § 7874(a)(2)(B)(i). As noted above, only inversion transactions completed after March 4, 2003 are subject to *IRC* § 7874. *Id.* Further, if more than half the properties of a domestic corporation or partnership were acquired prior to March 4, 2003, the inversion is not subject to *IRC* § 7874 even if the acquisition was not completed until after March 4. *IRC* § 7874(a)(2) (final paragraph). In determining whether a foreign corporation has acquired "substantially all" of a domestic entity's properties, all acquisitions made directly or indirectly by the corporation pursuant to a plan, or in a related series of transactions, are included. *IRC* § 7874(a)(2)(B). An acquisition will be deemed made pursuant to a plan if it occurs within a 4 year period beginning 2 years before the ownership requirements of *IRC* § 7874(a)(2)(B)(ii) (see below) are met. *IRC* § 7874(c)(3). Moreover, any transfer of the domestic entity's properties or liabilities (including by contribution or distribution) other than to the acquiring foreign corporation will be disregarded if made as part of a plan a principal purpose of which is to avoid the purposes of *IRC* § 7874. *IRC* § 7874(c)(4).

(n4)Footnote 4. *IRC* § 7874(a)(2)(B)(ii). Stock in the acquiring foreign corporation (1) held by members of the corporation's post-acquisition "expanded affiliated group" or (2) sold in a public offering related to the acquisition of the domestic entity's properties, is disregarded in determining whether the ownership test is met. *IRC* § 7874(c)(2). For the definition of "expanded affiliated group," see n 5, *infra*.

(n5)Footnote 5. *IRC* § 7874(a)(2)(B)(iii). An "expanded affiliated group," as that term is used in *IRC* § 7874, has the same meaning as "affiliated group" in *IRC* § 1504(a) except that (1) the 80 percent voting control and value test is replaced by a 50 percent voting control and value test, and (2) the requirement in *IRC* § 1504(a)(3) that deconsolidated entities may not rejoin the consolidated group less than 5 years after the deconsolidation occurs does not apply. *IRC* § 7874(c)(1).

(n6)Footnote 6. *IRC* § 7874(b). Taxation as a domestic corporation is required notwithstanding *IRC* § 7701(a)(4) (defining a domestic corporation as a corporation organized under the laws of the United States or any State), and notwithstanding "any treaty obligation of the United States heretofore or hereafter entered into..." *IRC* § 7874(f). When *IRC* § 7874(b) applies, the deemed conversion from foreign to domestic corporation is treated as a reorganization described in *IRC* § 368(a)(1)(F) that occurs immediately before the first date properties are acquired as part of the foreign corporation's acquisition of the domestic entity. *Temp Treas Reg* § 1.7874-2T(m)(1).

(n7)Footnote 7. *IRC* § 7874(a)(1). An "expatriated entity" includes the US company that transferred substantially all its properties to a surrogate foreign corporation, *IRC* § 7874(a)(2)(A)(i), and any US person related (within the meaning of *IRC* § 267(b) or *IRC* § 707(b)(1)) to such company. *IRC* § 7874 (a)(2)(A)(ii). Thus, every member of the US transferor's affiliated group is subject to the inversion gain provisions, which also apply notwithstanding any treaty obligation of the United States to the contrary. *IRC* § 7874(f), *supra*. However, no US entity is considered an "expatriated entity," and none is subject to the provisions of *IRC* § 7874 regarding "inversion gain," if the former owners of the US group end up owning 80 percent or more of the stock of the acquiring foreign corporation, in which case the acquiring foreign corporation is treated as a domestic corporation under *IRC* § 7874(b). As a technical matter, an "expatriated entity" must be owned at least in substantial part by a "surrogate foreign corporation," *IRC* § 7874(a)(2)(A), and a foreign corporation that is treated as a domestic corporation under *IRC* § 7874(b) is expressly

excluded from the definition of a "surrogate foreign corporation." *IRC § 7874(a)(3)*.

(n8)Footnote 8. *IRC § 7874(d)(2)*. Inversion gain does not include income or gain on a transfer of property that constitutes inventory in the hands of the expatriated entity, or similar property described in *IRC § 1221(a)(1)*. For purposes of computing inversion gain, property is transferred to a "foreign related person" if the transferee or licensee is a foreign person and either (1) "related" to the expatriated entity within the meaning of *IRC § 267(b)* or *707(b)(1)* or (2) under the same "common control" (within the meaning of *IRC § 482*) as the expatriated entity. *IRC § 7874(d)(3)*.

(n9)Footnote 9. See *IRC § 7874(e)(1)* and (3). "Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits)." See Conf Rep on § 7874, *supra*, at p 574.

(n10)Footnote 10. *IRC § 7874(d)(1)*. If an expatriated entity is a partnership, the disallowance of net operating losses and tax credits on inversion gain is applied at the partner level. The amount of inversion gain attributed to each partner is the sum of (i) each partner's distributive share of the partnership's inversion gain for the year plus (ii) any gain recognized for the taxable year by the partner by reason of the transfer during the applicable period of all or part of the partner's interest in the partnership to the surrogate foreign corporation. *IRC § 7874(e)(2)*.

(n11)Footnote 1. *IRC § 7874(g)*. See also *IRC § 7874(c)(6)* (express authority to issue such regulations "as may be appropriate to determine whether a corporation is a surrogate foreign corporation").

(n12)Footnote 2. See *Chevron USA, Inc v Natural Res Def Council, Inc*, 467 US 837, 843-844 (1984) ; *Beecher v Commr*, 481 F3d 717 (9th Cir 2007) .

(n13)Footnote 3. See TD 9238, 70 FR 76685 (December 28, 2005) ; TD 9399, 73 FR 29054 (May 20, 2008) .

(n14)Footnote 4. See *Treas Reg § 1.7874-1(c)(2)*. "Internal group restructuring" is defined as an acquisition of substantially all the properties of a domestic entity by a foreign corporation if the common parent of the "expanded affiliated group" of which the foreign corporation is a member (or "EAG" as it is referred to in the regulations) held directly or indirectly at least 80 percent of the stock of the domestic entity before the acquisition, and holds at least 80 percent of the stock of the foreign acquiring corporation after the acquisition. Treasury excluded internal group restructuring transactions from the scope of section 7874 because "Congress intended...to prevent the section from applying to certain transactions occurring within a group of corporations owned by the same common parent corporation before and after the transaction, such as the conversion of a wholly owned domestic subsidiary (or its assets) to a wholly owned foreign corporation, without a change in the parent corporation of the group." See TD 9238 , *supra*, 70 FR at 76686.

(n15)Footnote 5. "Loss of control" in this context means that after the acquisition, the former stockholders or partners of the transferor domestic entity do not hold, in the aggregate, directly or indirectly, more than 50 percent of the stock of the acquiring foreign corporation or members of its expanded affiliated group. See *Treas Reg § 1.7874-1(c)(3)*.

(n16)Footnote 6. Compare *IRC § 7874(c)(2)* and *Treas Reg § 1.7874-1(b)* (general rule) with *Treas Reg § 1.7874-1(c)(1)* (special rule for internal group restructurings and transactions involving a loss of control).

(n17)Footnote 7. *Treas Reg § 1.7874-1(c)(1)*, *supra*.

(n18)Footnote 8. See *Treas Reg § 1.7874-1(f)*, Ex 3. Note, however, that Treasury has announced its intention to narrow the "internal group restructuring" exception to exclude certain "divisive transactions." See TD 9453, 74 FR 27920, 27925 (June 12, 2009). The set of facts which led to this announcement involved a publicly traded US company,

USP, with a wholly owned subsidiary, S1, which in turn owned all the stock of S2. The S2 stock did not represent substantially all the properties of S1. Pursuant to a plan, S2 transferred substantially all of its properties to F1, a newly formed foreign subsidiary, in exchange for all of F1's stock, after which it distributed F1's stock to S1. At this point the internal group restructuring exception should apply, since USP, the common parent of the expanded affiliated group that includes F1, indirectly owned 100 percent of S2, the domestic entity/transferor, prior to the acquisition, and 100 percent of F1 after the acquisition. However, as part of the same plan, S1 subsequently transferred F1's stock to USP, which in turn distributed the F1 stock to its shareholders. "The IRS and the Treasury Department believe it is inappropriate for the internal restructuring exception to apply to divisive transactions such as the one described above," and intend to modify the regulations to prevent that exception from applying in these circumstances. *Id.*

(n19)Footnote 9. See *Treas Reg § 1.7874-1(f)*, Ex 7.

(n20)Footnote 1. See TD 9265, 71 FR 32437 (June 6, 2006), withdrawn and replaced by TD 9453, 74 FR 27920 (June 12, 2009). The temporary regulations issued in 2009 are scheduled to expire on June 8, 2012. *Temp Treas Reg § 1.7874-2T(p)*.

(n21)Footnote 2. "The legislative history of section 7704 indicates that the rationale for... [the passive income] exception was to preserve flow-through tax treatment where a partnership simply holds investments that the partners could have independently acquired, as opposed to business activities that would normally be conducted in corporate form and taxed at the entity level. See H.R. Rep. 100-3391 (Oct 26, 1987) (at 1966-1067), In the case of [a publicly held partnership participating in an inversion transaction]... the rationale for the exception provided by section 7704(c) does not clearly apply." TD 9265, *supra*, 71 FR at 32438.

(n22)Footnote 3. See *Temp Treas Reg § 1.7874-2T(h)(1)* and (2).

(n23)Footnote 4. *Temp Treas Reg § 1.7874-2T(h)(2)(ii)*. The 2005 regulations had a limited 2-year post-acquisition window in which the public trading of the partnership's interests could retroactively characterize the partnership as a corporation as of the time of the acquisition, although there was no requirement that such post-acquisition public trading have been contemplated by a plan in existence at the time of the acquisition. Although the 2009 regulations now provide that post-acquisition public trading of the partnership's interests for an unlimited period after the acquisition must have been part of a plan in existence on the date of acquisition, they also presume the existence of such a plan on the acquisition date if the partnership's interests are in fact publicly traded within a 2 year period. *Temp Treas Reg § 1.7874-2T(h)(2)(ii)*.

(n24)Footnote 5. *Temp Treas Reg § 1.7874-2T(h)(1)*.

(n25)Footnote 6. *Temp Treas Reg § 1.7874-2T(h)(3)*.

(n26)Footnote 7. *Temp Treas Reg § 1.7874-2T(h)(6)*.

(n27)Footnote 8. *Temp Treas Reg § 1.7874-2T(h)(4)*.

(n28)Footnote 9. *Id.*

(n29)Footnote 10. *Temp Treas Reg § 1.7874-2T(h)(5)*.

(n30)Footnote 11. *Temp Treas Reg § 1.7874-2T(c)(1)(i)*.

(n31)Footnote 12. *Temp Treas Reg § 1.7874-2T(b)(8)(i)*.

(n32)Footnote 13. *Temp Treas Reg § 1.7874-2T(c)(1)(ii)* and *1.7874-2T(b)(8)(ii)*.

(n33)Footnote 14. *Temp Treas Reg § 1.7874-2T(n)*, Ex 2.

(n34)Footnote 15. *Temp Treas Reg § 1.7874-2T(c)(iii)* and (iv). Where a partnership rather than a corporation is the acquiring entity, the test is whether the partnership would have been a member of the same affiliated group as the foreign issuing corporation if the partnership had also been a corporation.

(n35)Footnote 16. *Temp Treas Reg § 1.7874-2T(c)(2)*. "The IRS and Treasury Department believe that it was not Congress's intent for section 7874 to apply to indirect acquisitions by foreign corporations of domestic entities that were already owned by a foreign corporation before the acquisition." *TD 9265*, *supra*, 71 *FR* at 32439.

(n36)Footnote 17. *Temp Treas Reg § 1.7874-2T(d)*.

(n37)Footnote 18. 2009-40 *IRB* 452 .

(n38)Footnote 19. *Temp Treas Reg § 1.7874-2T(f)(1)*. The 2006 version of the temporary regulations had simply defined "by reason of" as meaning "in exchange for."

(n39)Footnote 20. *Temp Treas Reg § 1.7874-2T(n)*, Ex 9.

(n40)Footnote 21. *Temp Treas Reg § 1.7874-2T(f)(1)(iii)*.

(n41)Footnote 22. *Temp Treas Reg § 1.7874-2T(f)(2)*.

(n42)Footnote 23. *Temp Reg § 1.7874-2T(n)*, Ex 8.

(n43)Footnote 24. See *TD 9265*, *supra*, 71 *FR* at 32447.

(n44)Footnote 25. "An option (or similar interest) represents a claim on equity to the extent the value of the stock (or partnership interest) that may be acquired pursuant to the option (or similar interest) exceeds the exercise price under the terms of the option (or similar interest)." See *TD 9453*, 74 *FR* at 27923.

(n45)Footnote 26. *Temp Treas Reg §§ 1.7874-2T(j)(1)* and (2). In the case of an option to acquire stock in a domestic corporation, the value of the holder's claim on the equity of the corporation is determined immediately prior to the acquisition of the corporation's properties or stock by the acquiring foreign corporation. (Similar rules also apply to an option to acquire an interest in a domestic partnership). *Temp Treas Reg § 1.7874-2T(j)(1)*. In the case of an option to acquire stock in a foreign corporation, the holder's claim on the equity of the corporation is determined immediately after such an acquisition. *Temp Treas Reg §§ 1.7874-2T(j)(2)*.

(n46)Footnote 27. *Temp Treas Reg §§ 1.7874-2T(j)(2)(ii)*.

(n47)Footnote 28. *Temp Treas Reg §§ 1.7874-2T(j)(4)*.

(n48)Footnote 29. *Temp Treas Reg §§ 1.7874-2T(j)(3)*.

(n49)Footnote 30. *Temp Treas Reg § 1.7874-2T*, Examples 14 and 15.

(n50)Footnote 31. *Temp Treas Reg § 1.7874-2T(k)(1)*. Such "distribution rights" need not be accompanied by voting rights in the acquiring foreign corporation. See *Temp Treas Reg § 1.7874(n)*, Ex 17.

(n51)Footnote 32. *Id.*

(n52)Footnote 33. *TD 9453*, *supra*, 74 *FR* at 27924.

(n53)Footnote 34. See *Temp Treas Reg §§ 7874-2T(n)*, Examples 17 and 18.

(n54)Footnote 35. *Temp Treas Reg § 1.7874-2T(k)(2)*.

(n55)Footnote 36. *TD 9453*, *supra*, at 24924-25; *Treas Reg § 1.368-1(e)(6)*; *Helvering v Alabama Asphaltic Limestone Co*, 315 US 179 (1942) ; § 8.02[2], *supra* .

(n56)Footnote 37. *Temp Treas Reg § 1.7874-2T(e)*.

(n57)Footnote 38. *2009-40 IRB at 453* . The term "marketable securities" is defined in *IRC §§ 453(f)(2) and (3)*. The regulations will apply to transactions completed on or after September 17, 2009. *Id.*

(n58)Footnote 39. An article in Tax Notes Today reported that a representative of the Internal Revenue Service, speaking at a Bar association event, acknowledged that the bill that eventually became section 7874 initially and expressly disregarded stock sold by the foreign corporation in private placements as well as public offerings, but that the reference to private placements was subsequently deleted from the bill without explanation. Nevertheless, the article notes, the representative said the Service is "very comfortable" that it has the regulatory authority to disregard stock issued for cash or marketable securities in a private placement transaction related to the inversion of a domestic entity. "IRS Comfortable it has Authority to Issue Anti-Inversion Notice, Official Says," *2009 TNT 186-4* (September 29, 2009).

(n59)Footnote 40. See Notice 2009-58 , *supra*, 2009-40 IRB at 453 (§ 4, Ex. 3).

(n60)Footnote 41. See *Temp Treas Reg § 1.7874-2T(g)*.

(n61)Footnote 42. *TD 9265*, *supra*, 71 FR at 32444-45.

(n62)Footnote 43. *TD 9453*, *supra*, 74 FR at 27922.

(n63)Footnote 44. *Temp Treas Reg § 1.7874-2T(g)(3)*.

(n64)Footnote 45. *Temp Treas Reg § 1.7874-2T(g)(4)*.

(n65)Footnote 46. *Temp Treas Reg § 1.7874-2T(g)(5)*.



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Taxation of Securities Transactions

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CHAPTER 20 Foreign Securities and Foreign Shareholders

2-20 Taxation of Securities Transactions § 20.08

§ 20.08 Foreign Currency Transactions

[1] The Functional Currency Concept

Before the Tax Reform Act of 1986, the Code did not contain any express statutory rules for determining the amount and timing of gain or loss arising from fluctuations in the value of foreign currency (exchange gain or loss). The 1986 Act adopted a functional currency concept, under which exchange gain or loss is recognized on a transaction-by-transaction basis in the case of certain transactions denominated in a currency other than a functional currency.ⁿ¹

A taxpayer's functional currency is the United States dollar, or in the case of a qualified business unit (QBU) (a separate and clearly identified unit of a trade or business of a taxpayer that maintains separate books and records),ⁿ² the currency of the economic environment in which a significant part of the QBU's activities is conducted and that is used by the QBU in keeping its books and records.ⁿ³ If (i) the activities of the QBU are conducted in dollars; (ii) the QBU has the United States, or any possession or territory of the United States where the dollar is the standard currency, as its residence; (iii) the QBU does not keep books and records in the currency of any economic environment in which a significant part of its activities are conducted; or (iv) the QBU produces income or loss that is effectively connected with the conduct of a trade or business within the United States, the functional currency of the QBU must be the dollar.ⁿ⁴

A QBU with a legacy currency as its functional currency is required to change its functional currency to the euro beginning on the first day of the first taxable year that begins on or after the day that the euro is substituted for that legacy currency (in accordance with the Treaty on European Union) and in which the QBU begins to maintain its books and records in the euro.ⁿ⁵ Notwithstanding the foregoing, a QBU with a legacy currency as its functional currency is required to change its functional currency to the euro no later than the last taxable year beginning on or before the first taxable year the legacy currency is no longer valid tender. A QBU with a nonlegacy currency as its functional currency may change its functional currency to the euro if (1) the euro is the currency of the economic environment in which a significant part of the QBU's activities are conducted; (2) after the conversion, the QBU maintains its books and records in the euro; and (3) the QBU is not required to use the dollar as its functional currency.ⁿ⁶ The change is deemed made with the consent of the Commissioner.ⁿ⁷

An affected taxpayer of a QBU that changes its functional currency to the euro is required to attach to its return for the

taxable year of change a statement that includes the following: "TAXPAYER CERTIFIES THAT A QBU OF THE TAXPAYER HAS CHANGED ITS FUNCTIONAL CURRENCY TO THE EURO PURSUANT TO *TREAS. REG. SECTION 1.985-8*."n8 An affected taxpayer is in the case where a QBU is: (1) an individual as a result of his/her activities, the individual; (2) a QBU branch of a United States corporation, the corporation; (3) a controlled foreign corporation (or a QBU branch thereof), each U.S. shareholder of the controlled foreign corporation; (4) a partnership, each partner separately; (5) a noncontrolled Section 902 corporation, each domestic shareholder; or (6) a trust or estate, the fiduciary of the trust or estate.n9

A QBU that changes its functional currency from a legacy currency to the euro must make the following adjustments:n9.1

(1) The euro basis in property and the euro amount of liabilities and other relevant items must equal the product of the legacy functional currency adjusted basis or amount of liabilities multiplied by the applicable conversion rate.

(2) Except as provided in 3 and 4, a legacy currency denominated Section 988 transaction (determined after applying the rules applicable to 988 hedging transactions, discussed in § 20.08[3]) outstanding on the last day of the taxable year immediately prior to the year of change will continue to be treated as a Section 988 transaction and the principles of *IRC Section 988* will apply.

(3) The QBU must realize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to nonfunctional currency (coin or currency, and nonfunctional currency denominated demand or time deposits or similar instruments issued by a bank or other financial institution)n9.2 that is denominated in a legacy currency as if the currency were disposed of on the last day of the taxable year immediately prior to the year of change. The character and source of the gain or loss are determined under *IRC Section 988*.n9.3

(4) A QBU may elect to realize or otherwise take into account for all purposes of the Internal Revenue Code the amount of any unrealized exchange gain or loss attributable to a legacy currency denominated account receivable or payable as if the item were terminated on the last day of the taxable year ending prior to the year of change.n9.4

If a branch of the taxpayer changes its functional currency from a legacy currency to the euro for a taxable year during which the taxpayer's functional currency is other than the euro, the branch's euro equity pool must equal the product of the legacy currency amount of the equity pool multiplied by the applicable conversion rate; no adjustment to the basis pool is required.n9.5 If the change by the branch occurs for a taxable year in which the taxpayer's functional currency is the euro, the taxpayer will realize gain or loss attributable to the branch's equity pool under the principles of *IRC Section 987*, computed as if the branch terminated on the last day prior to the year of change.n9.6

If the taxpayer changes its functional currency to the euro in a taxable year during which the functional currency of a branch of the taxpayer is not the euro, the basis pool must equal the legacy currency amount of the basis pool multiplied by the applicable conversion rate; no adjustment to the equity pool is required.n9.7 If the change occurs when the functional currency of the branch is the euro, the taxpayer will realize gain or loss attributable to the branch's equity pool determined under the principles of *IRC Section 987*, computed as if the branch terminated on the last day prior to the year of change.n9.8

Additional adjustments are required when a corporation changes its functional currency to the euro. The amount of the corporation's euro currency earnings and profits and the amount of its euro paid-in capital must equal the product of the legacy currency amounts of those items multiplied by the applicable conversion rate.n9.9 The foreign income taxes and accumulated profits or deficits of a foreign corporation that were maintained in foreign currency for purposes of the

deemed-paid tax credit of *IRC Section 902* and were attributable to taxable years of the foreign corporation beginning before January 1, 1987, also must be translated into the euro at the conversion rate.^{n9.10}

For taxable years beginning after August 24, 1994, any QBU that would otherwise be required to use a hyperinflationary currency as its functional currency must use the dollar as its functional currency and compute income or loss or earnings and profits under the dollar approximate separate transactions method of accounting (DASTM) described below.ⁿ¹⁰ The currency of a country is hyperinflationary when there is cumulative inflation of at least 100 percent during the 36-month period preceding the first day of the current calendar year, determined by reference to the consumer price index of the country listed in the monthly issues of "International Financial Statistics" or a successor publication of the International Money Fund.ⁿ¹¹ The functional currency of a QBU that otherwise would be required to use a hyperinflationary currency as its functional currency and that is a branch of a foreign corporation having a non-dollar foreign functional currency that is not hyperinflationary shall be the functional currency of the foreign corporation.ⁿ¹² In addition, a foreign corporation (or its QBU branch) operating in a hyperinflationary environment is not required to use the dollar as its functional currency if that foreign corporation is not a controlled foreign corporation.ⁿ¹³

A QBU can elect to use the dollar as the functional currency if it keeps its books and records in dollars, and its functional currency, absent the dollar election, would be a hyperinflationary currency.ⁿ¹⁴ The taxpayer can also elect the dollar as its functional currency if the taxpayer uses a method of accounting that approximates a separate transactions method.ⁿ¹⁵ The election applies to the taxable year for which it is made and all subsequent years, unless revoked with the consent of the Service.

If an eligible QBU is a branch of a United States person, the dollar election is made by attaching a completed Form 8819 to the United States person's timely filed (taking extensions into account) tax return for the first taxable year for which the election is to be effective.ⁿ¹⁶ If an eligible QBU is a controlled foreign corporation, or a branch of a controlled foreign corporation, the election can be made either by the foreign corporation or by the controlling United States shareholders on behalf of the foreign corporation by (a) filing a completed Form 8819 and (b) giving written notice to all United States persons who are known to be shareholders of the foreign corporation that the dollar election will be made (the notice must also include all information required in Form 8819).ⁿ¹⁷ Failure of the controlling United States shareholders (or the foreign corporation, if the dollar election is made by the corporation) to timely file Form 8819 or give the required notice will not invalidate the dollar election, if it is established to the satisfaction of the district director that reasonable cause existed for such failure.ⁿ¹⁸ If an eligible QBU is a noncontrolled foreign corporation, or a branch of a noncontrolled foreign corporation, the dollar election must be made by the corporation or the majority domestic corporate shareholders on behalf of the corporation; the procedure and rules are the same as in the case of a controlled foreign corporation except that majority domestic corporate shareholders are substituted for controlling shareholders.ⁿ¹⁹ Any other person making a dollar election must file Form 8819 and fulfill any other notice requirement that may be required by the Service.ⁿ²⁰

If a dollar election is made for an eligible QBU (electing QBU), then the dollar will be the functional currency of any related person (regardless of when that person became related to the electing QBU) that is an eligible QBU, or any branch of the related person that is an eligible QBU.ⁿ²¹ For this purpose, the term "related person" means any person with a relationship defined in *IRC Section 267(b)* to the electing QBU (or to the United States or foreign person of which the electing QBU is a part). In determining whether two or more corporations are members of the same controlled group under *IRC Section 267(b)(3)*, a person is deemed to own stock owned directly by such person, stock owned due to the application of *IRC Section 1563(e)(1)* (stock considered owned because a person has an option to acquire the stock), and stock owned due to the application of the constructive ownership rules of *IRC Section 267(c)*. If a dollar election is made for a QBU branch of any person, each eligible QBU branch of such person must use the dollar as its functional currency.ⁿ²²

Once a dollar election is made by or on behalf of an eligible QBU, the QBU is deemed to have the dollar as its

functional currency.ⁿ²³ Each United States person that owns stock of a foreign corporation that has the dollar as its functional currency must make all of its federal income tax calculations with respect to the foreign corporation using the dollar as the corporation's functional currency (regardless of when ownership was acquired or whether the United States person received the written notice required as part of the election process).ⁿ²⁴

Under conformity requirements, if a dollar election is made for an eligible QBU, any related party of the QBU that is itself an eligible QBU, or any branch of the related party that is an eligible QBU, must use the dollar as its functional currency.^{n24.1} If a dollar election is made for a QBU branch of any person, each eligible QBU branch of the person must use the dollar as its functional currency.^{n24.2}

If an eligible QBU's functional currency changes due to a dollar election, or to the conformity requirements just mentioned, the change is deemed to be consented to by the Commissioner.^{n24.3} No adjustments under *IRC Section 481(a)* are required solely because of the change, but the QBU must make the following adjustments:^{n24.4}

(1) The QBU must recognize or otherwise take into account for all purposes of the Code the amount of any unrealized exchange gain or loss attributable to a Section 988 transaction that, after applying the rules relating to 988 hedging transactions, is denominated by reference to the new functional currency.^{n24.5} The amount of the gain or loss is determined without regard to whether any gain or loss would be realized on the transaction as a whole. The character and source of the gain are determined under *IRC Section 988*.

(2) The new dollar adjusted basis of property and the new dollar amount of liabilities and other relevant items (such as forward contracts, futures contracts, options, or similar financial instruments) must equal the product of the old functional currency basis or amounts multiplied by the new dollar/old functional currency spot exchange rate on the last day of the taxable year ending before the year of change.^{n24.6}

(3) If a QBU is a branch of a taxpayer, and both had the different functional currencies prior to the change to the dollar as the functional currency, the branch's new dollar equity pool must equal the product of the old functional currency amount of the equity pool multiplied by the spot rate; no adjustment to the basis pool is necessary.^{n24.7} If the branch and the taxpayer had the same functional currency before the change, the branch's basis pool must equal the difference between the branch's total old functional currency basis and its total old functional currency amount of its liabilities; the branch's equity pool must equal the product of the basis pool multiplied by the spot rate.^{n24.8}

Because of the conformity requirement of the dollar election, when a branch changes its functional currency to the dollar, the branch is treated as if it terminated on the last day of the taxable year ending before the year of change.^{n24.9} Because of this, the taxpayer must realize gain or loss attributable to the branch's equity pool under the principles of *IRC Section 987*.^{n24.10}

The amount of a corporation's dollar earnings and profits and the amount of its dollar paid-in capital must equal the old functional currency amounts of those items multiplied by the spot rate.^{n24.11} The foreign income taxes and accumulated profits or deficits of a foreign corporation that were maintained for purposes of the deemed-paid credit of *IRC Section 902* and that are attributable to taxable years of the foreign corporation beginning before January 1, 1987, also must be translated into the dollar at the spot rate.^{n24.12}

A United States shareholder of a controlled foreign corporation that changes its functional currency to the dollar must recognize foreign currency gain or loss computed under *IRC Section 988(c)* as if all previously taxed earnings and profits, if any, (including amounts attributable to pre-1987 taxable years that were translated from dollars into functional currency in the foreign corporation's first post-1986 taxable year) were distributed immediately prior to the change.^{n24.13} The shareholder must also recognize gain or loss attributable to the corporation's paid-in capital to the

same extent, if any, that such gain or loss would be recognized under the regulations under *IRC Section 367(b)* if the corporation were liquidated completely.^{n24.14} The full amount of the gain or loss must be included in income or earnings and profits on the last day of the taxable year ending before the year of change.^{n24.15}

Any eligible QBU that has a dollar functional currency must compute income or loss or earnings and profits (or deficit in earnings and profits) in dollars using DASTM.ⁿ²⁵ However, the QBU can use a method other than DASTM if the QBU demonstrates to the satisfaction of the Service that it can properly employ such method.ⁿ²⁶ Generally, this will require a showing that the QBU can compute foreign currency gain or loss under the principles of *IRC Section 988* with respect to each of its Section 988 transactions. If subsequently the QBU can no longer demonstrate that it can properly employ the alternative method, the QBU will be deemed to have changed its method of accounting to DASTM.

Under DASTM, income or loss or earnings and profits (or a deficit in earnings and profits) of a QBU for its taxable year is determined in dollars by first preparing an income or loss statement for the QBU using its hyperinflationary currency and then translating the amounts of hyperinflationary currency into dollars no less than monthly during the taxable year (translation period).ⁿ²⁷ The translation into dollars is made at an exchange rate determined under any reasonable method, provided that the method is consistently applied to all translation periods and conforms to the taxpayer's method of financial accounting.ⁿ²⁸ Reasonable methods include the average of beginning and ending exchange rates for the translation period and the spot rate on the last day of the translation period. Once chosen, a method for determining an exchange rate can be changed only with the consent of the district director.

A similar translation is required annually at the end of the taxable year to determine DASTM gain or loss of the QBU.ⁿ²⁹ Such gain or loss equals (i) the net worth of the QBU at the end of the taxable year minus the net worth of the QBU at the end of the preceding taxable year, plus (ii) the dollar amount of dividend distributions for the taxable year and any items that decrease net worth for the taxable year but that generally do not affect income or loss or earnings and profits (or a deficit in earnings and profits) reduced by items that increase net worth for the taxable year but that generally do not affect income or loss or earnings and profits (or a deficit in earnings and profits), minus (iii) the amount of dollar income or earnings and profits (or plus the amount of any dollar loss or deficit in earnings and profits) determined for the taxable year.ⁿ³⁰ DASTM gain or loss is treated as ordinary income or loss.ⁿ³¹

A taxpayer can elect to use a small QBU DASTM allocation for a QBU that has a translated adjusted basis in assets of \$10 million or less at the end of any taxable year.ⁿ³² In calculating the \$10 million threshold, a QBU is treated as owning all of the assets of each related QBU having its residence in the QBU's country of residence, with appropriate adjustment to eliminated double counting of assets created between related QBU's resident in the same country.ⁿ³³ In the case of a QBU branch of a United States person, the election is made by attaching a statement to the United States person's timely filed federal income tax return (including extensions) for the first year in which the election is to be effective.ⁿ³⁴ In the case of any other QBU, the election is made in the manner prescribed in *Regulations Section 1.964-1*.ⁿ³⁵ In either case, the election is deemed to have been made with the consent of the Commissioner.ⁿ³⁶

[2] Foreign Currency Translations

IRC Section 986(b) provides that, in determining the tax of any shareholder of a foreign corporation, the earnings and profits of the corporation must be determined in the corporation's functional currency.ⁿ¹ When the earnings and profits are distributed, deemed distributed, or otherwise taken into account by a United States person, they must be translated into dollars using the appropriate exchange rate.

Currency translation is also required in computing the amount of foreign income taxes deemed paid under *IRC Section 902* or *960*. Taxpayers who take foreign income taxes into account when accrued must translate the amount of those taxes into United States dollars at the average exchange rate for the taxable year to which the taxes relate.^{n1.1} This rule does not apply to any foreign income taxes paid before the beginning of the taxable year to which the taxes relate or more than two years after the close of that year, or to accrued taxes denominated in an inflationary currency.^{n1.2} If any

of the exceptions apply, the amount of the foreign taxes (and adjustments) must be translated into United States dollars using the exchange rate as of the payment date of the tax (or adjustment), while refunds are translated at the exchange rate on the date of original payment.ⁿ²

Foreign currency gain or loss with respect to distributions of previously taxed income (as described in *IRC Section 959* or *1293(c)*) attributable to movements in exchange rates between the times of the deemed and actual distributions is recognized and treated as ordinary income from the same source as the associated income inclusion.^{n2.1} The Treasury is authorized to prescribe regulations governing distributions of previously taxed earnings and profits through tiers of corporations.

Pursuant to new proposed *IRC Section 987* Regulations, the foreign exchange pool method must be used to determine the amount of Section 987 gain or loss a taxpayer must recognize in a taxable year.ⁿ³ Under the foreign exchange pool method, a balance sheet approach is used to determine gain or loss which is then recognized to the extent of the remittance portion.ⁿ⁴ The remittance portion is determined by dividing the total remittance by the total adjusted basis of *IRC Section 987* gross assets.ⁿ⁵ Exchange gain or loss on the remittance portion is treated as ordinary income or loss, sourced by using the average tax book value of assets in the year of remittance as determined under *Regulation Section 1.861-9T(g)*.ⁿ⁶

[3] Treatment of Section 988 Transactions

Pursuant to *IRC Section 988(a)(1)(A)*, "any foreign currency gain or loss attributable to a section 988 transaction shall be computed separately and treated as ordinary income or loss (as the case may be)."ⁿ¹ To the extent that regulations provide, any amount treated as ordinary income or loss will be treated as interest income or expense.ⁿ² Foreign currency gain or loss is gain or loss realized due to changes in exchange rates after the date (i) the taxpayer acquires a debt instrument or becomes the obligor under a debt instrument, or (ii) accrues any item of expense or gross income or receipts that is to be paid or received after the date on which accrued or taken into account (booking date) and before the date on which payment is made or received (payment date).ⁿ³

To be a Section 988 transaction, the transaction must be one in which the amount that the taxpayer is entitled to receive (or is required to pay) is denominated in terms of a nonfunctional currency, or is determined by reference to the value of one or more nonfunctional currencies, and must consist of: (1) the acquisition of a debt instrument or becoming the obligor under a debt instrument, (2) the accruing (or otherwise taking into account) of any item of expense or gross income or receipts that is to be paid or received after the date on which it is accrued or taken into account, (3) the entering into or acquiring of any forward contract, futures contract, option, or similar financial instrument,^{n3.1} or (4) the disposition of any nonfunctional currency.ⁿ⁴

After February 14, 2000, if a taxpayer issues, acquires, or otherwise enters into or holds a hyperinflationary debt instrument or a hyperinflationary deposit on which interest is paid or accrued that is denominated in (or determined by reference to) a nonfunctional currency of the taxpayer, the taxpayer realizes exchange gain or loss with respect to the instrument or deposit for its taxable year determined by reference to the change in exchange rates between (1) the later of the first day of the taxable year, or the date the instrument was entered into (or an amount deposited), and (2) the earlier of the last day of the taxable year, or the date the instrument (or deposit) was disposed of or otherwise terminated.^{n4.1} No gain or loss is realized by reason of factors other than movement in exchange rates.^{n4.2} Any exchange gain or loss realized under the foregoing rule is an adjustment to the functional currency principal amount of the issuer, the functional currency basis of the holder, or the functional currency amount of the deposit.^{n4.3}

After February 14, 2000, if a taxpayer acquires or enters into a hyperinflationary contract that has payments to be made or received that are denominated in (or determined by reference to) a nonfunctional currency of the taxpayer, the taxpayer realizes exchange gain or loss for its taxable year determined by reference to the change in exchange rates between (a) the later of the first day of the taxable year, or the date the contract was acquired or entered into, and (b) the

earlier of the last day of the year, or the date the contract is disposed of or otherwise terminated.^{n4.4} The foregoing rule does not apply if a qualified business unit uses DASTM or the hedging rules of *Regulations Section 1.446-4* or *1.988-5* apply.^{n4.5}

In general, foreign currency-related regulated futures contracts and nonequity options that would be marked to market under *IRC Section 1256* if held at the end of the taxable year are not treated as Section 988 transactions.ⁿ⁵ However, a taxpayer can elect to treat such regulated futures contracts and nonequity options as foreign currency gain or loss, and, thus, as ordinary in character and sourced on the basis of residence.^{n5.1} The election for any taxable year must be made on or before the first day of the taxable year, or if later, the first day during the year that the taxpayer holds such a contract or option.^{n5.2} The election cannot be made with respect to any income or loss of a partnership that has elected to be treated as a qualified fund, but, a partner in such a fund can elect to treat gain or loss from regulated futures contracts and nonequity options (other than such income or loss the partner receives by virtue of being a partner in a qualified fund) as gain or loss from Section 988 transactions.

In the case of a qualified fund, the entering into or acquisition of any forward contract, futures contract, option, or similar financial instrument that would be marked to market if held on the last day of the taxable year is not a Section 988 transaction.ⁿ⁶ A partnership can elect to be a qualified fund if (1) at all times during the taxable year (and during each year that the election is in effect), the partnership has at least 20 partners and no single partner owns more than 20 percent of the interests in the capital or profits of the partnership,ⁿ⁷ (2) the principal activity of the partnership for the taxable year (and each such preceding taxable year) consists of buying and selling options, futures, or forwards with respect to commodities, (3) at least 90 percent of the gross income of the partnership for the taxable year (and each such preceding taxable year) must be from interest, dividends, gain from the sale or disposition of capital assets held for the production of interest and dividends, and income and gains from commodities, futures, forwards, and options with respect to commodities, and (4) no more than a *de minimis* amount of the gross income of the partnership for the taxable year (and each such preceding taxable year) is derived from buying and selling commodities. The election must be made on or before the first day of the taxable year, or if later, the first day during the year on which the partnership holds one of the specified instruments.^{n7.1} The election continues to apply unless revoked with the consent of the Service.

For a qualified fund, any bank forward contract, foreign currency futures contract, or similar instrument (not otherwise a Section 1256 contract) is treated as a Section 1256 contract for the purposes of *IRC Section 1256*.^{n7.2} Therefore, if the instrument is held by the qualified fund on the last day of the taxable year, it will be marked to market--treated as sold on the last business day of the year, gain or loss taken into account for the taxable year, and proper adjustment made in the amount of any gain or loss subsequently realized to reflect gain or loss taken into account by year-end marking to market. In addition, gains and losses on instruments that become Section 1256 contracts solely because they are held by a qualified fund are treated as short-term capital gains and losses.^{n7.3}

If a partnership that elected to be treated as a qualified fund fails to meet the qualified fund definition for the current taxable year, the character of its gain or loss on its Section 1256 contracts will depend upon whether the gains and losses of the partnership for the taxable year from all such contracts result in a net gain or net loss. If the result is a gain, the gain is ordinary; if a loss, the loss is characterized under the rules that would have applied if the partnership had not ceased to be a qualified fund.ⁿ⁸ However, if the Service determines that the failure to meet the qualified fund requirements was inadvertent, the partnership takes steps within a reasonable time to meet the failed conditions, and the partnership agrees to make such adjustments (including adjustments with respect to partners) as may be required by the Service with respect to the period of inadvertent failure, the partnership will be treated as a qualified fund for the entire taxable year.

Mixed foreign currency straddles, i.e., straddles containing one or more currency positions that would normally give rise to capital gain or loss and one or more positions that would normally produce ordinary income or loss, are subject to the mixed straddle regulations prescribed under *IRC Section 1092(b)*.ⁿ⁹ The treatment of mixed straddles is discussed in § 9.02[4].

If any Section 988 transaction is part of a "988 hedging transaction," all transactions that are part of the transaction will be integrated and treated as a single transaction or otherwise treated consistently.ⁿ¹⁰ The determination of whether the hedging transaction is a Section 988 transaction is made without regard to the marked to market rules of *IRC Section 1256*, and neither those rules nor the loss deferral rules of *IRC Section 1092* will apply.

One type of 988 hedging transaction, a qualified hedging transaction, consists of a qualified debt instrument and a *Regulations Section 1.988-5* hedge.^{n10.1} In such case, the debt instrument and the hedge are integrated into a single synthetic debt instrument for income tax purposes.^{n10.2} If the qualified hedging transaction results in a synthetic functional currency denominated debt instrument, no foreign currency gain or loss will be realized.^{n10.3}

A qualifying debt instrument and a hedge are an integrated transaction if all of the following requirements are satisfied:^{n10.4}

1. All payments to be made or received under the qualifying debt instrument are fully hedged on the date the taxpayer identifies the transaction as a qualified hedging transaction such that a yield to maturity can be calculated.
2. The hedge is identified in the taxpayer's books and records on the date the hedge is entered into.^{n10.5}
3. None of the parties to the hedge are related.^{n10.6}
4. In the case of a qualified business unit with a residence outside the United States, both the qualifying debt instrument and the hedge are properly reflected on the books of the qualified business unit throughout the term of the qualified hedging transaction.
5. Both the qualifying debt instrument and the hedge are entered into by the same person.
6. With respect to a foreign person engaged in a United States trade or business that enters into a qualifying debt instrument or hedge through the trade or business, all items of income or expense associated with the debt instrument or hedge (other than the interest deduction of a foreign corporation coming within the rules of *Regulations Section 1.882-5*), would have been effectively connected with the United States trade or business throughout the term of the qualified hedging transaction had the special rules relating to qualified hedging transactions not applied.

If a taxpayer legs into an integrated transaction, that is, enters into a hedge after the date the qualifying debt instrument is entered into, then: (1) exchange gain or loss will be realized with respect to the qualifying debt instrument solely by reference to changes in exchange rates between (a) the date the instrument was acquired by the holder, or the date the obligor assumed the obligation to make payments under the instrument, and (b) the leg-in date; (2) the recognition of such gain or loss will be deferred until the date the qualifying debt instrument matures or is otherwise disposed of; and (3) the source and character of the gain or loss will be determined on the leg-in date as if the qualifying debt instrument was actually sold or otherwise terminated by the taxpayer.^{n10.7}

A taxpayer legs out of an integrated transaction if the taxpayer disposes of or otherwise terminates all or a part of the qualifying debt instrument or hedge prior to maturity of the qualified hedging transaction, or the taxpayer changes a material term of the qualifying debt instrument (such as exercising an option to change the interest rate or index, or the maturity date) or hedge (for example, changing the interest or exchange rates underlying the hedge, or the expiration date) prior to maturity of the qualified hedging transaction.^{n10.8} If a taxpayer legs out of integrated treatment, the following rules apply:

1. The transaction will be treated as a qualified hedging transaction during the time the requirements of *Regulations Section 1.988-5(a)* were satisfied.
2. If the hedge is disposed of or otherwise terminated, the qualifying debt instrument is treated as sold for its fair market value on the date the hedge is disposed of or otherwise terminated (the "leg-out date"), and any gain or loss (including gain or loss resulting from factors other than movements in exchange rates) from the identification date to the leg-out date is realized and recognized on the leg-out date. The spot rate on the leg-out date is used to determine exchange gain or loss on the debt instrument for the period beginning on the leg-out date and ending on the date the instrument matures or is disposed of or otherwise terminated. Proper adjustment to the principal amount of the debt instrument must be made to reflect any gain or loss taken into account.
3. If the qualifying debt instrument is disposed of or otherwise terminated, the hedge is treated as sold for its fair market value on the leg-out date, and any gain or loss from the identification date to the leg-out date is realized and recognized on the leg-out date. The spot rate on the leg-out date is used to determine exchange gain or loss for the period beginning on the leg-out date and ending on the date the hedge is disposed of or otherwise terminated.
4. The part of the qualified hedging transaction that has not been terminated (the remaining debt instrument in its entirety even if partially hedged, or the hedge) cannot be part of a qualified hedging transaction for any period subsequent to the leg-out date.^{n10.9}
5. If a taxpayer legs out of a qualified hedging transaction and realizes a gain with respect to the terminated instrument, then the rules in paragraphs 2 or 3, as appropriate, will not apply if during the period beginning 30 days before the leg-out date and ending 30 days after that date the taxpayer enters into a transaction that hedges at least 50 percent of the remaining currency flow with respect to the qualifying debt instrument that was part of the qualified hedging transaction (or, if appropriate, an equivalent amount under the *Regulations Section 1.988-5* hedge that was part of the qualified hedging transaction).

A hedged executory contract will also be treated as a single transaction.^{n10.10} An executory contract is an agreement entered into before the accrual date to pay nonfunctional currency (or an amount determined by reference thereto) in the future with respect to the purchase or sale of property used in the ordinary course of the taxpayer's trade or business, or the acquisition or performance of services, or the sale of inventory, in the future.^{n10.11} A contract to buy or sell stock is also an executory contract.

A hedge for this purpose is a deposit of nonfunctional currency in an account with a bank or financial institution used exclusively for deposits of nonfunctional currency used to hedge executory contracts, a forward or futures contract that reduces the risk of exchange rate fluctuations by reference to the taxpayer's functional currency with respect to nonfunctional currency payments made or received under the executory contract, or an option contract if the option's expiration date is on or before the accrual date.^{n10.12}

A hedged executory contract must meet the following requirements:^{n10.13}

1. The executory contract and the hedge are identified as a hedged executory contract in the taxpayer's records before the close of the date the hedge is entered into.^{n10.14}
2. The hedge is entered into (that is, settled or closed, or in the case of nonfunctional currency deposited with a bank or other financial institution, such currency is acquired or deposited) on or after the date the executory contract is entered into and before the accrual date.

3. The executory contract is hedged in whole or in part throughout the period beginning on the date the hedge is identified and ending on or after the accrual date.
4. None of the parties to the hedge are related.
5. In the case of a qualified business unit with a residence outside the United States, both the executory contract and the hedge are properly reflected on its books.
6. Both the executory contract and the hedge are entered into by the same person.
7. With respect to a foreign person engaged in a United States trade or business that enters into an executory contract or hedge through the trade or business, all items of income or expense associated with the executory contract or hedge would have been effectively connected with the United States trade or business throughout the term of the hedged executory contract had the special rules relating to hedged executory contracts not applied.

If a taxpayer enters into a hedged executory contract, amounts paid or received by the taxpayer under the hedge are treated as paid or received by the taxpayer under the executory contract, or any subsequent account payable or receivable, or that portion to which the hedge relates.^{n10.15} In addition, the taxpayer recognizes no exchange gain or loss on the hedge. If an executory contract, on the accrual date, becomes an account payable or receivable, the taxpayer does not recognize exchange gain or loss on the payable or receivable for the period covered by the hedge.

The effect of integrating an executory contract and a hedge that partially hedges the contract is to treat the amounts paid or received under the hedge as paid or received under the portion of the executory contract being hedged, or any subsequent account payable or receivable.^{n10.16} The income or expense of services performed or received under the executory contract, or the amount realized or basis of property sold or purchased under the executory contract, that is attributable to the portion of the executory contract that is not hedged must be translated into functional currency on the accrual date. Exchange gain or loss is realized when payment is made or received with respect to any payable or receivable arising on the accrual date with respect to the unhedged amount.

If the taxpayer disposes of (or otherwise terminates) the executory contract prior to the accrual date, the hedge is treated as sold for its fair market value on the date of disposition and any gain or loss must be realized and recognized on that date; the gain or loss is an adjustment to the amount received or expended with respect to the disposition or termination.^{n10.17} The spot rate on the date the hedge is treated as sold is used to determine subsequent exchange gain or loss on the hedge. If the hedge is disposed of prior to the accrual date, any gain or loss realized on the disposition is not recognized, but is an adjustment to the income from, or expense of, the services performed or received under the executory contract, or to the amount realized or basis of property sold or purchased under the contract. No gain or loss is recognized on a disposition of the hedge after the accrual date.^{n10.18}

IRC Sections 263(g), 1092, and 1256 generally do not apply with respect to the executory contract or hedge that comprises a hedged executory contract.^{n10.19} However, they may apply to a hedged executory contract if the transaction is part of a straddle.

If a taxpayer purchases or sells stock or securities that are traded on an established securities market, and (a) hedges all or part of the purchase or sale for any part of the period beginning on the trade date and ending on the settlement date, and (b) identifies the hedge and the underlying stock or securities as an integrated transaction, then any gain or loss on the hedge becomes an adjustment to the amount realized or the adjusted basis of the stock or securities sold or purchased (and is not taken into account as exchange gain or loss).^{n10.20} For this purpose, a hedge is a deposit of nonfunctional currency in an account with a bank or other financial institution, or a forward or futures contract, or any

combination thereof, that reduces the risk of exchange rate fluctuations for any portion of the period between the trade date and the settlement date. *IRC Sections 263(g), 1092, and 1256* do not apply with respect to stock or securities or the hedge.

The source of any amount treated as ordinary income or loss under *IRC Section 988(a)(1)(A)* is determined by reference to the residence of the taxpayer or the qualified business unit of the taxpayer on whose books the asset, liability, or item of income or expense is properly reflected.ⁿ¹¹ The following residence rules apply: (1) an individual's residence is that person's tax home; (2) the residence of a United States corporation, partnership, trust, or estates is the United States; (3) a foreign entity's residence is the foreign country; and (4) the residence of a qualified business unit is the country in which the principal place of business of the unit is located.ⁿ¹² If an individual does not have a tax home, (as so defined) the residence of the individual is the United States if the individual is a United States citizen or resident alien and a country other than the United States if the individual is not a United States citizen or resident alien. However, all swap income (income attributable to United States dollar denominated interest rate swaps where one party is a taxpayer with the United States dollar as its functional currency) attributable to a United States trade or business must be sourced in the United States and effectively connected to the United States trade or business.ⁿ¹³

Regulations provide that the noncontingent bond method of *Regulation Section 1.1275-4(b)* should apply to contingent payment debt instruments in which one or more payments are denominated in a currency other than the taxpayer's functional currency.ⁿ¹⁴ The regulations are applicable to the following instruments: (1) debt instruments issued for money or publicly-traded property for which all payments of principal and interest are denominated in, or determined by reference to, a single nonfunctional currency and that have one or more non-currency contingencies; (2) debt instruments issued for money or publicly-traded property for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and that have no non-currency contingencies; (3) debt instruments issued for money or publicly-traded property for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and that also have one or more non-currency contingencies; and (4) debt instruments that otherwise would fall into one of the three described categories but for the fact that the instruments are not issued for money or publicly-traded property.ⁿ¹⁵

The rules generally do not apply to an instrument under which any payment is determined by reference to a hyperinflationary currency.ⁿ¹⁶ In such case, the amount, timing, source, and character of interest, principal, foreign currency gain or loss, and gain or loss relating to a non-currency contingency must be determined under the method that reflects the instrument's economic substance.ⁿ¹⁷

The regulations generally provide that the noncontingent bond method is applied in the currency in which the instrument is denominated (the denomination currency).ⁿ¹⁸ This generally requires taxpayers (a) to accrue interest in the denomination currency at a yield at which the issuer would issue a fixed rate debt instrument denominated in the denomination currency with terms and conditions similar to those of the contingent payment debt instrument, (b) to translate the interest accrued from the denomination currency into the functional currency (and account for foreign currency gain or loss on payments of interest and principal) under the principles of *Regulation Section 1.988-2(b)*, and (c) to account for gain or loss arising from contingencies in a manner consistent with the rules of *Regulation Section 1.1275-4(b)*.ⁿ¹⁹

The holder of the debt instrument normally will use the yield and projected payment schedule determined by the issuer to determine the holder's interest accruals and adjustments for the instrument.ⁿ²⁰ If the issuer does not determine a comparable yield and projected payment schedule for the instrument, or if the issuer's comparable yield or projected payment schedule is unreasonable, the holder must do so and explicitly disclose both this fact and the reason why the holder made its own determination.

The regulations provide further that the holder maintains its adjusted basis in functional currency by computing basis adjustments in the denomination currency and then translating the adjustments into functional currency.ⁿ²¹ This means

that the holder's basis is increased by the holder's accrued but unpaid interest inclusions on the debt instrument, generally without regard to any positive or negative adjustment, and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument; all of these amounts are translated into functional currency.ⁿ²²

The holder of the debt instrument uses the denomination currency in determining the amount realized on the retirement or disposition of the instrument.ⁿ²³ If the payment is received on the scheduled retirement of the debt instrument, the holder generally is treated as receiving the projected amount of any contingent payment due at maturity. In the case of a sale or exchange or unscheduled retirement of the instrument, general recognition principles apply. However, the amount realized by a holder in any case is reduced by any negative adjustment carryforward existing in the year of sale, exchange, or retirement.

In calculating gain or loss other than foreign currency gain or loss, the amount realized must be translated into functional currency.ⁿ²⁴ Foreign currency gain or loss is recognized only when payments are made or received pursuant to the instrument.ⁿ²⁵ No foreign currency gain or loss is recognized with respect to a net positive or negative adjustment.

The noncontingent bond method does not apply to nonfunctional currency contingent debt instruments. Instead, the debt instrument is separated into its components based on the currency in which the payments are denominated and whether the payments are contingent or noncontingent.ⁿ²⁶ The noncontingent components in each currency are treated as a separate debt instrument denominated in the currency in which the payments are denominated. A component consisting of a contingent payment is generally treated in the manner provided in *Regulation Section 1.1275-4(c)(4)*.ⁿ²⁷

If a subsequent holder of the instrument purchases the instrument for a price greater or less than its adjusted issue price, the holder is required to allocate the excess to interest accrued on the instrument or to projected payments on the instrument in a reasonable manner.ⁿ²⁸ If the purchase price is greater than the adjusted issue price, each allocation is treated as a negative adjustment on the instrument, and the holder's basis on the instrument is decreased as the negative adjustments are taken into account. If the purchase price is less than the adjusted issue price, the holder is treated as having received a positive adjustment on the instrument and the holder's basis is increased accordingly.

FOOTNOTES:

(n1)Footnote 1. *IRC § 985(a)*. The conversion to the euro of legacy currencies (the national currency of a participating member state of the European Union prior to substitution of the euro for the national currency) is not an exchange of property for other property differing materially in kind or extent. Therefore, no gain or loss is recognized on the conversion. *Treas Reg § 1.1001-5(a)*.

(n2)Footnote 2. *IRC § 989(a)*. The determination as to whether activities constitute a trade or business is ultimately based upon an examination of all the facts and circumstances. Generally, a trade or business for this purpose is a specific unified group of activities carried on for profit, the expenses of which are deductible under *IRC § 162* or *IRC § 212(1)* or (2). The group of activities must ordinarily include every operation that forms a part of, or a step in, a process by which an enterprise may earn income or profit, including the collection of income and payment of expenses. *Treas Reg § 1.989(a)-1(c)*.

Any activity (wherever conducted and regardless of its frequency) that produces income or loss that is, or is treated as, effectively connected with the conduct of a US trade or business is treated as a separate QBU if the separate books and records requirement is satisfied. *Treas Reg § 1.989(a)-1(b)(3)*.

A complete and separate set of books and records must include books of original entry and ledger accounts, both general and subsidiary, or similar records. *Treas Reg § 1.989(a)-1(d)*. For purposes of *Treas Reg § 1.989(a)-1(b)(3)*, books and records include those used to determine income or loss that is, or is treated as, effectively connected with a

US trade or business. *Treas Reg § 1.989(a)-1(d)(2)*.

The Service will not ordinarily rule whether a unit or a taxpayer's trade or business is a QBU, or whether a currency is the functional currency of a QBU. Rev Proc 2007-7, 2007-1 CB 227 .

(n3)Footnote 3. *IRC § 985(b)(1)*. The economic environment in which a significant part of the activities of a QBU are conducted is determined by taking into account all the facts and circumstances, including (but not limited to): (i) the currency of the country in which the unit is a resident; (ii) the principal currency of the unit's cash flows; (iii) the principal currency in which the unit generates revenues and incurs expenses; (iv) the principal currency in which the borrowing or lending of the unit is conducted; (v) the currency of the unit's principal sales market; (vi) the duration of the unit's business operations; and (vii) the significance and/or volume of the unit's independent activities. The rate of inflation is not a factor to be used in determining the unit's economic environment. *Treas Reg § 1.985-1(c)(2)*.

The taxpayers, in *Quijano v US*, 93 F3d 26 (1st Cir 1996) , *cert denied* 117 S Ct 690 , sought to claim a currency loss incurred on the repayment of a mortgage on a personal residence. The court held that the taxpayers could not use a functional currency other than the US dollar because the property did not qualify as a QBU.

The Service will not ordinarily issue a ruling whether a currency is the functional currency of a QBU. Rev Proc 2007-7, 2007-1 CB 227 .

(n4)Footnote 4. *IRC § 985(b)(2)*; *Treas Reg § 1.985-1(b)(1)*. The dollar must be the functional currency of a taxpayer that is not a QBU (eg, an individual).

(n5)Footnote 5. *Treas Reg § 1.985-8(b)(2)*. A legacy currency is the former currency of a member state of the European Union for which the euro is substituted. *Treas Reg § 1.985-8(a)(1)*.

A QBU whose first taxable year begins after the euro has been substituted for a legacy currency cannot adopt a legacy currency as its functional currency. *Treas Reg § 1.985-8(b)(1)*.

(n6)Footnote 6. *Treas Reg § 1.985-8(b)(3)*. The change must be made within the same period as is required for a QBU with a legacy currency as its functional currency.

A QBU changing its functional currency from a nonlegacy currency to the euro must make the adjustments specified in *Treas Reg § 1.985-5*. *Treas Reg § 1.985-8(b)(4)*.

(n7)Footnote 7. *Treas Reg § 1.985-8(b)(4)*.

(n8)Footnote 8. *Treas Reg § 1.985-8(b)(5)*.

(n9)Footnote 9. *Treas Reg § 1.985-8(c)(2)*. The conversion rate is the rate at which the euro is substituted for the legacy currency. *Treas Reg § 1.985-8(a)(2)*.

(n10)Footnote 9.1. *Treas Reg § 1.985-8(c)(2), (3)*.

(n11)Footnote 9.2. *IRC § 988(c)(1)(C)(ii)*.

(n12)Footnote 9.3. New proposed regulations plan to modify *IRC § 988* sourcing regulations. Under the proposed regulations, generally effective a year after becoming final, certain transactions described in *IRC §§ 988(c)(1)(A)(i)* and *(ii)* and *988(c)(1)(C)* that are denominated in the owner's functional currency and that are attributable to a QBU under *Treas Reg § 1.987-2(b)* shall not be treated as *IRC § 988* transactions, thus no currency gain or loss shall be recognized under *IRC § 988* with respect to such items. *Prop Treas Reg § 1.987-3(e)(2)*.

(n13)Footnote 9.4. The election is made by attaching a statement to the return for the taxable year immediately prior to the year of change. The statement must contain the following: "TAXPAYER CERTIFIES THAT A QBU OF THE TAXPAYER HAS ELECTED TO REALIZE CURRENCY GAIN OR LOSS ON LEGACY CURRENCY DENOMINATED ACCOUNTS RECEIVABLE AND PAYABLE UPON CHANGE OF FUNCTIONAL CURRENCY TO THE EURO." *Treas Reg § 1.985-8(c)(3)(iv)(B)*.

(n14)Footnote 9.5. *Treas Reg § 1.985-8(c)(4)(i)*.

(n15)Footnote 9.6. *Treas Reg § 1.985-8(c)(4)(ii)*. The adjustment is taken into account by the taxpayer ratably over four taxable years beginning with the taxable year of change.

The principles of *IRC § 987* are discussed in § 20.09[2].

(n16)Footnote 9.7. *Treas Reg § 1.985-8(c)(5)(i)*.

(n17)Footnote 9.8. *Treas Reg § 1.985-8(c)(5)(ii)*.

(n18)Footnote 9.9. *Treas Reg § 1.985-8(c)(6)*.

(n19)Footnote 9.10. *Id.*

(n20)Footnote 10. *Treas Reg § 1.985-1(b)(2)(ii)(A)*. If a QBU is required to change its functional currency to the dollar, the change is considered made with the consent of the Commissioner. *Treas Reg § 1.985-1(b)(2)(C)*. Adjustments required to be made by reason of the change to DATSM are specified in *Treas Reg § 1.985-7*.

A QBU that has been required to use the dollar as its functional currency must change its functional currency as of the first day of the first taxable year that follows three consecutive taxable years in which the currency of its economic environment is not a hyperinflationary currency. *Treas Reg § 1.985-1(b)(2)(E)*.

(n21)Footnote 11. *Treas Reg § 1.985-1(b)(2)(ii)(D)*. The cumulative inflationary rate for the 36-month period is based on compounded inflation rates. Thus, if the current calendar year is 1996 and for 1993, 1994, and 1995, a country's annual inflation rates are 30%, 30%, and 35%, respectively, the cumulative inflation rate is 128 percent $(((1.30 \times 1.30 \times 1.35) - 1.00) \times 100 = 128\%)$ and the currency of the country for the qualified business unit's 1996 year is hyperinflationary.

If a country's currency is not listed in the monthly issues of "International Financial Statistics," a QBU may use any other reasonable method consistently applied for determining the country's consumer price index.

(n22)Footnote 12. *Treas Reg § 1.985-1(b)(2)(ii)(B)(1)*. In such case, the QBU's income or loss or earnings and profits are determined under the DASTM by substituting the functional currency of the foreign corporation for the dollar.

(n23)Footnote 13. *Treas Reg § 1.985-1(b)(2)(ii)(B)(2)*.

(n24)Footnote 14. *IRC § 985(b)(3)*; *Treas Reg § 1.985-2*. A QBU that could have used a hyperinflationary currency as its functional currency absent the dollar election is called an eligible QBU in the regulations. *Treas Reg § 1.985-2(b)(1)*.

A noncontrolled *IRC § 902* corporation (a foreign corporation in which at least 10 percent of the voting stock is owned by a domestic corporation) can elect to use the dollar as its (or its QBU branch's) functional currency under the procedures set forth in *Treas Reg § 1.985-2(c)(3)*. *Treas Reg § 1.985-1(b)(2)(ii)(B)(2)*.

(n25)Footnote 15. *IRC § 985(b)(3); Treas Reg § 1.985-3.*

(n26)Footnote 16. *Treas Reg § 1.985-2(c)(1)(i).*

(n27)Footnote 17. *Treas Reg § 1.985-2(c)(2)(i), (ii).* The controlling US shareholders are those US shareholders who, in the aggregate, own greater than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote. If the foreign corporation is a controlled foreign corporation, but the US shareholders do not, in the aggregate, own the requisite voting power, the controlling US shareholders are all the US shareholders who own stock of the controlled foreign corporation.

Stock ownership is determined by applying *IRC § 958(a)*, the ownership rules applicable to controlled foreign corporations.

(n28)Footnote 18. *Treas Reg § 1.985-2(c)(2)(iii).*

(n29)Footnote 19. *Treas Reg § 1.985-2(c)(3)(i).* Majority domestic corporate shareholders are those domestic corporate shareholders who, in the aggregate, own greater than 50 percent of the total combined voting stock of all classes of stock of the noncontrolled foreign corporation entitled to vote that is owned by all the domestic corporate shareholders.

(n30)Footnote 20. *Treas Reg § 1.985-2(c)(4).*

(n31)Footnote 21. *Treas Reg § 1.985-2(d)(3)(i).*

(n32)Footnote 22. *Treas Reg § 1.985-2(d)(3)(ii).*

(n33)Footnote 23. *Treas Reg § 1.985-2(d)(1).*

(n34)Footnote 24. Stock ownership is determined by applying the rules contained in *IRC § 958(a)*.

(n35)Footnote 24.1. *Treas Reg § 1.985-2(d)(3)(i).* A related person means any person with a relationship defined in *IRC § 267(b)* to the electing QBU (or to the US or foreign person of which the electing QBU is a part). In determining whether two or more corporations are members of the same controlled group under *IRC § 267(b)(3)*, a person is deemed to own stock owned directly by that person, stock owned with the application of *IRC § 1563(e)(1)*, and stock owned with the application of *IRC § 267(c)*.

(n36)Footnote 24.2. *Treas Reg § 1.985-2(d)(3)(ii).*

(n37)Footnote 24.3. *Treas Reg § 1.985-2(d)(4).*

(n38)Footnote 24.4. *Id; Treas Reg § 1.985-5.* The adjustments are made on the last day of the taxable year ending before the year of change. *Treas Reg § 1.985-5(a).*

(n39)Footnote 24.5. *Treas Reg § 1.985-5(b).* The full amount of the gain or loss must be included in income or earnings and profits on the last day of the taxable year ending before the year of change. *Treas Reg § 1.985-5(a).*

Section 988 transactions are the subject of § 20.09[3].

(n40)Footnote 24.6. *Treas Reg § 1.985-5(c).*

(n41)Footnote 24.7. *Treas Reg § 1.985-5(d)(1)(ii).* Proposed regulations provide that if the QBU and the owner had different functional currencies prior to the change, the owner and the QBU must make adjustments to both historic and marked items. These adjustments must be made pursuant to the principles set forth in the newly proposed section

987 regulations. *Prop Treas Reg § 1.985-5(d)(1)(ii)*.

(n42)Footnote 24.8. *Treas Reg § 1.985-5(d)(1)(iii)*. Under the proposed regulations, both the QBU and the taxpayer are subject to the rules prescribed in *IRC § 987* if the QBU, having the same functional currency as the taxpayer, changes to a new functional currency different from the taxpayer and, as a result of the change, the taxpayer will be an owner of a QBU. *Prop Treas Reg § 1.985-5(d)(1)(iii)*.

(n43)Footnote 24.9. *Treas Reg § 1.985-5(d)(2)*.

(n44)Footnote 24.10. The full amount of the gain or loss must be included in income or earnings and profits on the last day of the taxable year ending prior to the year of change. *Treas Reg § 1.985-5(a)*.

(n45)Footnote 24.11. *Treas Reg § 1.985-5(e)(1)*.

(n46)Footnote 24.12. *Id.*

(n47)Footnote 24.13. *Treas Reg § 1.985-5(e)(2)*.

(n48)Footnote 24.14. *Id.*

(n49)Footnote 24.15. *Treas Reg § 1.985-5(a)*.

(n50)Footnote 25. *Treas Reg § 1.985-2(d)(2)(i)*.

(n51)Footnote 26. *Treas Reg § 1.985-2(d)(2)(ii)*.

(n52)Footnote 27. *Treas Reg §§ 1.985-3(b), 1.985-3(c)(1), (7)*. A taxpayer can divide its taxable year into translation periods of equal length (with not more than one short period annually) that are less than one month. Once such a translation period is established, it cannot be changed without the consent of the district director.

(n53)Footnote 28. *Treas Reg § 1.985-3(c)(6)*.

(n54)Footnote 29. *Treas Reg § 1.985-3(d)*. The method of translation is set forth in *Treas Reg § 1.985-3(d)(5)*.

(n55)Footnote 30. *Treas Reg § 1.985-3(d)(3), (4)*. Net worth of a QBU at the end of any taxable year equals the aggregate dollar amount representing assets on the QBU's balance sheet at the end of the taxable year less the aggregate dollar amount representing liabilities on the balance sheet. The Service may adjust the amount of any asset or liability if a purpose for acquiring or disposing of the asset, or incurring or discharging the liability, is to manipulate the balance sheet in order to avoid tax. *Treas Reg § 1.985-3(d)(2)*.

If the item giving rise to the adjustment would be translated under *Treas Reg § 1.985-3(d)(5)* at the exchange rate for the last translation period of the year if it were on the QBU's year-end balance sheet, for purposes of *Treas Reg § 1.985-3(d)(3)* the item must be translated at the exchange rate on the date the item is transferred. If the item giving rise to the adjustment would be translated at the exchange rate for the translation period in which the cost of the item were incurred if it were on the QBU's year-end balance sheet, the item must be translated at the same historical rate. The rule is effective for any transfer, dividend, or distribution that is a return of capital that is made after March 8, 2005, and that gives rise to an adjustment under *Treas Reg § 1.985-3(d)(3)*.

(n56)Footnote 31. *Treas Reg § 1.985-3(d)(8)*.

(n57)Footnote 32. *Treas Reg § 1.985-3(e)(2)(i)*. If a taxpayer makes the election, DASTM gain or loss of a small QBU is allocated ratably to all items of the QBU's gross income (determined prior to the adjustment for DASTM gain or loss). *Treas Reg § 1.985-3(e)(2)(iv)*. In the case of a controlled foreign corporation, DASTM gain or loss is allocated

to Subpart F income in a separate category in the same ratio that gross Subpart F income in that category for the taxable year bears to its total gross income in that category for the taxable year.

(n58)Footnote 33. *Treas Reg § 1.985-3(e)(2)(i)*. A related person is any person with a relationship to the QBU (or to the US or foreign person of which the electing QBU is a part) that is defined in *IRC § 267(b)* or *707(b)*. *Treas Reg § 1.985-3(e)(2)(vi)*.

If an election of the small QBU DASTM allocation is made, each QBU of any related person that satisfies the \$10 million threshold requirement is deemed to have made the election as well. *Treas Reg § 1.985-3(e)(2)(v)*.

(n59)Footnote 34. *Treas Reg § 1.985-3(e)(2)(iii)(A)*. The statement must identify the QBU (or QBU's) for which the election is being made and the country of residence, state the adjusted basis of the assets of the QBU (and any related same-country QBU), and include a statement that the election is being made pursuant to *Treas Reg § 1.985-3(e)(2)*.

(n60)Footnote 35. *Treas Reg § 1.985-3(e)(2)(iii)(B)*.

(n61)Footnote 36. *Treas Reg § 1.985-3(e)(2)(ii)*. There is also deemed consent to any application of the DASTM procedure prescribed in *Treas Reg § 1.985-3(e)(3)* due to an increase in the adjusted basis of the QBU's assets.

(n62)Footnote 1. The amount of a distribution from a foreign corporation to a domestic shareholder also is determined in the foreign corporation's functional currency. *TAM 200143001*.

(n63)Footnote 1.1. *IRC § 986(a)(1)(A)*. The taxpayer can elect that the provision not apply to any foreign taxes if the liability for the taxes is denominated in a currency other than the taxpayer's functional currency. Regulations may prescribe that the election can apply to foreign income taxes attributable to a qualified business unit. *IRC § 986(a)(1)(D)*.

(n64)Footnote 1.2. *IRC § 986(a)(1)(B), (C)*. None of the translation rules apply to a regulated investment company that accounts for income on an accrual basis; any foreign income taxes paid or accrued by it on such income must be translated into dollars using the exchange rate as of the date the income accrues. *IRC § 986(a)(1)(D)*.

(n65)Footnote 2. *IRC § 986(a)(2)*. To the extent provided in regulations, the average exchange rate for the period (specified in the regulations) during which the tax or adjustment is paid may be used instead of the exchange rate as of the date of payment. *IRC § 986(a)(3)*. Cash basis taxpayers always use the exchange rate as of the date the tax is paid.

(n66)Footnote 2.1. *IRC § 986(c)*.

(n67)Footnote 3. Congress has withdrawn the 1991 proposed regulations and has provided new proposed regulations designed to more accurately facilitate the recognition of true economic foreign currency gain and loss while minimizing the recognition of non-economic foreign currency gain and loss. The new proposed regulations do not apply to financial institutions, S corporations, trusts or estates. *Prop Treas Reg § 1.987-1(b)(iii)*.

Rules contained in both *Prop Treas Reg § 1.987-4* and *Prop Treas Reg § 1.987-5* form the foreign exchange pool method.

(n68)Footnote 4. *Prop Treas Reg § 1.987-4(e)*. Under the balance sheet approach, the bases of *IRC § 987* marked items are translated into the owner's functional currency at the spot rate on the last day of the taxable year. *IRC § 987* historic items are translated into the owner's functional currency at the historic exchange rate.

(n69)Footnote 5. The total remittance, determined in the owner's function currency on the last day of the owner's taxable year, must equal the excess of the total amounts transferred from the QBU to the owner over the total amounts transferred from the owner to the QBU on an annual basis. *Prop Treas Reg § 1.987-5(c)*.

(n70)Footnote 6. *IRC § 987(3)(B)* requires a taxpayer to source exchange gain or loss by reference to the source of income giving rise to post-1986 accumulated earnings. To avoid the complexities of this sourcing rule, the average book value of assets under *Treas Reg § 1.861-9T(g)* is now used as a proxy for post-1986 accumulated earnings in the context of *IRC § 987*. *Prop Treas Reg § 1.987-6(b)(2)*.

(n71)Footnote 1. A taxpayer can elect to treat any foreign currency gain or loss attributable to a forward contract, futures contract, or option that (1) is not marked to market, (2) is a capital asset in the hands of the taxpayer, and (3) is not part of a straddle, as capital gain or loss if the taxpayer makes the election and identifies the transaction as such before the close of the day the transaction is entered into (or such earlier time as the Service may prescribe). *IRC § 988(a)(1)(B)*.

IRC § 988 does not apply to any Section 988 transaction entered into by an individual that is a personal transaction. *IRC § 988(e)(1)*. Under *IRC § 988(e)(2)*, no gain is recognized on the disposition of nonfunctional currency in a personal transaction to the extent that the gain does not exceed \$200. A personal transaction does not include any transaction to the extent that expenses properly allocable to the transaction are deductible under *IRC § 162* (other than traveling expenses) or *IRC § 212(1)* or (2). *IRC § 988(e)(3)*.

(n72)Footnote 2. *IRC § 988(a)(2)*.

(n73)Footnote 3. *IRC § 988(b), (c)(2), (3)*.

(n74)Footnote 3.1. A similar financial instrument includes a notional principal contract only if the payments required to be made or received under the contract are determined with reference to a nonfunctional currency. *Treas Reg § 1.988-1(a)(2)(iii)(B)(1)*. The term includes a currency swap, but does not include a swap referenced to a commodity or equity index. *Treas Reg § 1.988-1(a)(2)(iii)(B)(2)*. The treatment of foreign currency swaps is discussed in § 9A.07.

(n75)Footnote 4. *IRC § 988(c)(1)*. Nonfunctional currency includes coin or currency, and nonfunctional currency denominated demand or time deposits or similar instruments issued by a bank or other financial institution. *IRC § 988(c)(1)(C)(ii)*. Gain or loss from the disposition of nonfunctional currency is treated as foreign currency gain or loss. *IRC § 988(c)(1)(C)(i)(II)*.

Although there may be a conversion of a legacy currency to the euro, Section 988 transactions will continue to be treated as nonfunctional currency transactions, even though the remaining payments on an asset or liability will be made in a new functional currency, the euro. *Treas Reg 1.985-8(c)(3)*.

The accrual of a foreign tax liability is treated as a Section 988 transaction, except for a QBU of a domestic person that uses the US dollar as its functional currency and claims a tax credit for foreign taxes paid. *Treas Reg § 1.988-1(a)(2)(ii)*.

A payment as a mere guarantor does not qualify as an *IRC Section 988* transaction. *Intergraph Corp v Commr*, 106 TC 312 (1996), *affd in an unpublished opinion* (11th Cir 1997).

(n76)Footnote 4.1. *Treas Reg § 1.988-2(b)(15)(i)*. The provision does not apply to a debt instrument that has interest and principal payments that are to be made by reference to a currency or item that does not reflect hyperinflationary conditions in a country. *Treas Reg § 1.988-2(b)(15)(iii)*.

A hyperinflationary debt instrument is one that provides for (i) payments denominated in or determined by reference to a hyperinflationary currency at the time the taxpayer enters into or acquires the instrument, or (ii) payments denominated in or determined by reference to a hyperinflationary currency during the taxable year, and the terms of the instrument provide for the adjustment of principal or interest payments in a manner that reflects hyperinflation. *Treas Reg § 1.988-2(b)(15)(vi)*. A hyperinflationary deposit is a demand or time deposit or similar instrument issued by a bank

or other financial institution that provides for the same type of payments. *Treas Reg § 1.988-2(b)(15)(vii)*.

(n77)Footnote 4.2. *Treas Reg § 1.988-2(b)(15)(ii)*.

(n78)Footnote 4.3. *Treas Reg § 1.988-2(b)(15)(v)*.

(n79)Footnote 4.4. *Treas Reg § 1.988-2(d)(5)(i)*. Proper adjustments must be made in the amount of any gain subsequently realized for gain or loss taken into account under *Treas Reg § 1.988-2(d)(5)(i)*.

A hyperinflationary contract is one that provides for payments denominated in or determined by reference to a currency that is hyperinflationary at the time the taxpayer acquires or otherwise enters into the contract. *Treas Reg § 1.988-2(d)(5)(ii)*.

(n80)Footnote 4.5. *Treas Reg § 1.988-2(d)(5)(iii)*.

(n81)Footnote 5. *IRC § 988(c)(1)(D)*; *Treas Reg § 1.988-1(a)(7)*. The taxpayer can elect to have such transactions treated as Section 988 transactions.

(n82)Footnote 5.1. *Treas Reg § 1.988-1(a)(7)(ii)*.

(n83)Footnote 5.2. *Treas Reg § 1.988-1(a)(7)(iv)*. The procedure for making the election is set forth in *Treas Reg § 1.988-7(a)(iii)*.

(n84)Footnote 6. *IRC § 988(c)(1)(E)*.

(n85)Footnote 7. In the case of a partnership engaged in trading commodities futures, forwards, and options on Oct 22, 1988, or with respect to which a registration statement indicating that the partnership was to be principally engaged in such trading was filed with the SEC on or before Oct 18, 1988, a partner can own up to the lesser of 33 1/3 percent of capital or profits interest in the partnership, or the lowest percentage previously owned by that partner after Oct 20, 1988. *Treas Reg § 1.988-1(a)(8)(viii)*

The 20-percent ownership limitation does not apply to an interest of a general partner if neither that partner, nor any person whose taxable income is combined with the partner's taxable income in a consolidated return, has ordinary income or loss that is foreign currency gain or loss. The limitation does not apply as well to any partner whose share of the partnership's income and loss is not subject to federal income taxation. *IRC § 988(c)(1)(E)(v)(II), (III)*.

In computing a partner's interest in profits, income allocable to a general partner as incentive compensation and not deductible by the partnership is disregarded. *IRC § 988(c)(1)(E)(v)(II)*

(n86)Footnote 7.1. The procedure for making the election is set forth in *Treas Reg § 1.988-1(a)(8)(iv)*.

(n87)Footnote 7.2. *IRC § 988(c)(1)(E)(iv)(I)*.

(n88)Footnote 7.3. *IRC § 988(c)(1)(E)(iv)(II)*.

(n89)Footnote 8. HR Rep No 1104, 100th Cong, 2d Sess 193 (1988).

(n90)Footnote 9. HR Rep No 1104, 100th Cong, 2d Sess 193-194 (1988).

(n91)Footnote 10. *IRC § 988(d)(1)*. A "988 hedging transaction" is a transaction entered into by the taxpayer primarily (1) to manage risk of currency fluctuations with respect to property held (or to be held) by the taxpayer, or (2) to manage risk of currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer. *IRC § 988(d)(2)*.

A "988 hedging transaction" entered into by a securities dealer is not subject to the mark-to-market accounting rules imposed on such dealers by *IRC § 475*.

Feinschreiber, "Hedging Foreign Transactions Without Exposure to Currency Transactions," 11 *J Tax'n of Investments* 100 (1994); Homan, "The Section 988(d) Hedging Rules: Room to Expand Integration Treatment," 46 *Tax Lawyer* 887 (1993).

(n92)Footnote 10.1. *Treas Reg § 1.988-5(a)(1)*. A § 1.988-5(a) hedge is a spot contract, futures contract, forward contract, option contract, notional principal contract, currency swap contract, similar financial instrument, or series or combinations thereof, that when integrated with a qualifying debt instrument permits the calculation of a yield to maturity (under principles of *IRC § 1272*) in the currency in which the synthetic debt instrument is denominated. *Treas Reg § 1.988-5(a)(4)*.

(n93)Footnote 10.2. *Treas Reg § 1.988-5(a)(9)(ii)*. The synthetic debt instrument is subject to all of the original issue discount rules.

Neither the qualifying debt instrument nor the hedge that makes up the qualified hedging transaction is subject to *IRC § 263(g)*, *§ 1092*, or *§ 1256* for the period the transactions are integrated. However, the qualified hedging transaction may be subject to *IRC § 263(g)* or *§ 1092* if the transaction is part of a straddle. *Treas Reg § 1.988-5(a)(9)(i)(A)*.

(n94)Footnote 10.3. *Treas Reg § 1.988-5(a)(1)*. If the qualifying hedging transaction results in a synthetic nonfunctional currency denominated debt instrument, it is treated in the same manner as an actual nonfunctional currency debt instrument.

(n95)Footnote 10.4. *Treas Reg § 1.988-5(a)(5)*. At the discretion of the Commissioner, a transaction shall not satisfy the requirements of *Treas Reg § 1.988-5(a)(5)* if the debt instrument making up the qualified hedging transaction is part of a straddle prior to the time the qualified transaction is identified. *Treas Reg § 1.988-5(a)(7)*.

(n96)Footnote 10.5. The rules relating to identification are contained in *Treas Reg § 1.988-5(a)(8)*.

(n97)Footnote 10.6. Related means the relationships defined in *IRC § 267(b)* or *IRC § 707(b)*.

(n98)Footnote 10.7. *Treas Reg § 1.988-5(a)(6)(i)*.

(n99)Footnote 10.8. *Treas Reg § 1.988-5(a)(6)(ii)*.

(n100)Footnote 10.9. An exception to this rule obtains if identification is made by the Commissioner under *Treas Reg § 1.988-5(a)(8)(iii)*.

(n101)Footnote 10.10. *Treas Reg § 1.988-5(b)(1)*.

(n102)Footnote 10.11. *Treas Reg § 1.988-5(b)(2)(i), (ii)(A)*. An executory contract does not include a Section 988 transaction. *Treas Reg § 1.988-5(b)(2)(ii)(B)*.

The accrual date is the date when the item of income or expense (including a capital expenditure) that relates to the executory contract is required to be accrued under the taxpayer's method of accounting. *Treas Reg § 1.988-5(b)(3)(iv)*.

(n103)Footnote 10.12. *Treas Reg § 1.988-5(b)(iii)(A), (D)*.

(n104)Footnote 10.13. *Treas Reg § 1.988-5(b)(2)(i)*.

(n105)Footnote 10.14. *Treas Reg § 1.988-5(b)(3)(i)*.

(n106)Footnote 10.15. *Treas Reg § 1.988-5(b)(4)(i)*.

(n107)Footnote 10.16. *Treas Reg § 1.988-5(b)(4)(ii)*.

(n108)Footnote 10.17. *Treas Reg § 1.988-5(b)(4)(iii)(A)*.

(n109)Footnote 10.18. *Treas Reg § 1.988-5(b)(4)(iv)*. The booking date of the payable or receivable for purposes of computing exchange gain or loss is the date the taxpayer disposes of the hedge.

(n110)Footnote 10.19. *Treas Reg § 1.988-5(b)(4)(v)*.

(n111)Footnote 10.20. *Treas Reg § 1.988-5(c)*.

(n112)Footnote 11. *IRC § 988(a)(3)*.

(n113)Footnote 12. In the case of a partnership formed or availed of to avoid tax by altering the source of exchange gain or loss, the determination of residence is made at the partner level. *Treas Reg § 1.988-4(d)*.

(n114)Footnote 13. *Notice 87-4, 1987-1 CB 416*.

(n115)Footnote 14. The general rules regarding contingent payment debt instruments can be found in § 17.02A[2][b].

(n116)Footnote 15. *Treas Reg § 1.988-6(a)(1)*.

(n117)Footnote 16. *Treas Reg § 1.988-6(a)(2)(i)*.

(n118)Footnote 17. If the taxpayer does not account for the instrument in a manner that reflects economic substance, the Service can apply the rules of the proposed regulations to the instrument or apply the rules of *Treas Reg § 1.988-2(b)(15)*, discussed above, reasonably taking into account the contingent feature or features of the instrument. *Treas Reg § 1.988-6(a)(2)(ii)*.

(n119)Footnote 18. *Treas Reg § 1.988-6(b)(1)*. In the case of a multicurrency instrument the denomination currency is the predominant currency. *Treas Reg § 1.988-6(d)(1), (2)*.

(n120)Footnote 19. *Treas Reg § 1.988-6(b)(2)-(5)*.

(n121)Footnote 20. *Treas Reg § 1.988-6(b)(2)(i)*.

(n122)Footnote 21. *Treas Reg § 1.988-6(b)(2)(iv)*.

(n123)Footnote 22. *Treas Reg § 1.988-6(b)(3)(iii)*.

(n124)Footnote 23. *Treas Reg § 1.988-6(b)(2)(v)*.

(n125)Footnote 24. *Treas Reg § 1.988-6(b)(4)*.

(n126)Footnote 25. *Treas Reg § 1.988-6(b)(5)*.

(n127)Footnote 26. *Treas Reg § 1.988-6(e)*.

(n128)Footnote 27. See the discussion in § 17.02A[2][b] at Ns 81-88.

(n129)Footnote 28. *Treas Reg § 1.988-6(b)(7)*.



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CHAPTER 21 New Market Credit

2-21 Taxation of Securities Transactions 21.syn

§ 21.syn Synopsis to Chapter 21: New Market Credit

§ 21.01 Introduction

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CHAPTER 21 New Market Credit

2-21 Taxation of Securities Transactions § 21.01

§ 21.01 Introduction

The Internal Revenue Code contains a number of tax incentives to taxpayers making investments and loans in low-income communities. *IRC Section 45D*, enacted in 2000, adds to these incentives by providing a new tax credit for qualified equity investments made to acquire stock in a selected community development entity ("CDE").ⁿ¹

FOOTNOTES:

(n1)Footnote 1. The credit is part of the general business credit. *IRC § 38(b)(13)*. The provision is effective for qualified investments made after Dec 31, 2000.

As originally enacted, the credit was only available through the end of 2007. However, subsequent legislation has extended this incrementally. Most recently, the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (Pub L No 110-343, October 3, 2008) extended the availability of this credit through the end of the year 2009.

No portion of the unused business credit for any taxable year that is attributable to the new markets credit can be carried back to a taxable year ending before Jan 1, 2001. *IRC § 39(d)(9)*. Any unused credit is allowed as a deduction for the first taxable year following the last taxable year that the credit could have been allowed as a credit under *IRC § 39. IRC § 196(a), (c)(9)*.

Until further guidance is provided, the availability of federal tax benefits, other than the low-income housing credit provided by *IRC § 42*, does not limit the availability of the new markets tax credit. The Treasury Department and the Service are studying how *IRC § 42* may limit the availability of the new markets tax credit. *Notice 2002-64, 2002-2 CB 690*.



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CHAPTER 21 New Market Credit

2-21 Taxation of Securities Transactions § 21.02

§ 21.02 Allowance of the Credit

Pursuant to *IRC Section 45D(a)*, a taxpayer who holds a qualified equity investment (an investment in a qualified CDE) is entitled to 5-percent credit for the year in which the equity interest is purchased from the CDE and the first two anniversary dates thereafter, and a 6-percent credit for the next four anniversary dates.ⁿ¹ The credit is applied to the amount paid to the qualified CDE for the investment at its original issue.

A qualified equity investment is any equity investment in a qualified CDE if (a) the investment is acquired by the taxpayer at its original issue (directly or through an underwriter) solely in exchange for cash, (b) substantially all of the cash is used by the CDE to make qualified low-income community investments, and (c) the investment is designated for purposes of *IRC Section 45D* by the qualified CDE.ⁿ² Any equity investment issued by a qualified CDE more than five years after the date that the entity receives an allocation under *IRC Section 45D(f)* is not a qualified equity investment.ⁿ³

Generally, an equity investment in an entity is not eligible to be designated as a qualified equity investment if it is made before the entity enters into an allocation agreement with the Service.ⁿ⁴ However, an equity investment in an entity is eligible to be designated as a qualified equity investment if (i) it is made on or after April 20, 2001, (ii) the designation of the equity investment as a qualified equity investment is made for a credit allocation received pursuant to an allocation application submitted to the Service no later than August 29, 2002, and (iii) the equity investment otherwise satisfies the requirements of *IRC Section 45D*.ⁿ⁵

If an entity ceases to be a CDE during the seven-year period following the taxpayer's investment, the proceeds of the investment cease to be used to make qualified low-income community investments, or the equity investment is redeemed by the issuing CDE during that seven-year period, then any credits claimed with respect to the equity interest are recaptured (with interest) and no further credits are allowed.ⁿ⁶ The Commissioner can waive a requirement or extend a deadline if the waiver or extension does not materially frustrate the purposes of *IRC Section 45D*.ⁿ⁷

A qualified community development entity is any domestic corporation or partnership (1) whose primary mission is serving, or providing capital for, low-income communities or low-income persons, (2) that maintains accountability to residents of low-income communities by their representation on any governing board or on any advisory board of the CDE, and (3) is certified by the Treasury Department as an eligible CDE.ⁿ⁸ A specialized small business investment company (as defined in *IRC Section 1044(c)(3)*), and a community development financial institution (as defined in

Section 103 of the Community Development Banking and Financial Institutions Act of 1994) are treated as meeting the requirements set forth for a qualified CDE.ⁿ⁹

Qualified low-income community investments include:

- (a) capital or equity investments in, or loans to, qualified active low-income community businesses;
- (b) the purchase from another qualified CDE of any loan made by such entity that is a qualified low-income community investment;
- (c) financial counseling and other services specified in regulations to businesses and residents in low-income communities; and
- (d) an equity investment in, or loan to, another qualified CDE.ⁿ¹⁰

A loan purchased by a CDE (the ultimate CDE) from another CDE (whether or not that CDE had received an allocation under *IRC Section 45D(f)(2)*) is a qualified low-income community investment if it qualifies as such at the time the loan was made or at the time the ultimate CDE purchases the loan.ⁿ¹¹ The purchase of a loan by the ultimate CDE from a CDE that did not make the loan (the second CDE) is treated as a purchase of the loan by the ultimate CDE from the CDE that made the loan (the originating CDE) if the second CDE purchased the loan from the originating CDE or another CDE, and each entity that sold the loan was a CDE at the time of sale.ⁿ¹² A loan is treated as made by a CDE to the extent the CDE purchases the loan from the originator (whether or not the originator is a CDE) within 30 days after the date the originator makes the loan, if at the time the loan is made, there is a legally enforceable written agreement between the originator and the CDE that requires the CDE to approve the making of the loan either directly or by imposing specific loan underwriting criteria, and requires the CDE to purchase the loan within 30 days after it is made.ⁿ¹³

A qualified active low-income community business QALICB is defined as any corporation (including a nonprofit corporation) or partnership if for the taxable year:

- (i) at least 50 percent of the total gross income of the entity is derived from the active conduct of a qualified business within any low-income community;ⁿ¹⁴
- (ii) a substantial portion of the use of the tangible property of the entity (whether owned or leased) is within any low-income community;ⁿ¹⁵
- (iii) a substantial portion of the services performed for the entity by its employees are performed in any low-income community;ⁿ¹⁶ and
- (iv) less than 5 percent of the average of the aggregate adjusted bases of the property of the entity is attributed to collectibles (as defined in *IRC Section 408(m)(2)*) other than collectibles that are held primarily for sale to customers in the ordinary course of business, or to nonqualified financial services (as defined in *IRC § 1397C(e)*).ⁿ¹⁷

In no case will an entity be treated as a QALICB if the entity is located in a population census tract for which the median family income exceeds 120 percent of (a) in the case of a tract not located within a metropolitan area, the statewide median family income, or (b) in the case of a tract located within a metropolitan area, the greater of statewide median family income or metropolitan area median family income.ⁿ¹⁸ The 120-percent-income restriction does not apply to an entity located within a population census tract with a population of less than 2,000 if the tract is not located in a metropolitan area, or, if located in a metropolitan area, more than 75 percent of the tract is zoned for commercial

purposes.

A low-income community is any population census tract where (1) the poverty rate for the tract is at least 20 percent, or (2) the median family income for the tract does not exceed 80 percent of the greater of statewide median family income or metropolitan area income (or for a census tract not in a metropolitan area, 80 percent of statewide median family income).ⁿ¹⁹ Proposed Regulations have been issued that provide rules for determining when one or more targeted populations (within the meaning of Section 103(20) of the Riegle Community Development and Regulatory Act of 1994) may be treated as low-income communities.ⁿ²⁰ Specifically, targeted populations that will be treated as a low-income community are individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons as defined in *Proposed Treasury Regulation Section 1.45D-1(d)(9)(i)* or who are individuals who otherwise lack adequate access to loans or equity investments as defined in *Proposed Treasury Regulation Section 1.45D-1(d)(9)(ii)*.ⁿ²¹ The Proposed Regulations also include the qualified active low-income community business requirements for low-income targeted populations.ⁿ²² A population census tract with a population of less than 2,000 must be treated as a low-income community if the tract is within an empowerment zone the designation of which is in effect under *IRC Section 1391*, and is contiguous to one or more low-income communities.ⁿ²³

There is a national limitation on the amount of qualifying equity investment for each calendar year, namely: \$1 billion for 2001, \$1.5 billion for 2002 and 2003, \$2 billion for 2004 and 2005, and \$3.5 billion for 2006, 2007, 2008 and 2009.ⁿ²⁴ The limitation is allocated by the Secretary of the Treasury among qualified community development entities selected by the Secretary.ⁿ²⁵ In making allocations, the Secretary must give priority to any entity with a record of having successfully provided capital or technical assistance to disadvantaged businesses or communities, or that intends to use substantially all the cash it raises to make qualified low-income community investments in one or more businesses in which persons unrelated to the entity hold the majority equity interest.ⁿ²⁶ If the limitation for any year exceeds the aggregate amount allocated by the Secretary, the limitation for the succeeding calendar year is increased by the amount of the excess.ⁿ²⁷

A CDE must provide notice to any taxpayer who acquires a qualified equity investment in the CDE at its original issue that the equity investment is a qualified equity investment entitling the taxpayer to claim the new markets credit.ⁿ²⁸ In addition, if at any time during the seven-year period beginning on the date of original issue of a qualified equity investment in a CDE, there is a recapture event, the CDE must provide notice to each holder, including prior holders, that a recapture event has occurred.ⁿ²⁹

The availability of federal tax benefits does not limit the availability of the new markets credit.ⁿ³⁰ This rule does not apply to the low-income housing credit under *IRC Section 42*.ⁿ³¹ The bankruptcy of a CDE does not preclude a taxpayer from continuing to claim the new market credits on the remaining credit allowance dates.ⁿ³²

FOOTNOTES:

(n1)Footnote 1. The credit is available to the original purchaser and to any subsequent holder. *IRC § 45D(b)(4)*.

The basis of any qualified equity investment is reduced by the amount of any credit allowed under *IRC § 45D*. The reduction does not apply for purposes of *IRC §§ 1202, 1400B, and 1400F. IRC § 45D(h)*. See § 2.06[2][a][ii] for a discussion of *IRC § 1202*, and § 2.06[2][a][iv] for a discussion of *IRC §§ 1400B and 1400F*.

An equity investment is any stock (other than nonqualified preferred stock, as defined in *IRC § 351(g)(2)*) in a corporation or any capital interest in a partnership. *IRC § 45D(b)(6); Treas Reg § 1.45D-1(c)(2)*.

The credit is claimed by filing Form 8874 with the taxpayer's federal income tax return.

(n2)Footnote 2. *IRC § 45D(b)(1)*. The substantially-all investment requirement is met if at least 85 percent of the aggregate gross assets of the qualified CDE are invested in low-income community investments. *IRC § 45D(b)(3)*. The

regulations reduce the 85 percent requirement to 75 percent for the last year of the seven-year credit period. *Treas Reg § 1.45D-1(c)(5)(v)*.

For purposes of the substantially-all requirement, aggregate gross assets are determined according to cost basis, not fair market value. *Treas Reg § 1.45D-1(c)(5)(ii), (iii)*.

The CDE must invest the taxpayer's cash investment in a qualified low-income community investment within 12 months after the cash is paid by the taxpayer to the CDE. *Treas Reg § 1.45D-1(c)(3)(iv)*.

There is no prohibition against the use of cash derived from a borrowing, including a nonrecourse loan, to make a qualified equity investment in a qualified CDE. Rev Rul 2003-20, 2003-1 CB 465 .

(n3)Footnote 3. Any allocation not used within the five-year period can be reallocated. The maximum amount of equity investments issued by a qualified CDE that can be so designated by the entity cannot exceed the portion of the limitation allocated to the entity under *IRC § 45D(f)*. *IRC § 45D(b)(2)*.

(n4)Footnote 4. *Treas Reg § 1.45D-1(c)(3)(i)*. An allocation agreement is an agreement between the Service and a CDE relating to a new markets credit allocation under *IRC § 45D(f)(2)*.

(n5)Footnote 5. *Treas Reg § 1.45D-1(c)(3)(ii)(A)*. In addition, an equity investment in an entity is eligible to be designated as a qualified equity investment if (1) the equity investment is made on or after the date the Service publishes a Notice of Allocation Availability in the Federal Register; (2) the designation of the equity investment as a qualified equity investment is made for a credit allocation received pursuant to an allocation application submitted to the Service under that Notice; and (3) the equity investment otherwise satisfies the requirements of *IRC § 45D* and *Treas Reg § 1.45D-1*. *Treas Reg § 1.45D-1(c)(3)(ii)(B)*. If the entity in which the equity investment is made does not receive an allocation pursuant to an allocation application submitted no later than Aug 29, 2002, the equity investment will not be eligible to be designated as a qualified equity investment. *Treas Reg § 1.45D-1(c)(3)(iii)*.

(n6)Footnote 6. *IRC § 45D(g)*. The amount of recapture is limited to the amount of the credits that were used to reduce tax liability. Bankruptcy of a CDE is not a recapture event. *Treas Reg § 1.45D-1(e)(4)*.

(n7)Footnote 7. *Treas Reg § 1.45D-1(e)(5)(i)*. A CDE that believes it has good cause for a waiver or extension can request relief from the Commissioner in a ruling request that sets forth all the relevant facts and includes a detailed explanation describing the event or events relating to the request. *Treas Reg § 1.45D-1(e)(5)(ii)*.

(n8)Footnote 8. *IRC § 45D(c)(1)*.

(n9)Footnote 9. *IRC § 45D(c)(2)*.

(n10)Footnote 10. *IRC § 45D(d)(1)*; *Treas Reg § 1.45D-1(d)(1)*. The definition of a qualified low-income community investment contained in the regulations will be amended to include investments through two additional CDEs. Notice 2003-64, 2003-2 CB 646 . Reserves (but not in excess of 5 percent of the taxpayer's cash investments in the CDE) for loan losses and for additional investments in existing qualified low-income community investments are treated as invested in a qualified low-income community investment. *Treas Reg § 1.45D-1(d)(3)*.

(n11)Footnote 11. *Treas Reg § 1.45D-1(d)(1)(ii)(A)*. A loan by an entity is treated as made by a CDE if the entity is a CDE at the time it makes the loan. *Treas Reg § 1.45-1(d)(1)(ii)(B)*.

(n12)Footnote 12. *Treas Reg § 1.45D-1(d)(1)(ii)(C)*.

(n13)Footnote 13. *Treas Reg § 1.45D-1(d)(8)*.

(n14)Footnote 14. The 50 percent test is met if 50 percent of the use of tangible property of the entity is within any low-income community or if 50 percent of the services performed for the entity by its employees are performed in any low-income community. *Treas Reg § 1.45D-1(d)(4)(i)(A)*.

Proposed Treasury Regulations provide that at least 50% of the entity's gross income for any taxable year must be derived from sales, rentals, services, or other transactions with individuals who are low-income persons for purposes of *IRC § 45D(e)(2)*. *Prop Treas Reg § 1.45D-1(d)(9)(i)(B)(1)(i)*. The Proposed Regulations also provide that at least 50% of the entity must be owned by individuals who are low-income persons at the time the qualified low-income community investment is made. *Prop Treas Reg § 1.45D-1(d)(9)(i)(B)(1)(iii)*.

Special rules will apply to targeted populations in Gulf Opportunity Zones. Among them is the requirement that, in order to be a QALICB in such case, the entity must be located in a population census tract that contains one or more areas designated by FEMA as flooded, having sustained extensive damage, or having sustained catastrophic damage as a result of Hurricane Katrina.

An entity will be treated as engaged in the active conduct of a trade or business if, at the time the CDE makes a capital or equity investment in, or loan to, the entity, the CDE reasonably expects to generate revenues (or in the case of a nonprofit corporation, receive donations) within three years after the date the investment or loan is made. *Treas Reg § 1.45D-1(d)(4)(iv)*.

(n15)Footnote 15. The substantial-portion test is met if at least 40 percent of the use of the tangible property of the entity is within a low-income community. *Treas Reg § 1.45D-1(d)(4)(i)(B)*. The percentage is raised to 85% if the entity has no employees. *Treas Reg § 1.45D-1(d)(4)(i)(C)*.

(n16)Footnote 16. The substantial-portion test is met if at least 40 percent of the services performed for the entity by its employees are performed in a low-income community. *Treas Reg § 1.45D-1(d)(4)(i)(C)*.

Forthcoming regulations will provide that at least 40% of the entity's employees must be individuals who are low-income persons at the time of hiring. *Notice 2006-60, 2006-2 CB 82*.

(n17)Footnote 17. *IRC § 45D(d)(2)(A)*. A sole proprietorship can be a qualified active low-income community business if it would meet the statutory requirements were it incorporated. *IRC § 45D(d)(2)(B)*. The same holds true for a portion of a business. *IRC § 45D(d)(2)(C)*.

A qualified business has the meaning given to it by *IRC § 1397C(d)*, except that (a) the rental to others of nonresidential real property located in any low-income community shall be treated as qualified business if there are substantial improvements located on the property, and (b) any requirement relating to rental of tangible personal property is inapplicable. *IRC § 45D(d)(3)*; *Treas Reg § 1.45D-1(d)(5)(ii)*. *IRC § 1397C(d)* is discussed in § 17.03[3][b][ii].

The regulations will be amended to provide that the rental to others of real property for low-income targeted populations that otherwise satisfies the requirements to be a qualified business will be treated as located in a low-income community if at least 50% of the entity's total gross income is derived from rentals to individuals who are low-income persons or to a QALICB. *Notice 2006-60, 2006-2 CB 82*.

There is no requirement that employees of a qualified business be residents of a low-income community. *Treas Reg § 1.45D-1(d)(5)(i)*.

(n18)Footnote 18. *Notice 2006-60, 2006-2 CB 82*.

(n19)Footnote 19. *IRC § 45D(e)(1)*. The median family income test for population census tracts located in US

possessions (Puerto Rico, the Virgin Islands, Guam, the Northern Mariana Islands, and American Samoa) is applied using possession-wide income.

In the case of an area that is not tracted for population census tracts, the equivalent county divisions (as defined by the Bureau of the Census for purposes of defining poverty areas) is to be used for purposes of determining poverty rates and median family income. *IRC § 45D(e)(3)*.

(n20)Footnote 20. *IRC § 45D(e)(2); Prop Treas Reg § 1.45D-1(d)(9)*.

(n21)Footnote 21. *Prop Treas Reg § 1.45D-1(d)(9)*. An individual is considered to be low-income if the individual's family income, adjusted for family size, is not more than (1) for metropolitan areas, 80 percent of the area median family income; and (2) for non-metropolitan areas, the greater of 80 percent of the area median family income, or 80 percent of the statewide non-metropolitan area median family income. *Prop Treas Reg § 1.45D-1(d)(9)(i)(A)*.

(n22)Footnote 22. *Prop Treas Reg § 1.45D-1(d)(9)(i)(B)*.

(n23)Footnote 23. *IRC § 45D(e)(4)*.

(n24)Footnote 24. *IRC § 45D(f)(1)*. Pursuant to *IRC § 1400N(m)(2)*, the credit limitation is increased by an amount equal to \$300 million for 2005 and 2006, and \$400 million for 2007, to be allocated among qualified community development entities to make qualified low-income community investments within the Gulf Opportunity Zone, as defined in *IRC § 1400M*.

(n25)Footnote 25. *IRC § 45D(f)(2)*. A qualified community development entity is eligible for an allocation under *IRC § 45D(f)(1)* of the increased limitation applicable to the Gulf Opportunity Zone, described in N. 17, only if a significant mission of the entity is the recovery and redevelopment of the Gulf Opportunity Zone. *IRC § 1400N(m)(1)*.

(n26)Footnote 26. A party is related within the meaning of *IRC § 267(b)* or *IRC § 707(b)(1)*.

(n27)Footnote 27. *IRC § 45D(f)(3)*. No amount can be carried to a calendar year after 2014.

IRC § 45D(f)(3) is applied separately with respect to the increase in the credit limitation described in N. 17. *IRC § 1400N(m)(3)*.

(n28)Footnote 28. *Treas Reg § 1.45D-1(g)(2)(i)(A)*. The notice must be given no later than 60 days after the date the taxpayer makes the investment in the CDE and must contain the amount paid to the CDE for the qualified equity investment at its original issue and the taxpayer identification number of the CDE.

(n29)Footnote 29. *Treas Reg § 1.45D-1(g)(2)(i)(B)*. The notice must be provided no later than 60 days after the date the CDE becomes aware of the recapture event.

(n30)Footnote 30. *Treas Reg § 1.45D-1(g)(3)(i)*.

(n31)Footnote 31. *Treas Reg § 1.45D-1(g)(3)(ii)*.

(n32)Footnote 32. *Treas Reg § 1.45D-1(g)(4)*.



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APPENDICES

2-App Taxation of Securities Transactions APPENDIX.syn

§ App.syn Synopsis to Appendix App: APPENDICES



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APPENDIX A: Revenue Procedure 83-59

2-A Taxation of Securities Transactions APPENDIX A:..syn

§ A.syn Synopsis to Appendix A: Revenue Procedure 83-59

1 PURPOSE

2 BACKGROUND

3 CHANGES

4 INFORMATION TO BE INCLUDED IN REQUESTS FOR RULINGS UNDER SECTION 351 OF THE CODE

5 INQUIRIES

6 EFFECT ON OTHER DOCUMENTS



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APPENDIX A: Revenue Procedure 83-59

Checklist of information to be included in request for ruling under IRC Section 351

2-A Taxation of Securities Transactions 1

1 PURPOSE

The purpose of this revenue procedure is to update *Revenue Procedure 81-57, 1981-2 C.B. 674* which sets forth in a checklist questionnaire the information necessary to be included in a request for a ruling under *section 351 of the Internal Revenue Code*, relating to transfers to a corporation controlled by the transferor or transferors.



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APPENDIX A: Revenue Procedure 83-59

Checklist of information to be included in request for ruling under IRC Section 351

2-A Taxation of Securities Transactions 2

2 BACKGROUND

The Internal Revenue Service receives many requests for rulings in which the information furnished about the proposed transaction is not sufficient to permit a determination to be made. In such cases it is necessary to obtain additional facts from the taxpayer before the request for a letter ruling can be considered. This procedure is time consuming for both Service personnel and taxpayers and delays issuance of the final ruling letter. This checklist will facilitate the filing and processing of requests for rulings under section 351 of the Code by showing specific information and representations to be included so the request will be as complete as possible when initially filed. Because the information and representations necessary to rule on a particular transaction depend upon all the facts and circumstances, information or representations in addition to those set forth in this revenue procedure may be required.

The authority and general procedures of the National Office of the Internal Revenue Service and of the Office of the District Directors of Internal Revenue with respect to the issuance of letter rulings and determination letters are outlined in *Rev. Proc. 83-1, 1983-1 I.R.B. 16*. See also *Rev. Proc. 83-22, 1983-13 I.R.B. 73*, relating to areas in which advance rulings generally will not be issued.

Careful attention to all the requirements of these revenue procedures will aid in the timely processing of letter ruling requests.



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APPENDIX A: Revenue Procedure 83-59

Checklist of information to be included in request for ruling under IRC Section 351

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3 CHANGES

.01

Section 1 has been changed to indicate the purpose of the revenue procedure is to update *Rev. Proc. 81-57*.

.02

Section 2 is modified to set forth the necessary representations, as well as to update references to Revenue Procedures cited.

.03

Section 4 is substantially altered.

1

The taxpayer must now submit standard representations using the precise language or submit an explanation of the reasons why the representation cannot be made in that form.

2

Section 4.032 is expanded to include several representations concerning the issuance of stock or securities for services.

3

Section 4.033(a) is changed by rewording the request for information.

4

Section 4.033(a)(1) requests the same information in representation form, and adds a new representation relating to reporting items of income and deduction, and also requests information from transferors on the completed contract method of accounting.

5

Sections 4.033(a)(3) through (7) have been reworded using representation format.

6

Section 4.033(8) is expanded to request several new representations concerning solicitation, continuity of interest, and acquisition indebtedness.

7

Section 4.033(9) is added to request representations concerning the formation of bank holding companies.

8

Section 4.033(b) is modified to request information in representation format.

9

Section 4.044 is added to request information concerning the issuance of "section 306 stock".

10

Section 4.055(f) is added to request a representation pertaining to redemptions or other reacquisitions of stock.

11

Section 4.055(g) is added to request a representation pertaining to "control" of the transferee.

12

Section 4.06 is modified and reworded to request information in representation format.

13

Section 4.071 is modified to include citations to section 351(e)(1) of the Code and *section 1.351-1(c)(1)(ii) of the Income Tax Regulations*.

14

Section 4.074 is added to request a representation concerning personal service corporations.

15

Section 4.083(b) is updated to reflect the revenue procedure being superseded.

16

Section 4.10 is updated to reflect the revenue procedure being superseded:

17

Section 5 is updated to reflect a new title and symbols.

18

Section 6 is updated to reflect the revenue procedure being superseded.



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Taxation of Securities Transactions

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APPENDIX A: Revenue Procedure 83-59

Checklist of information to be included in request for ruling under IRC Section 351

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4 INFORMATION TO BE INCLUDED IN REQUESTS FOR RULINGS UNDER SECTION 351 OF THE CODE

Each of the items in this Section should be specifically dealt with in the letter ruling request. If an item is not applicable, so state and briefly explain why it is not applicable. Standard representations are set forth throughout this Section and are highlighted by having the word "representation" in boldface type. These representations are of equal importance with the other factual information requested herein. They, however, function to insure that specific statutory and judicial requirements, and administrative ruling guidelines, are satisfied. Each representation should be submitted in precisely the language requested. If a representation cannot be submitted, an explanation must be given. Variations of the language of the representations delay processing the ruling request and will not be accepted unless reasons satisfactory to the Service are submitted. Submission of the information and representations should follow the format of this revenue procedure as closely as possible.

.01 Information regarding transferee corporation.

1 Name, taxpayer identification number, and place and date of incorporation of the transferee corporation (transferee).

2 Description of the business of the transferee, and its method and period of accounting.

3 Identify the District Office having audit jurisdiction over the return of the transferee and the known transferors (collectively referred to as taxpayers). State whether, to the best of the knowledge of the taxpayers, and the taxpayer's representative(s), the identical issue is in a return of the taxpayers (or of a related taxpayer within the meaning of section

2-A Taxation of Securities Transactions 4

267 of the Code or a member of an affiliated group of which the taxpayer is also a member within the meaning of section 1504) and, if so, whether the issue (1) is being examined by a District Director, (2) has been examined and the statutory period of limitation on assessment or refund of tax has not expired or a closing agreement covering the issue or liability has not been entered into by a District Director, (3) is being considered by an Appeals Office in connection with the taxpayers return for an earlier period, or that issue has been considered by an Appeals Office and the statutory period of limitation on assessment or refund of tax has not expired or a closing agreement covering the issue or liability has not been entered into by an Appeals Office, or (4) is pending in litigation in a case involving the taxpayers or a related taxpayer. The request must contain a statement whether, to the best of the knowledge of the taxpayers and the taxpayers representative(s), the identical or similar issue has been the subject matter of a prior ruling request and whether it was ruled on by the Service to the taxpayers or to the taxpayers' predecessor and, if so, when and with what results. If after the request is filed but before a ruling is issued, the taxpayers know that an examination of the issue by a District Director has been started, the taxpayers must notify the National Office of such an action. If a return is filed before a ruling is received from the National Office concerning the return, a copy of the request must be attached to the return. This alerts the District Office and avoids premature District action on the issue.

.02 Information regarding the transferors.

1 Name and taxpayer identification number of all known transferors.

2 State the method and period of accounting used by such transferors.

.03 Transfer to corporation.

1 Property -- Identify and describe fully all types of property, tangible and intangible, to be transferred to the transferee by each transferor. Identify specifically each transferor and the property being transferred by that transferor. Also, furnish a description of the business, if any, of each transferor and the property transferred that is related to that business.

2 Services and Indebtedness-- State whether services have been or will be performed by any transferor for or on behalf of the transferee in connection with the transaction. Submit a **REPRESENTATION** as follows: (i) No stock or securities will be issued for services rendered to or for the benefit of the transferee in connection with the proposed transaction, and (ii) No stock or securities will be issued for indebtedness of the transferee that is not evidenced by a security or for interest on indebtedness of the transferee which accrued on or after the beginning of the holding period of the transferor(s) for the debt. See section 351(d) of the Code.

3 Assets and Liabilities.

2-A Taxation of Securities Transactions 4

a Assets-- State whether any of the assets to be transferred were received by the transferor(s) as part of a plan of liquidation of another corporation.

1 Unreported Income -- State whether income items, such as accounts receivable or commissions due, are being transferred to the transferee. If so, and the transferor(s) of these items uses the cash method of accounting, submit a **REPRESENTATION** as follows: (i) The transferor(s) neither accumulated receivables nor made extraordinary payment of payables in anticipation of the transaction, and (ii) The transferee will report items which, but for the transfer, would have resulted in income or deduction to a transferor in a period subsequent to the transfer and such items will constitute income or deductions to the transferee when received or paid by it. Further, submit a **REPRESENTATION** as follows: The proceeds received in collection of the income items will be included as ordinary income in computing the taxable income of the transferee. (*Rev. Rul. 80-198, 1980-2, C.B. 113*). If a transferor is on the completed contract method of accounting, explain fully how the transferor has reported income, costs and expenses related to each contract and how the transferee will report such items subsequent to the transfer.

2 Partners and Partnerships-- State whether the partners' interests in the partnership or the partnership's assets will be transferred and whether the partnership will be liquidated.

3 Patents or patent applications.-- If patents or patent applications are being transferred, submit a **REPRESENTATION** as follows: The patents or patent applications qualify as "property" within the meaning of section 351 of the Code. See *Rev. Rul. 64-56, 1964-1 C.B. (Part I) 133*. Also, submit a **REPRESENTATION** as follows: The transferor(s) will transfer all substantial rights in such patents or patent applications within the meaning of section 1235 of the Code. See *Rev. Rul. 69-156, 1969-1 C.B. 101*.

4 Copyrights-- If copyrights are being transferred, state whether the copyright for all media are being transferred and whether any contracts for the exploitation of a copyright in a particular medium are being transferred. Submit a **REPRESENTATION** as follows: All rights, title and interests for each copyright, in each medium of exploitation, will be transferred to the transferee.

5 Franchises, trademarks or trade names.-- If franchises, trademarks or trade names are being transferred, submit a **REPRESENTATION** as follows: The transferor will not retain any significant power, right, or continuing interest, within the meaning of section 1253(b) of the Code, in the franchises, trademarks or trade names being transferred.

6 Technical "Know-how"-- State whether the transaction involves an agreement that purports to furnish technical "know-how" in exchange for stock. If so, submit the information required by *Rev. Proc. 69-19, 1969-2 C.B. 301*, as amplified by *Rev. Proc. 74-36, 1974-2 C.B. 491*.

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7 Stock of another corporation-- State whether stock of another corporation is part or all of the property being transferred to the transferee. If so, state the percentage of the transferred stock and the percentage of the transferee's stock which is owned actually and constructively by the transferor. Also, state whether the stock is being transferred subject to any liabilities or whether any liabilities of the transferor are being assumed in connection with the transfer of such stock. See section 304 of the Code. If the stock to be transferred is other than common stock, submit a **REPRESENTATION** as follows: None of the stock to be transferred is "section 306 stock" within the meaning of section 306(c) of the Code.

8 Other information.

a Solicitation-- Submit a **REPRESENTATION** as follows: The transfer is not the result of the solicitation by a promoter, broker, or investment house.

b Retained rights-- Submit a **REPRESENTATION** as follows: The transferor(s) will not retain any rights in the property transferred to the transferee.

c Licenses, leases, etc.-- Describe any licenses, leases, etc., to be granted in exchange for stock or securities.

d Leaseback -- Describe any property to be transferred to the transferee that will be leased back to a transferor, other shareholder, or a related party. Furnish the terms of the lease and identify the lessee.

e Reserve for bad debts-- Submit a **REPRESENTATION** as follows: The value of the stock received in exchange for accounts receivable will be equal to the net value of the accounts transferred, i.e. the face amount of the accounts receivable previously included in income less the amount of the reserve for bad debts. See *Rev. Rul. 78-280, 1978-2 C.B. 139*.

f Continuity of interest-- If the exchange is part of a larger transaction that fits a pattern common to acquisitive reorganization (see section 3.0123 of *Rev. Proc. 83-22*), submit the following **REPRESENTATION**: (i) With respect to the larger transaction, shareholders of the acquired corporation will receive, in exchange for their stock of the acquired corporation, stock of the acquiring corporation equal, in the aggregate, to a number of shares having a value, as of the date of the exchange, of at least 50 percent of the value of all of the formerly outstanding stock of the acquired corporation as of the same date; (ii) There is no plan or intention on the part of the shareholders of the acquired corporation to sell or otherwise dispose of a number of shares of stock of the acquiring corporation to be received in the transaction that would reduce such shareholders' ownership to a number of shares having, in the aggregate, a value of less than 50 percent of the total fair market value of the acquired corporation's stock outstanding as of the effective date of the proposed transaction; and, (iii) There have not been any significant changes in the stock ownership of the

2-A Taxation of Securities Transactions 4

acquired corporation in the last five years that would cause the continuity of interest requirement not to be satisfied.

g Acquisition indebtedness-- If stock of a corporation is being transferred, submit a **REPRESENTATION** as follows: Any debt relating to the stock being transferred that is being assumed (or to which such stock is subject) was incurred to acquire such stock and was incurred when such stock was acquired, and each transferor is transferring all of the stock for which the acquisition indebtedness being assumed (or to which such stock is subject) was incurred.

9 Formation of bank holding companies--

(a) If the stock of a bank is being transferred to a bank holding company, submit a **REPRESENTATION** as follows: The transferee will be a bank holding company within the meaning of section 2(a) of the Bank Holding Company Act of 1956.

b Submit a **REPRESENTATION** as follows: An application to form a bank holding company was not filed with the Federal Reserve Board before August 16, 1982. If such an application was filed then submit a **REPRESENTATION** as follows: The bank holding company was formed no later than the later of (i) the 90th day after the date of the last required approval of any regulatory authority to form such bank holding company, or (ii) January 1, 1983.

c Submit a **REPRESENTATION** as follows: The transferor(s), in the aggregate, who have "acquisition indebtedness" assumed, or receive "securities", or receive other property (as described in section 304(a)), will not have the 50 percent control (as defined in section 304(c) by applying the modified section 318 attribution rules) of the transferee bank holding company.

d Submit a **REPRESENTATION** as follows: The transferor(s) receiving securities qualify as "Qualified Minority Shareholders", as defined in section 304(b)(3)(D)(i) of the Code.

e Submit a **REPRESENTATION** as follows: The bank, the stock of which is being transferred in the transaction to the transferee bank holding company, was an operating company when the acquisition indebtedness being assumed was incurred.

f If securities are being issued by the bank holding company, submit a **REPRESENTATION** as follows: The acquisition of control of the bank, the stock of which is being transferred in the transaction to the bank holding company, as well as the transfer of the bank stock that constitutes control, are transferred pursuant to a single plan.

b Liabilities.

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1 Submit a **REPRESENTATION** as follows: The adjusted basis and the fair market value of the assets to be transferred by the transferor(s) to the transferee will, in each instance, be equal to or exceed the sum of the liabilities to be assumed by the transferee plus any liabilities to which the transferred assets are subject. See section 357(c) of the Code.

2 Submit a **REPRESENTATION** as follows: The liabilities of the transferor(s) to be assumed by the transferee were incurred in the ordinary course of business and are associated with the assets to be transferred. If the liabilities to be assumed were not so incurred, state the business reason or purpose for the assumption of these liabilities. See section 357(b) of the Code.

3 Submit a **REPRESENTATION** as follows: There is no indebtedness between the transferee and the transferor(s) and there will be no indebtedness created in favor of the transferor(s) as a result of the transaction.

.04 Consideration from the transferee.

1 Stock-- Describe the terms of each class and the number of shares of each class to be issued to each transferor for:

a Property-- See.031 above and identify the property of each transferor.

b Services-- See.032 above and identify the services. Indicate those transferors who will also receive stock for property.

2 Indebtedness-- State the principal amount of indebtedness and its terms to be created in favor of each transferor for:

a Property-- See.031 above and identify the property of each transferor.

b Services-- See.032 above and identify the services.

3 Other property in addition to stock and indebtedness-- Indicate the amount and provide a complete description of

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any other property that will be issued to each transferor including, but not limited to:

a Cash.

b Stock rights, warrants, or certificates of contingent interest, with the terms of each.

4 Section 306 stock-- If any stock other than common stock will be received in the exchange, explain why it is believed this stock is not "section 306 stock" within the meaning of section 306(c)(3) of the Code.

.05 Control by transferors.

1 Stock of transferee outstanding immediately before transaction.

a Furnish a description of the terms and the total number of shares of each class outstanding.

b State the total number of shares of each class held by a shareholder who will be a transferor in the exchange.

c State the total number of shares of each class held by each shareholder owning five percent or more of a class and the number of shareholders owning the balance of each class outstanding.

2 Stock of transferee outstanding immediately after transaction.

a State the total number of shares of each class.

b State the total number and percent of shares of each class held by each transferor.

3 Plan and dates of exchanges.

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a Submit a **REPRESENTATION** as follows: The transfers and exchanges will occur under a plan agreed upon before the transaction in which the rights of the parties are defined. See *section 1.351-1(a)(1) of the regulations*.

b Submit a **REPRESENTATION** as follows: All exchanges will occur on approximately the same date.

c State whether any of the stock issued will be placed in escrow, or whether any of the stock will be issued later under a contingent stock arrangement.

4 Additional stock issues.

a State whether any stock will be issued in the near future in addition to that being issued under the plan. If so, give full particulars.

b If a public offering is planned, submit the following information:

1 The total number of shares of each class involved.

2 If underwriters are involved, explain whether the underwriter will purchase these shares for their own account or will act as agent for the transferee. See *Rev. Rul. 78-294, 1978-2 C.B. 141*.

c If any rights, warrants, or subscriptions of the transferee are outstanding or will be issued or offered, state the total number of shares of each class of stock involved and explain the circumstances in which they were or will be issued or offered.

5 Disposition of stock by transferor(s).

a Indicate the number of shares of each class that each transferor will dispose of after the exchange.

2-A Taxation of Securities Transactions 4

b State the consideration to be received in exchange for the transferee stock disposed.

c Provide the names of the acquiring parties and their relationship to the transferee or shareholder-transferor.

d State the circumstances and reasons for the disposition, including any agreements between the parties.

e If there are, or will be, any options to purchase stock from any of the transferors, give full particulars.

f Submit a **REPRESENTATION** as follows: There is no plan or intention on the part of the transferee to redeem or otherwise reacquire any stock or indebtedness to be issued in the proposed transaction.

g Submit a **REPRESENTATION** as follows: Taking into account any issuance of additional shares of transferee stock; any issuance of stock for services; the exercise of any transferee stock rights, warrants, or subscriptions; a public offering of transferee stock; and the sale, exchange, transfer by gift, or other disposition of any of the stock of the transferee to be received in the exchange, the transferor(s) will be in "control" of the transferee within the meaning of section 368(c) of the Code. See *Rev. Rul. 59-259, 1959-2 C.B. 115*, and *section 1.351-1(a)(1) of the regulations*.

.06 General.

1 Business reasons or purpose-- Explain the business reasons for the transaction.

2 Value for value-- Submit a **REPRESENTATION** as follows: Each transferor will receive stock, securities or other property approximately equal to the fair market value of the property transferred to the transferee or for services rendered or to be rendered for the benefit of the transferee.

3 Activities of transferee-- Submit a **REPRESENTATION** as follows: The transferee will remain in existence and retain and use the property transferred to it in a trade or business.

4 Disposition of property-- Submit a **REPRESENTATION** as follows: There is no plan or intention by the transferee to dispose of the transferred property other than in the normal course of business operations.

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5 Related, connected, or step transactions-- Describe any loans, sales, exchanges, or other transactions, other than recurring arm's length sales, purchases, etc. in the normal course of business, that will occur or are contemplated whether or not considered as related to or in connection with the exchange.

6 Expenses-- Submit a **REPRESENTATION** as follows: Each of the parties to the transaction will pay its or his/her own expenses, if any, incurred in connection with the proposed transaction.

.07 Special Corporations.

1 Investment Company-- Submit a **REPRESENTATION** as follows: The transferee will not be an investment company within the meaning of section 351(e)(1) of the Code and *section 1.351-1(c)(1)(ii) of the regulations*.

2 Small Business Corporation-- State whether the transferee intends to make the election under section 1362(a) of the Code to be taxed as a "small business corporation" as defined in section 1361(a).

3 Bankrupt Transferor-- Submit a **REPRESENTATION** as follows: The transferor is not under the jurisdiction of a court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) and the stock or securities received in the exchange will not be used to satisfy the indebtedness of such debtor. See section 351(e) of the Code.

4 Personal Service Corporation-- Submit a **REPRESENTATION** as follows: The transferee will not be a "personal service corporation" within the meaning of section 269A of the Code.

.08 Copies of documents to be submitted with request.

1 Balance sheets-- Latest of transferee or other business involved. If transferee is a new corporation, submit a pro-forma balance sheet.

2 Plan or agreement of exchange -- If one has been committed to writing.

3 Securities-- If it is contended that any part or all of the indebtedness described in 4.042(a) above is "securities" within the meaning of section 351 of the Code submit:

a A brief explaining why.

b A copy of the note or other evidence of the indebtedness and loan agreement, if any. However, see section 4.0112 of *Rev. Proc. 83-22*.

.09 Foreign Transferee-- If the transfer is to a foreign corporation, see section 367 of the Code and the regulations thereunder and *Rev. Proc. 68-23, 1968-1 C.B. 821*.

.10 Taxpayer's memorandum-- Submit the information required by section 9 of *Rev. Proc. 83-1, 1983-1 I.R.B. 16*.



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APPENDIX A: Revenue Procedure 83-59

Checklist of information to be included in request for ruling under IRC Section 351

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5 INQUIRIES

Inquiries in regard to this revenue procedure should refer to its number and should be addressed to the Associate Chief Counsel (Technical), Attention CC:C:R, Internal Revenue Service, Washington, D.C. 20224



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APPENDIX A: Revenue Procedure 83-59

Checklist of information to be included in request for ruling under IRC Section 351

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6 EFFECT ON OTHER DOCUMENTS

Revenue Procedure 81-57, 1981-2 C.B. 674, is superseded.



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APPENDIX B: Revenue Procedure 86-18

2-B Taxation of Securities Transactions APPENDIX B:.syn

§ B.syn Synopsis to Appendix B: Revenue Procedure 86-18

1 PURPOSE

2 BACKGROUND

3 CHANGES

4 TRANSACTIONS TO WHICH SECTION 303 OR 302(B)(4) OF THE CODE APPLIES

5 INFORMATION TO BE INCLUDED IN REQUESTS FOR RULINGS UNDER SECTIONS 302 AND 311 OF THE CODE

6 INQUIRIES



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APPENDIX B: Revenue Procedure 86-18

Checklist of information to be included in request for rulings under IRC Sections 302 and 311
Sections 302 and 311 Checklist Questionnaire

2-B Taxation of Securities Transactions 1

1 PURPOSE

The purpose of this revenue procedure is to update *Rev. Proc. 81-62, 1981-2 C.B. 684*, which sets forth in a checklist questionnaire the information that must be included in a request for a ruling under *section 302 and 311 of the Internal Revenue Code*, relating to distributions in redemption of stock.



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APPENDIX B: Revenue Procedure 86-18

Checklist of information to be included in request for rulings under IRC Sections 302 and 311
Sections 302 and 311 Checklist Questionnaire

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2 BACKGROUND

The Internal Revenue Service receives many requests for rulings in which the information relating to the proposed transaction is not sufficient to permit a determination to be made. In these cases, it is necessary to obtain additional facts from the taxpayer before the request for a letter ruling can be considered. Obtaining these additional facts is time consuming for both Service personnel and taxpayers and delays issuance of the ruling letter.

This checklist will facilitate the filing and processing of request for rulings under sections 302 and 311 of the Code by showing specific information and representations to be included so that the requests will be as complete as possible when initially filed. Because the information and representations necessary to rule on a particular transaction depend upon all the facts and circumstances, information or representations in addition to those set forth in the revenue procedure may be required.

The authority and general procedures of the National Office of the Internal Revenue Service and of the office of the District Directors of Internal Revenue with respect to the issuance of letter rulings and determination letters are outlined in *Rev. Proc. 86-1, 1986-1 I.R.B. 6*. See also *Rev. Proc. 86-3, 1986-1 I.R.B. 26*, relating to areas in which advance rulings generally will not be issued. These revenue procedures, along with the present checklist revenue procedure, are subject to periodic updating by the Service. Therefore, careful attention should be given to ensure usage of the most current revenue procedures.

Careful attention to all requirements of these revenue procedures will aid in the timely processing of letter ruling requests.



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APPENDIX B: Revenue Procedure 86-18

Checklist of information to be included in request for rulings under IRC Sections 302 and 311
Sections 302 and 311 Checklist Questionnaire

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3 CHANGES

01

Section 1 is modified to indicate that the purpose of the revenue procedure is to update *Rev. Proc. 81-62*.

02

Section 2 is modified to state that representations are now required, and to update references to revenue procedures cited.

03

Section 4 is modified to update references to Code sections.

04

Section 5 is substantially altered. The taxpayer must now submit standard representations using the precise language specified herein, or submit an explanation why the representations cannot be made in the requested form. Sections 5.021, 5.032, 5.033, 5.041, 5.044, 5.051, and 5.052 are modified accordingly. To properly reflect applicable changes, some citations to Code sections and to revenue rulings and procedures have been added or deleted. Changes include:

1

Section 5.012 now requires taxpayers to submit information concerning any prior ruling requests submitted by the taxpayer (or predecessor) that were withdrawn in which the identical or similar issue was present.

2

Section 5.014 has been deleted.

3

Section 5.02 is modified to update references to revenue procedures cited.

4

Section 5.022(b) is modified to reflect the addition of section 318(a)(5)(E) to the Code.

5

Section 5.023 is amplified to request information concerning the acquisition by the Redeemed Shareholder of the redeemed stock.

6

Section 5.033(a) is modified to request information concerning changes in Corporation's outstanding equity in the past 5 years.

7

Section 5.033(b) is modified to request details of transactions involving any related corporation.

8

Section 5.033(c) is modified to include indirect sales or acquisitions of Corporation's stock by the Redeemed Shareholder.

9

Section 5.041(b)(2)(C) is modified to request supporting relevant authority for taxpayer's contention.

10

Section 5.041(c) is added and requests information and a representation if the Redeemed Shareholder is an entity.

11

Section 5.043 is modified to update reference to the partial liquidation section and to request supporting authority for taxpayer's contention.

12

Section 5.044(a) is modified to request information if common stock is to be redeemed.

13

Section 5.062(b)(5) is modified to show changes in the recapture provisions.

14

Section 5.07 is modified to request general information, and requires taxpayers to list the specific rulings being requested and the authorities supporting the rulings.

05

Section 6 is modified to substitute Associate Chief Counsel (Technical) for Assistant Commissioner (Technical), and CC:C:R for T:C:R.

06

Section 7 is modified to state that *Rev. Proc. 81-62* is superseded.



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APPENDIX B: Revenue Procedure 86-18

Checklist of information to be included in request for rulings under IRC Sections 302 and 311
Sections 302 and 311 Checklist Questionnaire

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4 TRANSACTIONS TO WHICH SECTION 303 OR 302(B)(4) OF THE CODE APPLIES

01 Section 303. Distribution in redemption to pay death taxes.-- To the extent the distribution is within the terms of section 303 of the Code, section 302(b)(1), (2) or (3) does not apply to the distribution. If the stock redeemed was included in a decedent's gross estate, see section 303 which treats these redemptions under certain circumstances as in full payment in exchange for the stock so redeemed.

02 Section 302(b)(4) Distribution in partial liquidation.-- If any part of the distribution will qualify as a partial liquidation under section 302(b)(4) of the Code, state the amount and the reason reasons why it qualified under section 302(b)(4). See *Rev. Proc. 81-42, 1981-2 C.B. 611*.



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APPENDIX B: Revenue Procedure 86-18

Checklist of information to be included in request for rulings under IRC Sections 302 and 311
Sections 302 and 311 Checklist Questionnaire

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5 INFORMATION TO BE INCLUDED IN REQUESTS FOR RULINGS UNDER SECTIONS 302 AND 311 OF THE CODE

Each of the items in this section should be specifically dealt with in the letter ruling request. If an item is not applicable, so state, and briefly explain why. Standard representations are set forth throughout this section and are highlighted by the word "representation" in boldface type. These representations are of equal importance with the other factual information request herein. The representations function to ensure that specific statutory and judicial requirements and administrative ruling guidelines are satisfied. Each representation set forth in this section should be submitted precisely in the language requested. If a representation cannot be submitted as requested, an explanation must be given. Variations of the language of the representations may delay processing the ruling request and will not be accepted unless reasons satisfactory to the Service are submitted. Submission of the information and representations should follow the format of this revenue procedure as closely as possible, with appropriate descriptive headings. Care must be taken to ensure that all the facts relating to the transaction are submitted.

01 Information regarding the corporation that is redeeming its stock (Corporation).

1 Identification.-- Name, taxpayer identification number, and place and date of incorporation of Corporation.

2 Jurisdiction.-- Identify the District Office that will have audit jurisdiction over the return of Corporation (referred to below as "taxpayer"). State whether, to the best knowledge of the taxpayer and the taxpayer's representatives, if any, the identical issue is in a return of the taxpayer (or of a related taxpayer within the meaning of section 267 of the Code, or a member of an affiliated group of which the taxpayer is also a member within the meanings of section 1504) and, if so, whether the issue (1) is being examined by a District Director, (2) has been examined by a District Director and-(a)

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the statutory period of limitation either on assessment or for filing a claim for refund or credit of tax has not expired and (b) a closing agreement covering the issue or liability has not been entered into by a District Director, (3) is being considered by an Appeals Office in connection with the taxpayer's return for an earlier period, (4) has been considered by an Appeals Office and (a) the statutory period of limitation either on assessment or for filing a claim for refund or credit of tax has not expired and (b) a closing agreement covering the issue or liability has not been entered into by an Appeals Office, or (5) is pending in litigation in a case involving the taxpayer or a related taxpayer. The request must contain a statement whether, to the best knowledge of the taxpayer and the taxpayer's representatives, the identical or a similar issue has been (i) submitted to the Service, but withdrawn before a ruling was issued, or (ii) ruled on by the Service to the taxpayer or the taxpayer's predecessor and, if so, when and with what result. If, after the request is filed but before a ruling is issued, the taxpayer knows that an examination of the issue by a District Director has been started, the taxpayer must notify the National Office of this action. If a return is filed before a ruling is received from the National Office concerning the issue that is the subject of the request for ruling, a copy of the request must be attached to the return. This alerts the District Office and avoids premature District action on the issue.

3 Business.-- Provide the following information about Corporation: (i) a brief description of its businesses, (ii) its method of accounting, and (iii) its tax year.

02 Description of Corporation's capital structure and ownership of Corporation's stock.

1 Description of capital structure.

a In general.-- Furnish a complete description of each class of Corporation's outstanding stock (throughout this document the word "stock" includes all forms of equity ownership), setting forth the rights and privileges of each class, including voting or non-voting rights, dividend and liquidation preferences or limitations, and whether classified as common or preferred stock. Also describe all other outstanding interests (bonds, debentures, notes, warrants, options, etc.), and briefly explain why each of these items should or should not be considered a stock interest. If Corporation has no outstanding interests convertible into stock, submit the following Representation: There are no outstanding options or warrants to purchase Corporation stock, nor are there any outstanding debentures or other obligations that are convertible into Corporation stock or would be considered Corporation stock. Applying the constructive ownership rules of section 318(a) of the Code, state the relationship between the shareholders and the creditors of Corporation. In addition, describe any new debt or equity that Corporation anticipates issuing.

b Distribution of obligations of Corporation.-- If applicable, submit the following Representation: No notes or other obligations of Corporation will be distributed to a redeemed shareholder. Alternatively, if notes or other obligations of Corporation will be distributed to a shareholder whose stock is being redeemed (a Redeemed Shareholder), furnish the following:

1 Copy.-- Provide a copy or prototype of the instrument that set forth its terms and limitations.

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2 Period of payments.-- Give the beginning and ending payment dates. Submit the following Representation: In no event will the last payment on any note or other obligation be made more than 15 years after the date of issuance of the note or other obligation. See section 4.0112 of *Rev. Proc. 86-3*.

3 Payment of fixed amount.-- State whether the amount to be paid, including interest, is a fixed amount payable at a fixed time, and whether the amount or the time of payment is subject to any change or adjustment. Submit the following Representation: None of the consideration from Corporation, including interest, consists entirely or partly of corporation's promise to pay an amount that is based on, or contingent on, future earnings of Corporation, an amount that is contingent on working capital being maintained at a certain level, or any other similar contingency. See section 3.0117 of *Rev. Proc. 86-3*. Alternatively, furnish any payments' terms and reasons why the right to the payments should not be considered an equity interest in Corporation.

4 Financial statements.-- Submit profit and loss statements and balance sheets for the latest 3 years.

5 Subordination.-- Submit the following Representation: Any note or other obligation to be issued to a redeemed shareholder will not be subordinated to the claims of general creditors of Corporation.

6 Default.-- Submit the following Representation: In the event of default on any note or other obligation, no shares of stock will revert to or be received by a redeemed shareholder nor will any redeemed shareholder be permitted to purchase the stock at public or private sale. See Section 3.0116 of *Rev. Proc. 86-3*.

2 Ownership of stock before the redemption.

a Shares owned directly.-- State the total number of shares outstanding for each class of stock in Corporation immediately before the redemption. Also state the number of shares and percentage of each class of stock owned directly by each shareholder immediately before the redemption. However, if there are more than 25 shareholders, the statement in the preceding sentence may be limited to Redeemed Shareholders and those shareholders whose stock is attributed to them under section 318(a) of the Code.

b Shares constructively owned.-- State the number of shares and percentage of each Redeemed Shareholder, and the relationship under section 318(a) of the Code of any person or entity whose stock is attributed to a Redeemed Shareholder. In determining stock constructively owned by each Redeemed Shareholder under section 318(a), ownership may be attributed any number of times from an individual or entity to another, as provided in section 318(a)(5)(A). However, observe the exception in section 318(a)(5)(B) with respect to double attribution among members of the family (under section 318(a)(1)) and the exception in section 318(a)(5)(c) with respect to "sidewise"

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attribution to (under section 318(a)(3)) and from (under section 318(a)(2), a partnership, estate, trust, or corporation). Also, observe the following exceptions to constructive ownership: (i) to (under section 318(a)(3) of the Code) and from (under section 318(a)(2)) an employees' trust described in section 401(a) that is exempt from tax under section 501(a); and (ii) to a trust (under section 318(a)(3)) if the beneficiary's interest is a remote contingent interest. If it is contended that a trust is an employees' trust or that a beneficiary's interest is a remote contingent interest, submit information to support the contention. In addition, observe that pursuant to section 318(a)(5)(E) of the Code, an S corporation is treated as a partnership and each of its shareholders as partners of the partnership for purposes of section 318(a). But note the limitation for purposes of constructive ownership provided by section 318(a)(5)(E).

1 Section 318(a)(1) of the Code: family attribution.-- If the Redeemed Shareholder is an individual, indicate the number of shares and percentage of each class of stock of Corporation owned actually and constructively under section 318(a) by members of the Redeemed Shareholder's family described in section 318(a)(1).

2 Section 318(a)(2) of the Code: attribution from a partnership, estate trust, or corporation.-- Indicate the number of shares and percentage of each class of stock of Corporation owned actually and constructively under section 318(a) by any partnership, estate, trust, or corporation in which the Redeemed Shareholder has an interest and the interest of the Redeemed Shareholder in each of these entities.

3 Section 318(a)(3) of the Code: attribution to a partnership, estate, trust, or corporation.-- Indicate the number of shares and percentage of each class of stock of Corporation owned actually and constructively under section 318(a) as follows: (i) by any of the partners if the Redeemed Shareholder is a partnership; or (ii) by any of the beneficiaries if the Redeemed Shareholder is a trust or estate; or (iii) by any of the shareholders owning actually or constructively, under section 318(a), 50 percent or more in value of the stock of the Redeemed Shareholder, if the Redeemed Shareholder is a corporation.

4 Section 318(a)(4) of the Code: options to acquire stock of Corporation.-- Identify all holders of any rights or options (including those in the form of convertible debentures and stock rights or warrants) to acquire stock of Corporation and the relationship, direct or indirect under section 318(a), of the option holders to each of the Redeemed Shareholders.

c Percent of stock owned.-- Indicate the total percentage of each class of stock of Corporation owned actually and constructively, as determined in section 5.022(a) and (b) above, by each shareholder of Corporation immediately before the redemption.

3 Stock to be redeemed.-- State the number of shares of each class of stock to be redeemed from each shareholder of Corporation listed in section 5.022(a) above. Unless the stock is traded on an established securities market, also state when, from whom, and for what consideration each Redeemed Shareholder received the equity interest being redeemed.

2-B Taxation of Securities Transactions 5

4 Ownership of stock after the redemption.-- Indicate the number of shares of each class of stock of Corporation owned actually and constructively by each shareholder, the total outstanding, and the percentage of each class of stock owned actually and constructively by each Redeemed Shareholder immediately after the redemption, determined in the same manner and including the same information as required in section 5.022 above.

03 Other relationships or transactions.-- Information showing the complete factual background relating to the redemption of each Redeemed Shareholder.

1 Other relationships between Corporation and any Redeemed Shareholder.-- With regard to each Redeemed Shareholder, state whether the shareholder was, or will be, an employee of, an officer of, or in any way related to, Corporation. Describe fully all business and debtor-creditor relationships between each Redeemed Shareholder and Corporation. Describe all direct and indirect payments by Corporation to, or for the benefit of, each Redeemed Shareholder. (See e.g., *Rev. Rul. 77-467, 1977-2 C.B. 92* and section 3.0118 of *Rev. Proc. 86-3*). Give details of any agreements between a Redeemed Shareholder and Corporation, such as an employment contract, covenant not to compete, insurance, pensions, deferred compensation, or other benefits, and state whether the agreements, payments, or benefits had an affect upon the amount of property to be distributed in the redemption. Describe any property a Redeemed Shareholder will transfer or surrender in the transaction other than stock of Corporation, and the consideration to be received in exchange therefor. State whether any part of the consideration from Corporation will be received by a Redeemed Shareholder, directly or indirectly, as a creditor, employee, or in some capacity other than as a Redeemed Shareholder. Describe whether the Redeemed Shareholder conducts or will conduct any business with, or leases or will leases any property to, Corporation.

2 Agreements between shareholders.-- Submit the following Representation: No shareholder of Corporation has been or will be obligated to purchase any of the stock to be redeemed. Alternatively, if there are, or within the 3-year period prior to the transaction have been, any agreements between a Redeemed Shareholder and other shareholders as to the acquisition or disposition of any equity interest, such as buy-sell agreements or option, describe the agreements or options in full. Submit copies of all pertinent agreements. See *Rev. Rul. 69-608, 1969-2 C.B. 43*.

3 Other transactions.-- Submit the following Representation: The redemption described in this ruling request is an isolated transaction and is not related to any other past or future transaction. Alternatively, state whether there have been, or will be, any related transactions, and, if so, briefly describe these other transactions and fully explain their relationship to, and impact on, the present transaction. See section 9.06 of *Rev. Proc. 86-1*.

a Transactions involving Corporation.-- If there have been no changes in Corporation's outstanding equity in the past 5 years, submit the following Representation; There have been no redemptions, issuances, or exchanges by Corporation of its stock in the past 5 years. Alternatively, describe all changes in Corporation's outstanding equity during this period, including every redemption, issuance, or exchange of stock by Corporation. State whether any of the shareholders involved in any of these prior transactions are Redeemed Shareholders, or related within the meaning of section 318 of the Code to a Redeemed Shareholder, in the present transaction. If no future transactions are planned or intended, submit the following Representation: Corporation has no plan or intention to issue, redeem, or exchange

2-B Taxation of Securities Transactions 5

additional share of its stock. Alternatively, if any issuances, redemptions, or exchanges are planned, describe the transaction, the number and type of shares, and the consideration to be paid or received in exchange for the stock, and state whether any of the shareholders involved in any future transaction are Redeemed Shareholders, or related within the meaning of section 318 of the Code to a Redeemed Shareholder, in the present transaction.

b Transactions involving any related corporation.-- State whether there were, or will be, any distributions, redemptions, or issuances of stock of any related corporation, and if so, briefly describe the transactions and fully explain their relationship to the present transaction.

c Transactions involving any Redeemed Shareholder.-- State whether any Redeemed Shareholder or a related party has sold or acquired, or intends to sell or acquire, any stock in Corporation or any related corporation either directly or constructively within five years of the redemption. If so, state the number of shares of each class, identify the parties to the transaction, the relationship of the parties and their relationship to any Redeemed Shareholder within the meaning of section 318(a) of the Code, and the consideration to be received in exchange therefor. State whether the sale or disposition of the stock has been considered consummated in computing the ownership of stock before and after the redemption in section 5.022 and 4 above. State whether Corporation will be liable, directly or indirectly, for any part of the buyer's obligation in the purchase of stock. See *Rev. Rul. 69-608*, supra.

4 In general.-- Describe any relationship or transaction between Corporation and any Redeemed Shareholder, and describe any transaction by either Corporation or any Redeemed Shareholder, if the relationship or transaction affects the Redeemed Shareholder's percentage ownership of any class of Corporation's stock, regardless of whether the transaction or relationship is past, contemplated, or not considered related to the redemption.

04 Information to determine whether the redemption is an exchange or dividend.

1 Termination of shareholder's interest.

a Complete termination of shareholder's stock interest.-- Submit the following Representation: None of the redeemed shareholders are related, within the meaning of section 318 of the Code, to any remaining shareholders of Corporation.

b Termination of shareholder's interest except for constructive ownership under section 318(a)(1) of the Code.-- If it is contended there has been a complete termination of a Redeemed Shareholder's interest except for constructive ownership from a family member under section 318(a)(1) so that section 302(b)(3) should apply pursuant to the application of section 302(c)(2), furnish the following with respect to the Redeemed Shareholders:

2-B Taxation of Securities Transactions 5

1 Identity of the Redeemed Shareholders.

2 Acquisitions or dispositions of stock of Corporation within the last 10 years by the Redeemed Shareholders. Do not include a change in interest resulting from partition of community property. See *Rev. Rul. 82-129, 1982-2 C.B. 76*.

(A)

Acquisitions by Redeemed Shareholders within the last 10 years.--Submit the following Representation: None of the stock to be redeemed was acquired by the redeemed shareholder within the 10-year period preceding the redemption from a person whose stock would be attributed under section 318(a) of the Code to the redeemed shareholder at the time of redemption. (Alternatively, see (C) below.)

(B)

Dispositions by Redeemed Shareholder within the last 10 years.--Submit the following Representation; No person whose stock would be attributed to the redeemed shareholder under section 318(a) of the Code will own stock of Corporation after the redemption if the stock was acquired by that person from the redeemed shareholder within 10 years preceding the redemption. (Alternatively, see (C) below.)

(C)

Avoidance of federal income tax.--If the representation in either (A) or (B) immediately above cannot be furnished because of an acquisition or disposition described therein, but it is contended that the acquisition or disposition did not have as one of its principal purposes the avoidance of federal income tax, give a full description and furnish an analysis of both the facts and supporting relevant authority for the contention. See section 3.0119 of *Rev. Proc. 86-3*.

3 Interest in Corporation after the redemption.

(A)

No interests other than creditor and constructive owner under section 318(a)(1) of the Code.--Describe whether Corporation will provide any compensation or economic benefit to any Redeemed Shareholder (regardless of whether the compensation or benefit is related to prior services) including termination bonuses, payments under covenants not to complete, free insurance, and future employment of any type whether directly as an officer or employee or indirectly as an independent contractor or consultant. Submit the following Representation: After the redemption, no redeemed shareholder will have any interest in Corporation, including an interest as an officer, director, or employee (other than an interest as a creditor as described in *section 1.302-4(d) of the Income Tax Regulations*, and constructive ownership under section 318(a)(1) of the Code). See *Rev. Ruls. 84-135, 1984-2 C.B. 80, 81-233, 1981-2 C.B. 83, and 71-426*,

1971-2 C.B. 173.

(B)

Agreement as to future interests.--When attribution under section 318(a)(1) of the Code is to be waived pursuant to section 302(c)(2)(A), submit the following Representation: Each redeemed shareholder will execute and file the agreement required by section 302(c)(2)(A)(iii) of the Code with respect to the acquisition of any interest in Corporation within 10 years from the date of the redemption.

(C)

Termination of entity-shareholder's interest except for constructive ownership under section 318(a)(1) of the Code.--If a partnership, estate, trust, or corporation is a Redeemed Shareholder and stock is attributed to it under section 318(a)(3) of the Code from a "related person" (defined in section 302(c)(2)(C)(ii)), submit: (i) the name and relationship to the entity of each related person; (ii) the representations in section 5.041(b)(2)(A) for each Redeemed Shareholder and in section 5.041(b)(2)(B) for each Redeemed Shareholder and each related person (or the information in section 5.041(b)(2)(C)); (iii) the information and representations required by section 5.041(b)(3)(A) and (B) for each Redeemed Shareholder and each related person; and (iv) the following Representation: The Redeemed Shareholder and each related person will agree to be jointly and severally liable for any deficiency (including interest and additional tax) resulting from an acquisition of an interest in Corporation within 10 years from the date of the redemption.

2 Substantially disproportionate redemption.-- If it is contended the redemption is substantially disproportionate to one or more of the Redeemed Shareholders, furnish the information required in section 302(b)(2) of the Code with respect to each of those shareholders.

a Fifty-percent rule.-- State the percent of the total combined voting power of all classes of stock entitled to vote owned actually and constructively by each Redeemed Shareholder (as determined in section 5.024 above) immediately after the redemption.

b Eighty-percent rule.-- Submit computations to show that each Redeemed Shareholder owns actually and constructively immediately after the redemption (as determined under section 5.024 above) less than 80 percent of the percentage of the outstanding common stock (voting and nonvoting) owned immediately before the redemption, in accordance with the requirements in section 302(b)(2)(C) of the Code. If a Redeemed Shareholder holds no common stock, either directly or constructively, no computation for common stock is required (see *Rev. Rul. 81-41, 1981-1 C.B. 121*).

3 Redemption not essentially equivalent to a dividend.-- If the redemption does not qualify as a partial liquidation under section 301(b)(4) of the Code, as an exchange under section 303, or under section 302(b)(2) or (3), and it is contended "the redemption is not essentially equivalent to a dividend" within the meaning of section 302(b)(1), submit

2-B Taxation of Securities Transactions 5

whatever facts and analysis of supporting authority are relevant with respect to each Redeemed Shareholder (which have not been furnished above) to support this contention. Supply information to show that each Redeemed Shareholder will have a meaningful reduction in proportionate interest in vote, dividend rights, and right to receive assets on liquidation with regard to Corporation. See *United States v. Davis*, 397 U.S. 301 (1969), Ct. D. 1937, 1970-1 C.B. 62, section 1.302-2 of the regulations, and Rev. Rul. 81-289, 1981-2 C.B. 82.

4 Other information to determine whether the redemption is an exchange, a dividend, or other ordinary income transaction to the Redeemed Shareholder or any other person.

a "Section 306 stock".-- If it is contended that none of the stock to be redeemed is "section 306 stock" within the meaning of section 306(c) of the Code, submit the following Representation: None of the stock to be redeemed is "section 306 stock" within the meaning of section 306(c) of the Code. If the stock to be redeemed is common stock, state whether it was received in exchange for preferred stock. If the stock to be redeemed is preferred stock, furnish the following information:

1 Issued for cash.-- If issued for cash, furnish a statement to that effect and state whether the stock was paid for in full.

2 Issued upon incorporation.-- If the stock was issued upon incorporation in exchange for property, furnish a statement to that effect. (See section 306(c)(3) and (4) of the Code.)

3 Issued under other circumstances.

(A)

When issued.--Give the date or dates on which the stock was issued.

(B)

Transaction.--Describe the transaction in which the stock was issued (whether a stock dividend, or reorganization, or other transaction).

(c) Consideration to Corporation.--Describe the kind of property, if any, Corporation received in exchange for the stock.

b Declared but unpaid dividends.-- Submit the following Representation: There are no declared but unpaid

2-B Taxation of Securities Transactions 5

dividends, or funds set apart for dividends, or any of the stock to be redeemed. (See *Rev. Rul. 75-320, 1975-2 C.B. 105*, and *Rev. Rul. 69-130, 1969-1 C.B. 93*.)

c Financing of redemption.-- State the source of the cash or other property to be distributed in the redemption. If cash has been or will be borrowed for the redemption, give full redemption, give full particulars as to the parties to, and terms of, the loan agreement.

d Stock not to be cancelled, retired, or held as treasury stock.-- If a party other than Corporation will hold the stock to be redeemed, give all facts concerning the arrangement and the conditions, if any, under which the stock may be returned to the Redeemed Shareholder or any person other than Corporation, and the relationship under section 318(a) of the Code of that person to the Redeemed Shareholder.

e Debt owed by Redeemed Shareholder to Corporation.-- If a Redeemed Shareholder owes any amount to Corporation, state the circumstances under which the debt arose, the terms of the debt, and when and how it will be discharged.

f Redemption price and fair market value of the stock.-- Submit the following Representation: At the time of the exchange, the fair market value of the consideration to be received by the redeemed shareholder will be approximately equal to the fair market value of Corporation's stock to be exchanged therefor. Alternatively, if it will not be approximately equal, give a complete explanation, including the fair market value of both the stock redeemed and the assets distributed.

05 Effect on Redeemed Shareholder when redemption is treated as an exchange.

1 Loss to Redeemed Shareholder.-- Submit the following Representation: The price to be paid for Corporation's stock to be redeemed will not result in a loss with respect to those shares of stock. Alternatively, if any Redeemed Shareholder will realize a loss on the redemption, state reasons to establish why section 267 of the Code will not apply.

2 Installment method.-- If a Redeemed Shareholder requests a ruling that the installment method under section 453 of the Code will apply to the redemption, furnish information to support the contention that the requirements in section 453(b) will be met with respect to the Redeemed Shareholder. Further, submit the following Representation: The redemption of Corporation stock (i) is not a disposition of personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property on the installment plan and (ii) is not a disposition of personal property of a kind required to be included in the inventory of any redeemed shareholder at the close of the taxable year. Any note or other obligation to be issued to a redeemed shareholder will not be issued in any form designed to render it readily tradable on an established securities market. See section 453(b), (f)(2), and (f)(5) of the Code.

2-B Taxation of Securities Transactions 5

06 Property distributed in redemption of the stock.-- Describe in detail the property to be received by each Redeemed Shareholder.

1 United States cash.-- Indicate the amount of United States cash (including cash equivalents within the meaning of *Rev. Rul. 66-290, 1966-2 C.B. 112*) to be distributed to each Redeemed Shareholder.

2 Property other than United States cash.

a Description.-- Describe fully all types and categories of property, tangible and intangible, other than United States cash (including cash equivalents within the meaning of *Rev. Rul. 66-290*), to be distributed by Corporation to each Redeemed Shareholder.

b Recognition of gain or income to Corporation.-- In order to determine whether gain or income will be recognized to Corporation upon the distribution of property, provide the following:

1 Inventory (section 311(b)).-- A statement whether any inventory will be distributed and, if distributed, whether Corporation is on the LIFO method of inventory.

2 Liability in excess of basis (section 311(c)).-- A statement as to the amount of any liabilities to be assumed by a Redeemed Shareholder, the amount of any liability to which the property distributed is subject, and the adjusted basis in the hands of Corporation of all property distributed.

3 Appreciated property (section 311(d)).-- A statement whether any appreciated property will be distributed by Corporation to a Redeemed Shareholder as part of the redemption. If so state any exceptions or limitations which may be applicable to prevent recognition of gain to Corporation and give reasons for their applicability.

4 Unreported and anticipatory assignment of income.-- State whether Corporation will distribute to a Redeemed Shareholder any assets which represent earned but unreported income such as receivables being reported on a cash basis, unfinished construction contracts, commissions due, or other assets resulting in an anticipatory assignment of income.

5 Installment obligations and recapture provisions.-- State whether Corporation will distribute to a Redeemed

2-B Taxation of Securities Transactions 5

Shareholder in the redemption (i) any installment obligations (section 453B of the Code), (ii) any property described in the recapture provisions of the Code including, but not limited to, sections 47, 291(a), 341(f), 617(d), 897(d), 904(f), 1245(a), 1248(f), 1250(c), 1252(a), 1254, or 1255, (iii) any property for which the taxpayer obtained a deduction (See *Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1983); *Rev. Rul. 74-396*, 1974-2 C.B. 106; *Rev. Rul. 61-214*, 1961-2 C.B. 60), or (iv) any property described in sections 1256 or 1276.

6 Reserve for bad debts.-- A statement whether Corporation will distribute to a Redeemed Shareholder any receivables. If so, state the amount of any reserve for bad debts related to the receivables.

7 Sale, lease, or other disposition of property.-- State whether the Redeemed Shareholder will sell, lease, or otherwise dispose of any property received in the redemption, and give full particulars as to the circumstances and agreement with respect to the sale, lease, or other disposition. If property will be leased back to Corporation, submit a copy of the lease, and state whether: (i) the terms of the lease are the result of arm's length negotiation; (ii) the payments to be made thereunder will be in an amount equal to the fair rental value of the property; (iii) the payments will be dependent on the future earnings of Corporation; and (iv) the payments will be subordinated to the claims of general creditors. See *Rev. Rul. 77-467*, 1977-2 C.B. 92.

8 Cross-redemption.-- If the Redeemed Shareholder is a corporation and the property to be distributed by Corporation is stock of the Redeemed Shareholder, submit a statement concerning treatment of the cross-redemption by each of the corporations, together with a statement of relevant authorities to support the treatment.

07 07 General

1 Additional statements.-- See *Rev. Proc. 86-1* for additional information and statements that must be submitted with all ruling requests, including statements required under sections 9.02 and 9.09 (relating to instructions to taxpayers).

2 Requested rulings.-- List the rulings being requested in the exact wording desired, and provide statutory, regulatory, or other authority for their issuance.

3 Taxpayer's memorandum.-- Submit the information required by section 9.03 of *Rev. Proc. 86-1* (relating to relevant authorities regarding the tax results of the transaction).



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APPENDIX B: Revenue Procedure 86-18

Checklist of information to be included in request for rulings under IRC Sections 302 and 311
Sections 302 and 311 Checklist Questionnaire

2-B Taxation of Securities Transactions 6

6 INQUIRIES

Inquiries in regard to this revenue procedure should refer to its number and should be addressed to the Associate Chief Counsel (Technical), Attention: CC:C:R, Internal Revenue Service, Washington, D.C. 20224.



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APPENDIX C: Revenue Procedure 81-42

2-C Taxation of Securities Transactions APPENDIX C:.syn

§ C.syn Synopsis to Appendix C: Revenue Procedure 81-42

1 PURPOSE

2 BACKGROUND

3 CHANGES

4 INFORMATION TO BE INCLUDED IN REQUESTS FOR RULINGS UNDER SECTION 346 OF THE CODE

5 INQUIRIES

6 EFFECT ON OTHER DOCUMENTS



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APPENDIX C: Revenue Procedure 81-42

Checklist of information to be included in request for ruling under IRC Section 346 (now Section 302(b)(4))

SECTION 346 CHECKLIST QUESTIONNAIRE

2-C Taxation of Securities Transactions 1

1 PURPOSE

The purpose of this Revenue Procedure is to update *Rev. Proc. 73-36, 1973-2 C.B. 496*, which sets forth in a convenient checklist questionnaire the information necessary to be included in a request for a ruling under *section 346 of the Internal Revenue Code* (and its related sections, 331 and 336) which relates to a distribution by a corporation in partial liquidation.



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APPENDIX C: Revenue Procedure 81-42

Checklist of information to be included in request for ruling under IRC Section 346 (now Section 302(b)(4))

SECTION 346 CHECKLIST QUESTIONNAIRE

2-C Taxation of Securities Transactions 2

2 BACKGROUND

The Internal Revenue Service receives many requests for rulings in which the information furnished as to the proposed transaction is not complete enough to permit a determination to be made. In such cases it is necessary to secure additional facts from the taxpayer before the ruling request can be considered. This procedure is time-consuming for both Service personnel and taxpayers and delays issuance of the final ruling letter. This checklist will facilitate the filing of requests for rulings under section 346 of the Code by showing specific information which should be included so that the application will be as complete as possible when originally filed.

However, since the information necessary to rule on a particular transaction depends upon all the facts and circumstances of that case, information in addition to that suggested in this revenue procedure may be required. Nevertheless, careful use of the checklist should avoid much needless delay and permit the issuance of rulings in the most expeditious fashion possible.

The authority and general procedures of the National Office of the Service and of the Office of the District Directors of Internal Revenue with respect to the issuance of rulings and determination letters are outlined in *Rev. Proc. 80-20, 1980-1 C.B. 633*, as amended by *Rev. Proc. 81-33, 1981-32 I.R.B. 19*. See also *Rev. Proc. 81-10, 1981-13 I.R.B. 44*. Careful attention to all the requirements of those revenue procedures will serve to minimize needless delays in processing requests for rulings.



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APPENDIX C: Revenue Procedure 81-42

Checklist of information to be included in request for ruling under IRC Section 346 (now Section 302(b)(4))

SECTION 346 CHECKLIST QUESTIONNAIRE

2-C Taxation of Securities Transactions 3

3 CHANGES

.01

Section 1 has been changed to indicate that the purpose of the revenue procedure is to update *Rev. Proc. 73-36*.

.02

Sections 2 and 4 and the index have been modified by substituting more complete and updated numbering and references. The present section 4 was section 3 in the prior revenue procedure.

.03

Section 4 has been modified to emphasize the desirability of providing all the information requested in the checklist, or, if appropriate, briefly stating why a checklist item is believed not to be nonapplicable.

.04

Section 4.01-1 has been modified to provide that references in this revenue procedure to the Distributor corporation include a liquidating subsidiary of such Distributor.

.05

Section 4.01-3 has been expanded regarding whether the identical issue presented in the ruling request is, or has been, under consideration elsewhere in the Service.

.06

Section 4.02-2(a) has been expanded to request a description of the continuing business.

.07

Section 4.02-2(c) has been expanded to include termination of a business (as well as a contraction), and to request a five-year dividend history for the Distributor.

.08

Section 4.02-2(d)(1)(A) has been expanded to request information as to whether reduced assets were active or passive.

.09

Section 4.02-2(d) also has been expanded to request information as to the amount of assets to be reduced, and to request any other information demonstrating a contraction or termination.

.10

Section 4.02-2(g) has been modified by having the term "cash" also reference cash equivalents and by requesting a breakdown between United States and foreign cash.

11

. Section 3.02-2(g)(3)(B)(ii) has been expanded to request information whether proceeds from sales, etc., will be segregated in a special account and not used in the continuing business of the Distributor.

.12

Section 4.02-2(g)(5) has been added to request a statement that the distributed assets are assets that were actively used in the business or the proceeds from their sale, and not substituted assets.

.13

Section 4.03-3 has been modified by changing section 453(d) to section 453B and adding sections 1248, 1254, and LIFO inventory.

.14

Section 4.03-4 is modified by deleting the phrase "other than cash."

.15

Section 4.05 has been expanded to request information as to employment agreements between the Distributor corporation and its shareholders.

.16

Section 4.06 has been expanded to show representations that must be included in a taxpayer's ruling request.

.17

Section 4.07 has been added to deal with related or multiple transactions in addition to the partial liquidation.



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APPENDIX C: Revenue Procedure 81-42

Checklist of information to be included in request for ruling under IRC Section 346 (now Section 302(b)(4))
SECTION 346 CHECKLIST QUESTIONNAIRE

2-C Taxation of Securities Transactions 4

4 INFORMATION TO BE INCLUDED IN REQUESTS FOR RULINGS UNDER SECTION 346 OF THE CODE

Each of the items included in this section should be specifically dealt with in the application even though some may not appear to be applicable. Presentation of the information required should follow the format of this revenue procedure as closely as possible with appropriate descriptive headings. If an item is believed not to be applicable, say so, and briefly explain why it does not apply. Processing ruling requests is significantly expedited by providing all the information requested in exactly the order in which it is requested herein.

.01 Information regarding the liquidating corporation.

1 Identification.-- Name, taxpayer identification number, and place and date of incorporation of the liquidating corporation (the Distributor). If the transaction also includes a liquidation of a subsidiary of the Distributor, then, throughout this checklist questionnaire, the information requested should be furnished with regard to both the Distributor and such liquidating subsidiary.

2 Tax year.-- The last day of the Distributor's taxable year.

3 Jurisdiction.-- Identify the District Office that will have audit jurisdiction over the return of the Distributing corporations and state whether to the best of the knowledge of the taxpayer and the taxpayer's representative(s), if any, the identical issue is in a return of the taxpayer (or of a related taxpayer within the meaning of section 267 of the Code, or a member of an affiliated group of which the taxpayer is also a member within the meaning of section 1504) and, if

2-C Taxation of Securities Transactions 4

so, whether the issue (1) is being examined by a District Director, (2) has been examined and the statutory period of limitation on assessment or refund of tax has not expired or a closing agreement covering the issue or liability has not been entered into by a District Director, (3) is being considered by an Appeals office in connection with the taxpayer's return for an earlier period, or that issue has been considered by an Appeals office and the statutory period of limitation on assessment or refund of tax has not expired or a closing agreement covering the issue of liability has not been entered into by an Appeals office, or (4) is pending in litigation in a case involving the taxpayer or a related taxpayer. The request must contain a statement whether, to the best of the knowledge of the taxpayer and the taxpayer's representative(s), the identical or similar issue has been ruled on by the Service to the taxpayer or to the taxpayer's predecessor and, if so, when and with what results. If after the request is filed but before a ruling is issued, the taxpayer knows that an examination of the issue by a District Director has been started, the taxpayer must notify the National Office of such action. If a return is filed before a ruling is received from the National Office concerning the return, a copy of the request must be attached to the return. This alerts the District Office and avoids premature District action on the issue.

.02 Type and description of partial liquidation.

1 Series of distributions in complete liquidation.-- If it is contended the distribution is one of a series of distributions in redemption of all of the stock of the Distributor, furnish the following information:

a Reasons.-- Give reasons why the Distributor is being liquidated in a series of distributions rather than in one distribution.

b Expected date and amount of each of the distributions.-- In this respect, see Sec. 4.017 of *Rev. Proc. 81-10*, which states that rulings will not ordinarily be issued on the tax effect to shareholders of the liquidation of a corporation by a series of distributions, where the distributions in liquidation are to be made over a period in excess of three years from the adoption of the plan of liquidation.

c Dissolution.-- State whether the Distributor will be dissolved at the time of the final distribution in complete liquidation. If it will not, give the reasons for not dissolving it.

2 Distribution not essentially equivalent to a dividend.-- If it is contended the distribution is not essentially equivalent to a dividend within the meaning of section 346(a)(2) of the Code, furnish the following information:

a General information as to the business or businesses of the Distributor, both before and after the transaction.

2-C Taxation of Securities Transactions 4

1 Description.-- Furnish a full and complete description of the business of the Distributor, identify the business terminated or contracted, and describe in detail the business to be continued.

2 How and when the business or businesses were acquired.

(A)

Acquired from another person.--If the business or businesses were acquired within the past five years from other persons, identify the persons, their relationship to the Distributor or its shareholders, the type of transactions in which they were acquired, the consideration given in exchange, the date of the transactions, and the amount of gain or loss, if any, recognized on the transactions.

(B)

Initiated by the Distributor.--If the business or businesses were commenced within the past five years by the Distributor, give the source of the capital and assets used to commence and operate each business and give the dates the operation of each business commenced.

b Termination of a business.-- If it is contended the distribution is not essentially equivalent to a dividend because of the termination of a business within the meaning of section 346(b) of the Code, furnish the following information.

1 Active business.-- Furnish the information necessary to establish that the businesses are "active businesses" within the meaning of *section 1.355-1(c) of the Income Tax Regulations*.

2 Five-year requirement.

(A)

Date terminated.--Give the date the business operations were terminated.

(B)

Continuous and continued operation.--State whether the businesses have been continuously and actively conducted within the meaning of *section 1.355-1(c) of the regulations* for the five-year period immediately preceding the date of sale (see 4.02-2(g)(3)(B) below) or distribution (see 4.02-2(g)(3)(A) below) of the assets of the terminated business and whether the remaining businesses will continue to be actively operated.

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c Genuine or bona fide contraction or termination of a business.-- If it is contended the distribution is not essentially equivalent to a dividend because of a genuine or bona fide contraction of the Distributor's business within the meaning of section 346(a)(2) of the Code or a termination of a business within the meaning of section 346(b), furnish the following information:

1 Involuntary.-- If the contraction or termination was involuntary in that it was beyond the control of the Distributor, describe the conditions or causes of the contraction such as a fire, flood, storm, condemnation, loss of a franchise, etc.

2 Voluntary.-- If the contraction or termination was voluntary, give the business purpose for, and a complete description of, the circumstances, conditions, or transactions leading to the contraction.

3 Date or period contracted or terminated.-- If the contraction or termination was involuntary give the date of the incident leading to the contraction. If the contraction or termination was voluntary, give the dates on which the contraction commenced and was completed.

4 Dividends paid.-- Give the dates and amounts of all dividends paid by the Distributor in the last five years.

d Reductions resulting from the termination or contraction of a business.

1 Assets.

(A)

Description.--Describe those assets of the Distributor which have been or will be reduced, and identify each asset reduction with the terminated business or the involuntary or the voluntary acts described in 4.02-2(c)(1) or 4.02-2(c)(2) above. Relate these assets to those assets described in 4.02-2(g)(1) and (2) ("Distribution of assets") below. State whether the assets being reduced are actively used in the business or are passive assets. For either voluntary or involuntary contractions, give the fair market value, net and gross, of both the reduced active assets and the retained assets.

(B)

Disposition other than by distribution.--If the Distributor will sell, lease, or otherwise dispose of any property, other

than by distribution to the shareholders, furnish the following information:

(i) Transaction.--Describe the assets to be disposed of and the type of transaction.

(ii)

Basis and amount realized.--Give the tax basis and the amount and type of consideration to be received in exchange, including insurance proceeds and condemnation award if applicable.

(iii)

Relationship of acquiring party.--Identify the person acquiring the assets, and give the relationship, direct or indirect, of the Distributor and its shareholders to that person, including, if a corporation, the number of shares of stock the Distributor and its shareholders own in the acquiring corporation.

(C)

Inventory.--If any inventory will be sold other than in the ordinary course of business, furnish the following:

(i) Average inventory.--A statement whether the items in such inventory were substantially similar to, and substantially the same in quantity as, those during the prior five-year period.

(ii)

Bulk sale.--A statement whether the inventory will be sold in "bulk" and the number of persons purchasing the inventory.

(D)

Actively used in operations.--Furnish a statement whether all of the assets which will be distributed to the shareholders, or those assets which will be sold and the proceeds from the sale distributed, were being actively used in operations at the time of termination or contraction of the business, and whether such assets had been actively used for the past five years, or were replacements of assets actively used for such period, or whether such assets are or were idle, passive or investment assets.

2 Gross sales, fees, etc.-- Give the average annual amount of gross sales, fees, etc. of the terminated or contracted business over the past five years, the percentage of that gross to the total gross of the Distributor and the amount the total gross will be reduced as a result of the termination or contraction.

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3 Employees.-- Give the number of employees of the Distributor whose services will be terminated and who will be discharged as a result of the termination or contraction and the percent that number is of the total number of employees of the Distributor.

4 Other reductions.-- Furnish any other information demonstrating a contraction or termination of the business such as reductions in territory, floor space, production, fixed assets, activities, etc.

e Changes in business and assets of the Distributor.

1 Past changes.

(A)

Business activity.--Describe any substantial changes in the business activities of the distributor during the past five years in addition to the one on which this application is based, such as acquisitions, expansions, conversions, and other contractions or terminations.

(B)

Assets.--Describe any substantial changes in assets during the past five years other than those occurring in the normal course of business, such as an unusual or abnormal increase in working capital, extraordinary sales, purchases, replacements, and renovations of fixed and operating assets, and shifts, transfers, or loans of assets (including working capital) from one business activity to another including the business terminated or contracted.

2 Proposed changes.-- Describe any acquisitions, expansions, additions, conversions, renovations, or replacements of business activity or assets proposed for the future and the source of funds and capital for such changes.

f Other factors relevant in determining whether there is a true termination or genuine contraction.

1 Information as to source of assets to be distributed.-- A statement whether the assets to be distributed or proceeds from sale of assets, are from the following sources:

(A)

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Expansion reserve.--A reserve for expansion no longer needed.

(B)

Business decline.--A mere decline in, or loss of, business.

(C)

Working capital decrease.--A mere decrease in need for working capital.

(D)

Nominal business.--Proceeds from the sale of a business which is nominal in relation to the entire business of the Distributor.

(E)

Loss business.--A business operated at a loss which acquired assets from another business of the Distributor.

2 Purpose of distribution.

(A)

The Distributor's purpose.--State the business purpose of, and the advantages to, the Distributor in making the distribution.

(B)

Shareholder purpose.--State the reasons why the shareholders desire this distribution, their part in formulating and approving the plan, and the advantages to the shareholders as a result of the distribution.

g Distribution of assets.

1 Property other than cash (including negotiable instruments and other cash equivalents within the meaning of *Rev. Rul. 66-290, 1966-2 C.B. 112*).--Describe fully all types and categories of property, tangible and intangible, other

than cash, to be distributed by the Distributor to the shareholders.

2 Cash (including negotiable instruments and other cash equivalents within the meaning of *Rev. Rul. 66-290*).

(A)

Amount.--State the total amount of cash to be distributed, and whether it is United States or foreign cash.

(B)

Source.--Furnish a statement whether the amount to be distributed will be limited to the following:

(i) Working capital.--The portion of the working capital reasonably attributable to the terminated or contracted business activities and no longer required in the operation of the continuing business activities. See *Rev. Rul. 60-232*, 1960-2 C.B. 115, and *Rev. Proc. 81-10*.

(ii)

Net proceeds.--The amount realized on the sale of assets of the business terminated or contracted (or insurance proceeds or condemnation award) less all liabilities attributable to those assets retained or distributed in kind (including all expenses and taxes incurred on the sale and those incurred in connection with the distribution).

3 Timely distributions.

(A)

Date of distributions.--Give the dates, or expected dates, of distributions of all assets pursuant to the plan of partial liquidation. State whether all distributions pursuant to the plan will be made within the taxable year in which the plan is adopted or within the succeeding taxable year.

(B)

Proceeds from sale, insurance benefits, condemnation award, etc.

(i) Time between receipt of proceeds and distribution.--Give the dates of sale, destruction, or condemnation, and receipt of proceeds therefrom. If there is any time lag between the receipt of proceeds and distribution, give the reasons.

(ii)

Use of proceeds between time of receipt and distribution.

(a) Temporary investments.--Describe how the proceeds will be maintained before the distribution, the type of investment, if any, and how the investment was or will be disposed of. Will the proceeds be segregated in a special account and not used in the Distributor's continuing business?

(b) Gain, income or loss on temporary investments.--State the amount of gain, income or loss realized on the temporary investment and the disposition of any such gain or income.

4 All assets or proceeds from terminated business distributed.-- If it is contended the partial liquidation is a termination under section 346(b) of the Code, furnish a statement that all assets or net proceeds from the sale of the assets will be distributed. If all such assets will not be distributed, give reasons why and explain how the undistributed assets will be used by the Distributor in the future.

5 Distributed assets are not to be substituted assets.-- State that the distributed assets are assets that were being actively used in a business, or the proceeds from their sale, and not substituted assets. See *Rev. Rul. 79-275, 1979-2 C.B. 137*.

h Discharge or disposition of liabilities.

1 Amount.-- Furnish the amount of liabilities of the terminated or contracted business.

2 Discharge.-- State the source of the funds that will be used to discharge these liabilities.

3 Reduction in distribution.-- State whether the property of the terminated or contracted business or the proceeds which will be distributed to the shareholders from the sale of such property will be reduced by the amount of such liabilities. See 4.02-2(g)(1)(B)(ii) above.

4 Assumption by shareholders.-- Furnish the amount of liabilities, if any, to be assumed by each of the distributee-shareholders, the amount of liabilities to which the property distributed is subject, the adjusted basis of the property distributed to each such shareholder in the hands of the Distributor, and the fair market value of the property distributed to such shareholder.

.03 *Recognition of gain or income to the Distributor.*-- If it is contended that neither gain nor income will be

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recognized to the Distributor upon the distribution of property, state the reasons, including statements with respect to the following:

1 Unreported or anticipatory assignment of income.-- State whether the Distributor will distribute any assets which represent earned income to shareholders, such as receivables being reported on a cash basis, unfinished construction contracts, commissions due, or other assets resulting in an anticipatory assignment of income.

2 Reserve for bad debts.-- If the Distributor will distribute to its shareholders any receivables, state the amount of any reserve for bad debts related to the receivables.

3 Installment obligations and recapture provisions.-- State whether the Distributor will distribute to the shareholders in partial liquidation any installment obligations (section 453B of the Code), property described in sections 48, 341(f), 617(d), 1245(a), 1248, 1250(c), 1251(e), 1252(a), or 1254, or LIFO inventory distributed pursuant to a plan adopted after December 31, 1981 (See section 336(b)), or other assets the cost of which had previously been deducted for federal income tax purposes.

4 Sale, lease, or other disposition of property.-- State whether the shareholders will sell, lease, or otherwise dispose of any property received in the distribution. If they will, describe the assets to be so disposed of and the transaction, including the consideration to be received in exchange. Identify the person acquiring the assets, and give the relationship, direct or indirect, of the Distributor and its shareholders to that person including, if a corporation, the number of shares of stock the Distributor and its shareholders own in the acquiring corporation.

.04 Redemption of stock.

1 Description of outstanding stock.-- Furnish a complete description of each class of the Distributor's stock outstanding, setting forth the rights and privileges of each class.

2 Ownership of Stock.-- State whether the stock is closely or widely held, and if the former, identify the shareholders, the number of shares of each class held by each shareholder, and the relationship of the shareholders to each other. If widely held, give the number of shareholders and the largest number of shares held by a shareholder.

3 Shares Redeemed.

a Number.-- Give the number of shares of each class of stock of the Distributor to be redeemed from each

shareholder.

b None redeemed.-- If no shares of stock of the Distributor will be surrendered, give reasons why the distribution should not be considered a dividend.

c Non pro rata redemption.-- If the distribution of property or redemption of stock will be non pro rata, submit reasons.

4 Transactions in which stock to be redeemed was acquired if stock is closely held and acquired within last five years.

a When acquired.-- Give the dates on which the stock was acquired.

b From whom acquired.-- Identify the person or entity from whom the stock was acquired and the relationship of such person to any of the shareholders of the Distributor.

c Consideration.-- Describe the amount and kind of consideration paid or transferred for the stock.

5 Other factors affecting the taxable status of the distribution.

a Declared but unpaid dividends.-- State whether there are any declared but unpaid dividends on any of the stock to be redeemed.

b Distribution in redemption of stock under section 302 of the Code.-- If it is contended any part of the distribution will qualify as one in redemption of stock under section 302, state the amount, identify the shareholders, and furnish information necessary to make a determination under section 302. See *sections 1.302-1(b) and 1.346-2 of the regulations*. See also *Rev. Proc. 73-35, 1973-2 C.B. 490*.

6 Value of stock redeemed.-- State whether the fair market value of the assets distributed to each shareholder will be equal to the fair market value of the stock surrendered by each shareholder in the exchange. If it will not, give a complete explanation.

.05 General.

1 Covenants not to compete.-- If a business of the Distributor will be sold or otherwise acquired by another person, state whether the Distributor will receive consideration for an agreement not to compete with the acquiring person. If it will, state whether such consideration will be included in the distribution to the shareholders.

2 Documents.-- Submit copies of the following documents:

a Plan of complete or partial liquidation.-- If no formal plan of liquidation has been or will be adopted, state whether the plan has been or will be approved by the directors and shareholders, and give the date or expected date of approval or adoption.

b Financial statements.-- Submit year-end balance sheets and profit and loss statements for each of the past five years.

.06 Assumptions or representations.-- Furnish all applicable assumptions and representations including the following representations:

(i) There is no plan or intention to completely liquidate the Distributor.

(ii)

The Distributor has no plan or intention to reenter a terminated business or to expand its continuing business operations other than through normal internal growth.

(iii)

The liquidation will not be preceded or followed by the reincorporation in, or transfer or sale to, a recipient corporation (Recipient) of any of the business or assets of the Distributor, if persons holding more than 20 percent in value of the stock in the Distributor also hold more than 20 percent in value of the stock in the Recipient. Representation (i) above does not apply when there will be a series of distributions in complete liquidation under section 346(a)(1) of the Code.

.07 Transactions in addition to the partial liquidation.

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1 Multiple transaction.-- Describe any property the shareholders will transfer or surrender in the transaction, other than stock of the Distributor, and the consideration to be received in exchange therefor.

2 Shareholder and the Distributor in dual capacity.-- State whether all or any part of the consideration from the Distributor will be received by a shareholder as a debtor, creditor, employee, or in some capacity other than that of a shareholder of the Distributor whose stock is being redeemed pursuant to sections 331 and 346 of the Code.

3 Related transactions.-- If the request deals with only one step of a larger integrated transaction, the facts, circumstances, etc., relating to the entire transaction must be submitted.



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APPENDIX C: Revenue Procedure 81-42

Checklist of information to be included in request for ruling under IRC Section 346 (now Section 302(b)(4))

SECTION 346 CHECKLIST QUESTIONNAIRE

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5 INQUIRIES

Inquiries in regard to this revenue procedure should refer to its number and should be addressed to the Assistant Commissioner (Technical), Attention: T:C:R, Internal Revenue Service, Washington, D.C. 20224.



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APPENDIX C: Revenue Procedure 81-42

Checklist of information to be included in request for ruling under IRC Section 346 (now Section 302(b)(4))

SECTION 346 CHECKLIST QUESTIONNAIRE

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6 EFFECT ON OTHER DOCUMENTS

Rev. Proc. 73-36 is superseded.



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APPENDIX D: Revenue Procedure 90-52

2-D Taxation of Securities Transactions APPENDIX D:.syn

§ D.syn Synopsis to Appendix D: Revenue Procedure 90-52

Scope



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APPENDIX D: Revenue Procedure 90-52

Checklist of information to be included in request for ruling under IRC Section 332

2-D Taxation of Securities Transactions Scope

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APPENDIX E: Revenue Procedure 96-30, as Modified and Amplified by Revenue Procedure 2003-48

2-E Taxation of Securities Transactions APPENDIX E::syn

§ E.syn Synopsis to Appendix E: Revenue Procedure 96-30, as Modified and Amplified by Revenue Procedure 2003-48

1. PURPOSE
2. BACKGROUND
3. CHANGES
4. INFORMATION TO BE INCLUDED IN REQUESTS FOR RULINGS UNDER SECTION 355
5. EFFECT ON OTHER DOCUMENTS
6. EFFECTIVE DATE



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APPENDIX E: Revenue Procedure 96-30, as Modified and Amplified by Revenue Procedure 2003-48
Checklist of information to be included in request for ruling under IRC Section 355 IRC Section 355
SECTION 355 CHECKLIST QUESTIONNAIRE

2-E Taxation of Securities Transactions 1

1. PURPOSE

This revenue procedure updates *Rev. Proc. 86-41, 1986-2 C.B. 716*, which sets forth in a checklist questionnaire the information that must be included in a request for rulings under section 355, relating to the nonrecognition of gain or loss on distributions of stock and securities of controlled corporations.



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APPENDIX E: Revenue Procedure 96-30, as Modified and Amplified by Revenue Procedure 2003-48
Checklist of information to be included in request for ruling under IRC Section 355 IRC Section 355
SECTION 355 CHECKLIST QUESTIONNAIRE

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2. BACKGROUND

This checklist is intended to facilitate the filing and processing of ruling requests under section 355. It specifies information and representations to be included so that the requests will be as complete as possible when initially filed. Nevertheless, because the information and representations necessary to rule on a particular transaction depend upon all the facts and circumstances, the Service may require information or representations in addition to those set forth in this revenue procedure.

The general procedures of the Internal Revenue Service with respect to the issuance of letter rulings and determination letters by the National Office are outlined in the first revenue procedure published each year (the "annual revenue procedure"). See, e.g., *Rev. Proc. 96-1, 1996-1 I.R.B. 8*. The Service also publishes a revenue procedure, generally in the first Internal Revenue Bulletin of the year, which provides a list of those areas of the Code under the jurisdiction of the Associate Chief Counsel (Domestic) for which the Service will not issue advance letter rulings. See, e.g., *Rev. Proc. 96-3, 1996-1 I.R.B. 82*. The Service periodically updates these revenue procedures, along with this checklist questionnaire.

Careful attention to all requirements of the most recent revenue procedures, including this checklist questionnaire, will aid in the timely processing of ruling requests. Failure to submit the requisite information and representations will often delay consideration of the transaction and the issuance of a letter ruling.



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APPENDIX E: Revenue Procedure 96-30, as Modified and Amplified by Revenue Procedure 2003-48
Checklist of information to be included in request for ruling under IRC Section 355 IRC Section 355
SECTION 355 CHECKLIST QUESTIONNAIRE

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3. CHANGES

This revenue procedure substantially modifies *Rev. Proc. 86-41*. The principal changes are to add to, delete, or modify the information and representations requested, and to add an appendix that provides guidelines with respect to ruling requests involving certain corporate business purposes. This document also revokes section 3.01(23) of *Rev. Proc. 96-3*, which sets forth "no rule" positions regarding certain corporate business purposes.



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APPENDIX E: Revenue Procedure 96-30, as Modified and Amplified by Revenue Procedure 2003-48 Checklist of information to be included in request for ruling under IRC Section 355 SECTION 355 CHECKLIST QUESTIONNAIRE

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4. INFORMATION TO BE INCLUDED IN REQUESTS FOR RULINGS UNDER SECTION 355

This section describes the information and representations to be provided in a section 355 ruling request. The presentation of the information and representations in the ruling request should follow the organization of this section and use appropriate descriptive headings. Taxpayers are welcome to provide a narrative description of the transaction to supplement (but not substitute for) the presentation requested in this section.

A ruling request should address each item in this section and provide all facts relevant to the transaction. If an item is not applicable, so state and briefly explain why.

Standard representations are set forth throughout this section and are highlighted by the word "representation" in boldface type. The representations are necessary to ensure that specific statutory and judicial requirements, and administrative ruling guidelines relating thereto, are satisfied. Each representation should be submitted in the language requested. If a representation cannot be submitted exactly as requested, an explanation must be given. Deviation from the language of the representations should be avoided, except as required by the facts being described. Unnecessary variations may delay processing the ruling request and will not be accepted unless reasons satisfactory to the Service are submitted.

The terms "Distributing" and "Controlled" in this document refer to the "distributing corporation" and "controlled corporation" as described in section 355(a)(1)(A). References to the term "distribution" include a distribution of stock or securities of Controlled with respect to Distributing stock, an exchange of Distributing stock or securities for Controlled stock or securities, or some combination thereof, as the context requires.

Requests for information and representations regarding Distributing or Controlled include, as the context requires, a request for information (or representations) regarding a successor of Distributing or Controlled. For example, if Distributing will merge with an acquiring corporation after the distribution, the representation requested in section 4.03(8) of this revenue procedure (that is, Distributing will continue to conduct its business) should be modified to include a similar representation under penalties of perjury by the acquiring corporation regarding the continuing

conduct of Distributing's business after the merger, in addition to Distributing's representation. Similarly, the representation requested in section 4.05(1) of this revenue procedure (that is, there is no plan or intention by the Distributing shareholders to dispose of their shares in Distributing), should be modified to include a similar representation regarding dispositions of acquiring corporation shares by the Distributing shareholders. If a taxpayer believes that information regarding, or a representation by, a successor is inappropriate or should be modified, the taxpayer must explain why.

.01 Information regarding Distributing and Controlled

(1) Identification.-- State the name, employer identification number, and place and date of incorporation of Distributing and Controlled. If Controlled is not in existence, state its proposed name and place of incorporation. If Distributing joins in the filing of a consolidated federal income tax return, provide the name and employer identification number of the common parent corporation of the affiliated group.

(2) Jurisdiction.-- Identify the District Office that has or will have examination jurisdiction over the return of Distributing (sometimes referred to below as the "taxpayer") and of Controlled.

(1) Taxable year.--

State the last day of the taxable year of Distributing and Controlled.

.02 Ownership of interests in Distributing and Controlled

(1) Capital structure of Distributing and Controlled immediately prior to the distribution.-- Under a separate heading for each corporation, provide the following information with respect to the stock and securities of Distributing and Controlled that will be outstanding immediately prior to the distribution:

(a) A complete description of each class of stock, setting forth the rights and privileges of each class, including voting or nonvoting rights, dividend and liquidation preferences or limitations, and whether classified as common or preferred stock.

(b) A list of the number of shares and the percentage of each class of stock owned by each shareholder prior to the distribution. However, if the corporation has more than 100 shareholders, the taxpayer need only list those shareholders owning 5 percent or more of any class of stock, and state the total number of other shareholders together with the total number of shares and the percentage that these other shareholders own of each class of stock.

(c) A description of any existing, planned, or intended agreements, such as a voting trust, affecting the rights of any shareholder. However, if the corporation has more than 100 shareholders, the taxpayer need only describe agreements affecting shareholders owning directly, or as a result of the agreement, controlling, 5 percent or more of any class of stock.

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(d) A description of any securities and all other outstanding interests (bonds, debentures, notes, warrants, options, puts, etc.) and a brief explanation as to whether any of these items should be considered a stock interest.

(2) Foreign shareholders.-- If Distributing has any foreign shareholders, state whether: (i) Distributing or Controlled was a United States real property holding corporation (as defined in section 897(c)(2)) at any time during the 5-year period ending on the date of the distribution, and (ii) Distributing or Controlled will be a United States real property holding corporation immediately after the distribution. See section 367(e)(1) and section 897. In addition, if Distributing is publicly traded, provide a list of all foreign persons owning 5 percent or more of Distributing stock either before or after the distribution. If Distributing is not publicly traded, provide a list of all foreign persons owning stock of Distributing either before or after the distribution. See section 4.08(7) of this revenue procedure for additional information regarding foreign parties.

(3) Description of stock, securities, and other property being distributed.

(a) Stock.-- State the number of shares and percentage of each class of stock of Controlled being distributed. In addition, if preferred stock is being distributed and it is contended that this stock is not "section 306 stock," within the meaning of section 306(c), fully explain the reasons for this contention.

(b) Securities.-- State the principal amount of each series of securities of Controlled being distributed.

(c) Other Property.-- Provide complete details as to any property, other than stock and securities of Controlled, to be distributed or received in the transaction including, but not limited to, cash, stock rights, warrants, or the payment of expenses incurred in connection with the transaction (see section 356).

(d) Timing.-- State the date of the distribution and whether all the stock, securities, and other property will be distributed on that date. If all the stock, securities, and other property are not being distributed on the same date, state the approximate length of, and the reasons for, the delay in the distribution.

(e) Planned stock issuances, etc.-- Describe any planned or intended stock issuances, redemptions, or dispositions of Controlled shares. Explain the effect of any of these transactions on the distribution-of-control requirement of section 355(a)(1)(D), and if property is being transferred from Distributing to Controlled, the effect on the control-immediately-after requirement of section 368(a)(1)(D).

(f) Obtaining control.-- State whether Distributing has modified or will modify its ownership of Controlled stock, such as in a recapitalization, within the 5-year period preceding the distribution with the result that Distributing obtained

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or will obtain control of Controlled, as defined in section 368(c). Provide complete details, including the information requested in section 4.08(8) of this revenue procedure, with respect to such modifications.

(4) Ownership of stock and securities in controlled immediately after the distribution.

(a) Interests in Controlled to be held by Distributing (see section 1.355 2(e) of the Income Tax Regulations).

(i) Retention of stock, securities, or options.-- State the number of shares and percentage of each class of stock in, and the principal amount of each series of securities of, Controlled to be held by Distributing after the distribution and the length of time Distributing will hold this interest. Describe any options that Distributing will hold after the distribution to acquire stock in Controlled and the length of time Distributing will hold these options.

(ii) Retention of debt.-- If Controlled will be indebted to Distributing after the distribution of Controlled stock, submit the following REPRESENTATION: *The indebtedness owed by the controlled corporation to the distributing corporation after the distribution of the controlled corporation stock will not constitute stock or securities.*

(iii) Purpose for Distributing holding stock, securities, or options in Controlled.-- If Distributing will hold stock, securities, or options in Controlled after the distribution, explain the reasons therefor and why this should not be viewed as in pursuance of a plan having as one of its principal purposes avoiding federal income tax. See Appendix B of this revenue procedure regarding favorable rulings with respect to the retention of stock, securities, or options. State whether a distribution of all the stock or securities of Controlled would be treated to any extent as a distribution of "other property" under section 356.

(b) Interests in Controlled to be held by shareholders of Distributing.

(i) Distributions or exchange.-- State whether the distribution of Controlled stock will be pro rata or non pro rata with respect to the shareholders of Distributing. Fully describe the transaction between Distributing and its shareholders.

(ii) Stock ownership.-- State the number of shares and the percentage of each class of stock outstanding in Distributing and Controlled that will be owned by each shareholder immediately after the distribution. However, if there will be more than 100 shareholders immediately after the distribution, the taxpayer need only list those shareholders who will own 5 percent or more of any class of stock, and state the expected total number of other shareholders together with the expected total number of shares and the expected percentage that these other shareholders will own of each class of stock.

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(iii) Securities.-- Identify any shareholders of Distributing receiving securities of Controlled and state the principal amount of each series of securities to be received in the transaction. With respect to each shareholder, state the principal amount of each series of Distributing securities to be surrendered in the transaction, or, if no securities are being exchanged, so state. See section 1.355-2(f)(1).

(iv) Surrender of stock.-- If one or more Distributing shareholders will surrender Distributing stock in the transaction, submit the following REPRESENTATION: *The fair market value of the controlled corporation stock and other consideration to be received by each shareholder of the distributing corporation will be approximately equal to the fair market value of the distributing corporation stock surrendered by the shareholder in the exchange.*

(c) Interests in Controlled to be held by security holders of Distributing.-- Identify those security holders of Distributing receiving Controlled stock, the total number of shares of each class of stock being received, and the principal amount of the securities of Distributing being exchanged. Identify those security holders of Distributing receiving securities of Controlled, the principal amount being received by each holder, and the principal amount of the securities of Distributing being exchanged. See section 1.355-2(f)(1). If no securities are being exchanged, so state. If the securities are, or, immediately after the distribution, will be, held by more than 100 security holders, identify only those security holders that will own 5 percent or more of the outstanding shares of any class of Controlled stock or of any outstanding series of Controlled securities immediately after the distribution.

(d) Receipt of consideration other than with respect to stock or securities.

(i) Shareholder in dual capacity.-- Submit the following REPRESENTATION: *No part of the consideration to be distributed by the distributing corporation will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.*

(ii) Security holder in dual capacity. -- If consideration will be distributed to security holders, submit the following REPRESENTATION: *No part of the consideration to be distributed by the distributing corporation will be received by a security holder as an employee or in any capacity other than that of a security holder of the corporation.*

(iii) Other transfers.-- State whether the shareholders or security holders of Distributing will transfer or surrender any property in the transaction other than stock or securities of Distributing. If so, provide full details. Information concerning the businesses of Distributing and Controlled (see generally section 1.355-3)

.03 *Information concerning the businesses of Distributing and Controlled.*

(1) Description of businesses.-- Describe each line of business engaged in by Distributing, Controlled, and their respective subsidiaries, whether or not the business will be relied upon to meet the requirements of section 355(b). Note which corporations are engaged in each line of business.

(2) Distributing's Active Businesses.-- Submit a complete description of each trade or business that will be relied upon to meet the requirements of section 355(b) (an "Active Business"), that is conducted directly by Distributing, and that will be retained by Distributing. Provide the following information with respect to each such Active Business:

(a) Active conduct during the preceding 5-year period.-- Provide all information necessary to establish that the Active Business is a trade or business that has been actively conducted for the entire 5-year period ending on the date of the distribution (within the meaning of section 1.355-3(b)(2) and (3)). In general, the description should conclusively show that substantial managerial and operational activities have been directly carried on by the Active Business during each of the past 5 years.

(b) Employee Information.-- If the Active Business employed fewer than 50 full-time employees during any of the past 5 years, submit separate lists for each of the past 5 years showing the job titles of the Active Business' employees, the function (managerial, operational, or other) of each position, and the number of persons employed in each position. Include a brief description of the type of duties performed by each category of employee during each of these years.

(c) Nonemployee Information.-- If Distributing is required to submit the employee information specified in section 4.03(2)(b) of this revenue procedure with respect to an Active Business, also state whether Distributing uses persons who are not employees, such as independent contractors. If so, include a brief description of the duties they perform, and the percentage of the activities they perform for the Active Business.

(d) Continuous ownership of an Active Business during the preceding 5-year period.-- State whether the Active Business has been continuously conducted, within the meaning of section 1.355-3(b), by Distributing for the 5-year period ending on the date of distribution. Give the date Distributing commenced conduct of the Active Business or acquired the Active Business. If an Active Business has not been continuously conducted by Distributing for such 5-year period, see section 4.03(6) of this revenue procedure.

(e) Change in business.-- Describe any substantial change during the preceding 5-year period in the type of business activity conducted or the method of conducting business, such as substantial changes in: products or services offered, production capacity, assets owned or used, technology employed, sales or distribution channels, or locations. If the preceding 5-year period includes any time during which there was no business activity, or a significant amount of time during which there was a substantial reduction in business activity, identify the period of time, the type and amount of business activity during this period, and the reasons for the cessation or reduction in activity.

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(f) Separation of real property, intellectual property, or other intangible property from user.-- State whether all or a portion of any real property, intellectual property, or other intangible property historically occupied or used by one business will be separated in the transaction from that business. If so, describe the property. State whether the business formerly using the property will continue to use the property after the transaction, and the terms upon which it will be allowed to use the property. Describe any other planned use of the property after the transaction. Explain the reason for separating the ownership of the property from its historic user.

(g) Balance sheets.-- Provide a copy of the most recent balance sheet of Distributing (including all applicable notes). The balance sheet should not be limited to assets and liabilities of Distributing's Active Businesses. Also submit any consolidated balance sheets prepared for financial accounting purposes that include Distributing.

(h) Profit and loss statements.-- Submit separate unconsolidated profit and loss statements (including all applicable notes) for each of the past 5 years for each Active Business. The statements must show that each business has had gross receipts and operating expenses (including employee expenses such as payroll withholding taxes) representative of the active conduct of a trade or business for each of the past 5 years. Submit the following REPRESENTATION: *The 5 years of financial information submitted on behalf of the distributing corporation is representative of the corporation's present operation, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.*

(3) Description of Active Businesses being transferred by Distributing to Controlled.-- If, in connection with the plan, Distributing transfers all or part of the assets of one or more of its Active Businesses (see section 1.355-3(c), example (4)) to either a newly formed or pre-existing Controlled, identify and submit a complete description of each Active Business or part of an Active Business being transferred. Submit the information and representation required by section 4.03(2)(a) through (h) of this revenue procedure for each such Active Business, or part of an Active Business, being transferred. If property will be transferred from Distributing to Controlled, submit a pro forma balance sheet for Controlled reflecting the transfer of assets to Controlled and all liabilities to be assumed or to which the property transferred will be subject.

(4) Pre-existing Controlled's Active Businesses.-- If Controlled is a pre-existing corporation, submit a complete description of each Active Business conducted directly by Controlled. Submit the information and representation required by section 4.03(2)(a) through (h) of this revenue procedure with respect to each such Active Business, treating references to Distributing as references to Controlled, as appropriate.

(5) Indirect conduct of trade or business through ownership of stock in other corporations.-- If either Distributing or Controlled is not directly engaged in an Active Business but will be so engaged indirectly through ownership of stock and securities in one or more corporations controlled by it ("Other Corporations") immediately after the distribution, submit the information and representation required by sections 4.03(2)(a) through (h) of this revenue procedure (treating, for this purpose, each Other Corporation as Distributing or Controlled, as appropriate). In addition, if Distributing or Controlled is not directly engaged in an Active Business, submit the following REPRESENTATION:

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Immediately after the distribution, at least 90 percent of the fair market value of the gross assets of [insert the name of the corporation so indirectly engaged] will consist of the stock and securities of controlled corporations that are engaged in the active conduct of a trade or business as defined in section 355(b)(2). See section 3.04 of Rev. Proc. 77-37, 1977-2 C.B. 568, 570.

(6) Changes in ownership of an Active Business during the 5-year period ending on the date of distributing.-- If an Active Business that is directly conducted by Distributing, Controlled, or an Other Corporation has been acquired by that corporation during the 5-year period ending on the date of distribution, identify the Active Business that was acquired and provide the following information with respect to that Active Business:

(a) Identity.-- Identify the party from whom the business was acquired, and the transferor's relationship, if any, to Distributing or its shareholders.

(b) Date.-- State the date the business was acquired and the period of time the business had been previously conducted by Distributing's, Controlled's, or Other Corporation's predecessor in interest.

(c) Transaction.-- Describe the transaction in which the business was acquired. For example, was the business acquired in a reorganization under section 368(a)(1), by purchase, or by some other means? If a letter ruling was issued with respect to the transaction, attach a copy.

(d) Consideration.-- State the consideration given in the acquisition.

(e) Gain or loss.-- State whether gain or loss was recognized, in whole or in part, to any party to the transaction and whether the basis of the assets acquired was determined, in whole or in part, by reference to the transferor's basis.

(7) Stock ownership during the preceding 5-year period (see section 355(b)(2)(D)).

(a) Stock of Controlled or Other Corporations continuously owned during the preceding 5-year period.-- Identify Controlled and Other Corporations whose shares have been continuously held by Distributing or Controlled for the 5-year period ending on the date of distribution.

(b) Stock of Controlled or Other Corporations acquired by Distributing, Controlled, or Other Corporations during the preceding 5-year period.-- If the stock of Controlled or Other Corporations has been acquired by Distributing, Controlled, or Other Corporations during the 5-year period ending on the date of the distribution, identify the stock that

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was acquired and provide the following information with respect to that stock:

(i) Identity.-- Identify the party from whom the stock was acquired and the transferor's relationship, if any, to Distributing or its shareholders.

(ii) Date and consideration.-- State the date the stock was acquired and the consideration given in the acquisition.

(iii) Transaction.-- Describe the transaction in which the stock was acquired. For example, was the stock acquired in a section 368(a)(1) reorganization, by purchase, or by some other means? State whether control was acquired in a transaction in which Distributing transferred cash or other liquid or inactive assets to Controlled. See section 4.01(31) of *Rev. Proc.* 96-3. If a letter ruling was issued with respect to the transaction, attach a copy.

(iv) Gain or loss.-- State whether gain or loss was recognized, in whole or in part, to any party to the transaction and whether the basis of the stock acquired was determined, in whole or in part, by reference to the transferor's basis.

(c) Other changes in ownership.-- Provide complete details concerning any change in ownership of the stock of Distributing, Controlled, or Other Corporations during the 5-year period ending on the date of the distribution that is not fully described under section 4.03(7)(b) of this revenue procedure. For this purpose, a change of ownership includes, but is not limited to, acquisitions, redemptions, recapitalizations, stock dividends, and sales. Information regarding sales of stock to which the issuing corporation was not a party need not be provided if: (i) the sale occurred on a recognized stock exchange or in an established market, and (ii) both the purchaser and the seller held less than 5 percent of the corporation's stock both before and after the sale.

(8) Continuation of business.-- If the transaction involves the vertical division of a single Active Business, submit the following REPRESENTATION: *Following the transaction, the distributing and controlled corporations will each continue, independently and with its separate employees, the active conduct of its share of all the integrated activities of the business conducted by the distributing corporation prior to consummation of the transaction.* If the transaction involves the separation of two or more Active Businesses, submit the following REPRESENTATION: *Following the transaction, the distributing and controlled corporations will each continue the active conduct of its business, independently and with its separate employees.* Additionally, if, following the transaction, Distributing and Controlled will share the services of any employees, identify these employees, specify the services to be performed, the length of time the employees will be shared, the compensation arrangements, and explain why the services of these employees will be shared. In addition, describe any planned or intended substantial reduction in business activity for any Active Business. Generally, a substantial reduction in business activity does not include a vertical division of a single Active Business where Distributing and Controlled together continue all of the integrated activities of the Active Business.

.04 *Business purpose.*

(1) Detailed description.-- Describe in detail narrative form each corporate business purpose for the distribution of the stock of Controlled. Do not provide any documentation or substantiation in support thereof. Submit the following *REPRESENTATION: The distribution of the stock, or stock and securities, of the controlled corporation is carried out for the following corporate business purposes: [list these Corporate Business Purposes]. The distribution of the stock, or stock and securities, of the controlled corporation is motivated, in whole or substantial part, by one or more of these corporate business purposes.* The Service will decline to issue a letter ruling in all cases in which the taxpayer fails to submit the required representation. The National Office will not determine whether the distribution is being carried out for one or more corporate business purposes. This determination may be made upon an examination of the taxpayer's return.

.05 *Device.*

(1) Disposition of stock or securities.-- Submit the following *REPRESENTATION: The transaction is not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both. See §355(a)(1)(B).* The Service will decline to issue a letter ruling in all cases in which the taxpayer fails to submit the required representation. The National Office will not determine whether the transaction is used principally as a device for the distribution of the earnings and profits of the distribution corporation, the controlled corporation, or both. The determination may be upon an examination of the taxpayer's return.

.06 *Continuity of shareholder interest.* The taxpayer must explain how the continuity of interest requirement will be satisfied. Generally, the Service will view this requirement as satisfied if one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution own, in the aggregate, 50 percent or more of the stock in each of the modified corporate forms in which the enterprise is conducted after the separation. In appropriate cases, the Service may require a continuity of interest representation from the taxpayer.

.07 *Disqualified distribution.* Explain in detail why the distribution of Controlled stock, or of Controlled stock and securities, will not be a disqualified distribution within the meaning of section 355(d)(2). Generally, the explanation should set forth facts establishing that, taking into account the application of section 355(d)(6), (7), and (8), immediately after the distribution: (i) no person holds disqualified stock in Distributing that constitutes a 50 percent or greater interest in Distributing; and (ii) no person holds disqualified stock in Controlled that constitutes a 50 percent or greater interest in Controlled. It is not necessary for the taxpayer to submit information accounting for all of the stock of Distributing or Controlled if, by providing information with respect to a smaller amount of stock, it can establish that the distribution will not be a disqualified distribution.

.08 *Miscellaneous.*

(1) Transfers and transactions between Distributing and Controlled

(a) Contributions to capital.-- Provide complete details concerning any transfers of property by Distributing to Controlled in anticipation of or in connection with the transaction. For ruling purposes, such transfers ordinarily will be treated as occurring in connection with a reorganization pursuant to section 368(a)(1)(D). If a transfer of property from Distributing to Controlled will not qualify as a reorganization pursuant to section 368(a)(1)(D), and the taxpayer contends that section 351 applies to the transaction, submit the information and representations specified in *Rev. Proc. 83-59, 1983-2 C.B. 575*, as modified or superseded, or explain why an item is not being submitted.

(b) Liabilities.-- If Controlled is assuming liabilities submit the following REPRESENTATIONS:

(i) *The total adjusted bases and the fair market controlled corporation by the distributing corporation liabilities assumed by the controlled corporation plus assets are subject; and*

(ii)

The liabilities assumed in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets being transferred.

(c) Investment credit property.-- If any property is being transferred between Distributing and Controlled, state whether any investment credit determined under section 46 has been (or will be) claimed with respect to any of such property. If the answer is in the affirmative, submit the following REPRESENTATION: *The income tax liability for the taxable year in which investment credit property (including any building to which section 47(d) applies) is transferred will be adjusted pursuant to section 50(a)(1) or (a)(2) (or section 47, as in effect before amendment by Public Law 101-508, Title 11, 104 Stat. 1388, 536 (1990), if applicable) to reflect an early disposition of the property.* Alternatively, explain why no increase in tax will be required under section 50 (or section 47, as in effect before such amendment) as a result of the transaction.

(d) Matching of income and deductions.-- State the overall method of accounting of Distributing and Controlled. Further, state whether the transaction involves or will result in a situation in which one party recognizes income but another party recognizes the deductions associated with such income or one party owns property but another party recognizes the income associated with such property. See, for example, *Notice 95-53, 1995-44 I.R.B. 21*. If one or more parties use the cash method of accounting, explain the extent to which any actions have been or will be taken that are not in the ordinary course of business and that might affect the timing or the amount of any income or deduction to be recognized by a cash basis party to the transaction. See, for example, *Rev. Rul. 80-198, 1980-2 C.B. 113*. In addition, submit a statement as to whether any income items, such as accounts receivable, or any items resulting from a sale, exchange or disposition that would have resulted in income to Distributing, or any items of expense, will be transferred to Controlled. If any of these items are being transferred, fully explain. Further, submit the following REPRESENTATION: *The distributing corporation neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.* If Distributing uses the cash method of accounting or a

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similar method and Controlled uses the accrual method or a similar method, a closing agreement will be required unless the taxpayer submits the following REPRESENTATION: *No income items, including accounts receivable or any item resulting from a sale, exchange or disposition of property, that would have resulted in income to the distributing corporation, and no items of expense will be transferred to the controlled corporation if the distributing corporation has earned the right to receive the income or could claim a deduction for the expense under the accrual or similar method of accounting.*

(2) Indebtedness.

(a) Cancellation of indebtedness.-- If any indebtedness has been or will be cancelled in connection with the transaction, give complete details concerning the principal amount of the indebtedness, the circumstances under which it arose, and the date and method under which the indebtedness will be discharged.

(b) Continuing indebtedness.-- Submit the following REPRESENTATION: *No intercorporate debt will exist between the distributing corporation and the controlled corporation at the time of, or subsequent to, the distribution of the controlled corporation stock.* Alternatively, submit a full description of all existing, planned, or intended debt between Distributing and Controlled, including complete details as to principal amounts, terms, and reasons for the issuance. Include copies of any instruments evidencing the intercorporate indebtedness. If any debt exists between Controlled, as debtor, and Distributing, as creditor, state whether such debt arose in connection with a transfer of assets by Distributing to Controlled. If so, explain the circumstances.

(3) Consolidated transactions.-- If Distributing joins in the filing of a consolidated federal income tax return, submit the following REPRESENTATION: *Immediately before the distribution, items of income, gain, loss, deduction, and credit will be taken into account as required by the applicable intercompany transaction regulations (See section 1.1502-13 and section 1.1502-14 as in effect before the publication of T.D. 8597, 1995-32 I.R.B. 6, and as currently in effect; section 1.1502-13 as published by T.D. 8597). Further, Distributing's excess loss account with respect to the Controlled stock will be included in income immediately before the distribution (See section 1.1502-19).*

(4) Continuing transactions between Distributing and Controlled (or two or more controlled corporations).-- Describe in detail any continuing, planned, or intended transactions between Distributing and Controlled following the distribution, either directly or indirectly (such as through a partnership), or between an Other Corporation and a corporation from which it will be separated. In addition, submit the following REPRESENTATION: *Payments made in connection with all continuing transactions, if any, between the distributing and controlled corporations, will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.*

(5) Investment company.-- If assets are transferred by Distributing to Controlled, or if liabilities owed by Controlled to Distributing are cancelled, submit the following REPRESENTATION: *No two parties to the transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv).*

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(6) Transfers of money or property to Distributing.-- Set forth all consideration received by Distributing, including distributions by Controlled to Distributing, in connection with the transaction. Describe any receipt of money or property by Distributing from Controlled in contemplation of the distribution (other than in the ordinary course of business).

(7) Foreign corporation.-- State whether Distributing, Controlled, or any Other Corporation is a foreign corporation and whether any such foreign corporation is a passive foreign investment corporation (as defined in section 1296(a)), or a controlled foreign corporation (as defined in section 957) both before and after the distribution. See sections 367(b), 367(e)(1), 897, and 1248(f).

(8) Other transactions.-- State whether there have been, or will be, any related transactions, and, if so, describe these other transactions and fully explain their relationship to, and impact on, the present transaction. Even if the transaction is thought to be unrelated, provide full details if it is contemplated that any stock is to be issued or redeemed by Distributing, Controlled, or Other Corporations, other than that already described as being distributed pursuant to the plan. Provide a description of any plan or intention to issue, redeem, or alter any rights in, such as voting rights, shares of stock of Distributing, Controlled, or Other Corporations.

(9) Plan of reorganization and other relevant documents.-- Submit a copy of the plan of reorganization or distribution. Alternatively, state why a copy is not available. In addition, submit a copy of any indemnification and tax sharing agreements to which Distributing or Controlled is a party. If these or any other documents requested in this revenue procedure become available after filing the ruling request, submit copies as soon as possible.

(10) Requested rulings.-- List the rulings being requested in the exact wording desired, and provide statutory, regulatory, or other authority for their issuance.

(11) Presubmission conference.-- Prior to submitting a section 355 ruling request, the taxpayer may request a conference with the Office of Assistant Chief Counsel (Corporate). A presubmission conference is particularly recommended if the transaction does not satisfy all of the requirements or relevant guidelines of this revenue procedure. The taxpayer must submit a description of the transaction, including the name of the taxpayer, and a memorandum of the issues to be discussed at the conference, at least three business days before the conference. The taxpayer must provide a power of attorney for each representative attending the conference. In appropriate cases, the Service will consider conducting the presubmission conference by telephone. For additional information regarding presubmission conferences, see the annual revenue procedure referred to in section 2 of this revenue procedure and contact the Office of the Assistant Chief Counsel (Corporate) at (202) 622-7710 (not a toll-free call).

(12) Distribution in Connection with Acquisitions.-- Regarding whether there is a plan (or series of related transactions) under § 355(e)(2)(A)(ii), submit one of the following *REPRESENTATIONS*: (i) *There is no acquisition of*

*stock of the distributing corporation or any controlled corporation (including any predecessor or successor of an such corporation) that is part of a plan or series of related transactions (within the meaning of § 1.355-7T) that includes the distribution of the controlled corporation stock; (ii) Each of the following acquisitions of stock of the distributing corporation or any controlled corporation (including any predecessor or successor of any such corporation) is or may be a part of a plan or series of related transactions (within the meaning of § 1.355-7T) that includes the distribution of controlled corporation stock: [DESCRIBE ACQUISITIONS HERE]. Taking all of these acquisitions into account, stock representing a 50-percent or greater interest (within the meaning of § 355(d)(4) in the distributing or controlled corporation (including any predecessor or successor of any such corporation) will not be acquired by any person or persons; or (iii) The distribution is not part of a plan or series of related transactions (within the meaning of § 1.355-7T) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest (within the meaning of § 355(d)(4)) in Distributing or Controlled (including any predecessor or successor of any such corporation). If a representation cannot be submitted exactly as requested, an explanation must be given. The taxpayer must submit one of the three representations set forth above (as set forth above or in approximately modified form to the satisfaction of the Service) before the Service will issue a letter ruling. While the National Office will not determine whether a distribution and an acquisition are part of a plan (or series or related transactions) under § 355(e)(2)(A)(ii), the Service may rule on related significant issues (as defined in section 3.01(29) of *Rev. Proc. 2003-3, 2003-1 I.R.B. 113 at 115*). The determination of whether a distribution and an acquisition are part of a plan (or series of related transactions) may be made upon an examination of the taxpayer's return.*

(13) Regulatory filings.-- Provide copies of any proxy, statements, information statements, or prospectuses filed or prepared in connection with the distribution or any related transactions.

(14) Previously Declined Request for Ruling.-- The Service will not entertain any ruling request regarding a proposed or completed transaction if the Service has previously declined to rule on that transaction (or a similar transaction) because the Service was not satisfied that the distribution met the corporate business purpose requirement, was not a device for the distribution of earnings and profits, or was not part of a plan (or series of related transactions under § 355 (e).

(15) Request for Supplemental Ruling.-- The Service will decline a request for a supplemental letter ruling, unless the request presents a significant issue (as defined in section 3.01 (29) of *Rev. Proc. 2003-3*). A change in circumstances arising after the transactions ordinarily does not present a significant issue.



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Taxation of Securities Transactions

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APPENDIX E: Revenue Procedure 96-30, as Modified and Amplified by Revenue Procedure 2003-48
Checklist of information to be included in request for ruling under IRC Section 355 IRC Section 355
SECTION 355 CHECKLIST QUESTIONNAIRE

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5. EFFECT ON OTHER DOCUMENTS

.01

Rev. Procs. 91-63, 91-62, and 86-41 are superseded. Section 3.01(23) of *Rev. Proc. 96-3* is revoked.

.02

The item relating to the section 355 Checklist Questionnaire in section 9.01 of *Rev. Proc. 96-1* is amended to read as follows: *Rev. Proc. 96-30, 1996-19 I.R.B. 8.*

.03

Section 9.02 of *Rev. Proc. 96-1* is modified to replace the reference to *Rev. Proc. 91-63* with a reference to section 4.05(1)(b) of *Rev. Proc. 96-30*.



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APPENDIX E: Revenue Procedure 96-30, as Modified and Amplified by Revenue Procedure 2003-48 Checklist of information to be included in request for ruling under IRC Section 355 IRC Section 355 SECTION 355 CHECKLIST QUESTIONNAIRE

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6. EFFECTIVE DATE

This revenue procedure will apply to all ruling requests postmarked, or, if not mailed, received, on or after June 5, 1996. However, the Service may ask the taxpayer to submit information specified in this revenue procedure for any ruling requests submitted prior to that date. The revocation of section 3.01(23) of *Rev. Proc. 96-3* is effective on date May 6, 1996. The Service will entertain ruling requests on the business purposes listed in Appendix A of this revenue procedure whether the ruling request arrives before, on, or after the publication date of this revenue procedure.

DRAFTING INFORMATION

The principal author of this revenue procedure is Dean P. Lekos of the Office of Assistant Chief Counsel (Corporate). For further information regarding this revenue procedure, contact Mr. Lekos on (202) 622-7550 or Mr. Howard W. Staiman on (202) 622-7750 (not toll-free calls).

APPENDIX B

SECTION 1. RULING REQUESTS INVOLVING RETENTION OF STOCK OR OPTIONS BY DISTRIBUTING

.01

The Service will issue favorable rulings regarding the application of section 355(a)(1)(D)(ii), relating to the retention by Distributing of stock or options in Controlled, to transactions in which Controlled stock will be widely held if Distributing establishes that the following requirements are satisfied:

(1) A sufficient business purpose exists for the retention of the stock, options, and any stock acquired on the exercise of the options.

(2) None of Distributing's directors or officers will serve as directors or officers of Controlled as long as Distributing retains the stock, options, or any stock acquired on the exercise of the options. Under appropriate facts and circumstances, the Service may issue a favorable ruling in cases in which the directors or officers of Distributing will serve as directors or officers of Controlled. For example, the Service may issue a favorable ruling if a director or officer of Distributing serves as a director or officer of Controlled solely to accommodate Controlled's business needs.

(3) The retained stock, options, and any stock acquired upon exercise of the options will be disposed of as soon as a disposition is warranted consistent with the business purpose specified in section 1.01(1) of this Appendix B, but in any event, not later than 5 years after the distribution.

(4) Distributing will vote the retained stock and any stock acquired on exercise of the options in proportion to the votes cast by Controlled's other shareholders. For example, if after the distribution the other shareholders of Controlled vote 70 percent in favor of a matter and 30 percent against, Distributing would be required to vote the stock 70 percent in favor and 30 percent against the matter.

.02

In other cases, the Service may issue favorable rulings, based upon all relevant facts and circumstances, regarding the application of section 355(a)(1)(D)(ii). For example, the Service will rule favorably if the transaction is covered by *Rev. Rul. 75-321, 1975-2 C.B. 123*.



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APPENDIX F: Revenue Procedure 72-18 Revenue Procedure 74-8

2-F Taxation of Securities Transactions APPENDIX F::syn

§ F.syn Synopsis to Appendix F: Revenue Procedure 72-18 Revenue Procedure 74-8

26 CFR 601.20: Rulings and determination letter. (Also Part I, Section 265; 1.265-2.)

Rev. Proc. 72-18

Rev. Proc. 74-8

Rev. Proc. 87-53



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APPENDIX F: Revenue Procedure 72-18 Revenue Procedure 74-8

2-F Taxation of Securities Transactions Scope

26 CFR 601.20: Rulings and determination letter.
(Also Part I, Section 265; 1.265-2.)

Certain taxpayers holding tax-exempt State and local obligations are provided guidelines for the application of Section 265(2) of the Code, relating to the nondeductibility of interest on indebtedness incurred for obligations on which interest is exempt from tax.



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Taxation of Securities Transactions

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APPENDIX F: Revenue Procedure 72-18 Revenue Procedure 74-8

2-F Taxation of Securities Transactions Scope

Rev. Proc. 72-18

SECTION 1. PURPOSE. The purpose of this Revenue Procedure is to set forth guidelines for taxpayers and field offices of the Internal Revenue Service for the application of *section 265(2) of the Internal Revenue Code of 1954* to certain taxpayers holding state and local obligations the interest on which is wholly exempt from Federal income tax. Guidelines for the application of section 265(2) of the Code to banks holding such tax-exempt obligations were set forth in *Revenue Procedure 70-20*, C.B. 1970-2, 499. This Revenue Procedure provides guidelines for the application of section 265(2) of the Code to individuals, to dealers in tax-exempt obligations, and to business enterprises that are not dealers in tax-exempt obligations, and to banks in situations not dealt with in *Revenue Procedure 70-20*.

SEC. 2. BACKGROUND.

.01

Section 265(2) of the Code provides, with two exceptions not here relevant, that no deductions shall be allowed for interest on indebtedness "incurred or continued to purchase or carry obligations * * * the interest on which is wholly exempt" from Federal income tax.

.02

Section 265(2) of the Code is derived from section 1202(1) of the Revenue Act of 1917 and section 234(a)(2) of the Revenue Act of 1918. It is clear from the legislative history of those sections and of subsequent unsuccessful efforts to amend such sections (or their successors) that Congress intended to disallow interest under section 165(2) of the Code only upon a showing of a purpose by the taxpayer to use borrowed funds to purchase or carry tax-exempt securities. See, *e.g.*, H. Rept. 767, 65th Cong., 10; S. Rept. 617, 65th Cong., 6, 7 (1918); 65 Cong. Rec. 7541-7542 (1924); and 67 Cong. Rec. 2964 (1925).

.03

Where the required purposive relationship is established, section 265(2) of the Code will be applicable even though the taxpayer does not receive tax-exempt interest, as for example, where the taxpayer holds defaulted obligations (see *Clyde C. Pierce Corp. v. Commissioner*, 120 F. 2d 206 (1941)), or where the taxpayer holds the obligation for a period before interest begins to accrue (see *Illinois Terminal Railroad Co. v. United States*, 375 F. 2d 1016, 1022 (1967)). Similarly, section 265(2) of the Code may be applicable even though the taxpayer's purpose in purchasing or carrying the tax-exempt obligations is to produce a taxable profit rather than tax-exempt interest. See *Denman v. Slayton*, 282 U.S. 514 (1931).

SEC. 3. GENERAL RULES.

01

.Section 265(2) of the Code is only applicable where the indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt securities. Accordingly, the application of section 265(2) of the Code requires a determination, based on all the facts and circumstances, as to the taxpayer's purpose in incurring or continuing each item of indebtedness. Such purpose may, however, be established either by direct evidence or by circumstantial evidence.

.02

Direct evidence of a purpose to *purchase* tax-exempt obligations exists where the proceeds of indebtedness are used for, and are directly traceable to, the purchase of tax-exempt obligations. *Wynn v. United States*, 411 F. 2d 614 (1969), certiorari denied 396 U.S. 1008 (1970). Section 265(2) does not apply, however, where proceeds of a bona fide business indebtedness are temporarily invested in tax-exempt obligations under circumstances similar to those set forth in *Revenue Ruling 55-389*, C.B. 1955-1, 276.

.03

Direct evidence of a purpose to *carry* tax-exempt obligations exists where tax-exempt obligations are used as collateral for indebtedness. "[O]ne who borrows to buy tax-exempts and one who borrows against tax-exempts already owned are in virtually the same economic position. Section 265(2) makes no distinction between them." *Wisconsin Cheeseman v. United States*, 338 F. 2d 420, at 422 (1968).

.04

In the absence of direct evidence linking indebtedness with the purchase or carrying of tax-exempt obligations as illustrated in paragraphs.02 and.03 above, section 265(2) of the Code will apply only if the totality of facts and circumstances supports a reasonable inference that the purpose to purchase or carry tax-exempt obligations exists. Stated alternatively, section 265(2) will apply only where the totality of facts and circumstances establishes a "sufficiently direct relationship" between the borrowing and the investment in tax-exempt obligations. See *Wisconsin Cheeseman*, 338 F.2d 420, at 422. The guidelines set forth in sections 4, 5, and 6 shall be applied to determine whether such a relationship exists.

.05

Generally, where a taxpayer's investment in tax-exempt obligations is insubstantial, the purpose to purchase or carry tax-exempt obligations will not ordinarily be inferred in the absence of direct evidence as set forth in sections 3.02 and 3.03. In the case of an individual, investment in tax-exempt obligations shall be presumed insubstantial only where during the taxable year the average amount of the tax-exempt obligations (valued at their adjusted basis) does not exceed 2 percent of the average adjusted basis of his portfolio investments (as defined in section 4.04) and any assets held in the active conduct of a trade or business. In the case of a corporation, an investment in tax-exempt obligations shall be presumed insubstantial only where during the taxable year the average amount of the tax-exempt obligations (valued at their adjusted basis) does not exceed 2 percent of the average total assets (valued at their adjusted basis) held in the active conduct of the trade or business. This paragraph shall not apply to a dealer in tax-exempt obligations.

SEC. 4. GUIDELINES FOR INDIVIDUALS.

01

.In the absence of direct evidence of the purpose to purchase or carry tax-exempt obligations (as set forth in sections 3.02 and 3.03), the rules set forth in this section shall apply.

02

.An individual taxpayer may incur a variety of indebtedness of a personal nature, ranging from short-term credit for purchases of goods and services for personal consumption to a mortgage incurred to purchase or improve a residence or other real property which is held for personal use. Generally, section 265(2) of the Code will not apply to indebtedness of this type, because the purpose to purchase or carry tax-exempt obligations cannot reasonably be inferred where a personal purpose unrelated to the tax-exempt obligations ordinarily dominates the transaction. For example, section 265(2) of the Code generally will not apply to an individual who holds salable municipal bonds and takes out a mortgage to buy a residence instead of selling his municipal bonds to finance the purchase price. Under such circumstances the purpose of incurring the indebtedness is so directly related to the personal purpose of acquiring a residence that no sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations may reasonably be inferred.

.03

The purpose to purchase or carry tax-exempt obligations generally does not exist with respect to indebtedness incurred or continued by an individual in connection with the active conduct of trade or business (other than a dealer in tax-exempt obligations) unless it is determined that the borrowing was in excess of business needs. However, there is a rebuttable presumption that the purpose to *carry* tax-exempt obligations exists where the taxpayer reasonably could have foreseen at the time of purchasing the tax-exempt obligations that indebtedness probably would have to be incurred to meet future economic needs of the business of an ordinary, recurrent variety. See *Wisconsin Cheeseman v. United States*, 388 F. 2d 420, at 422. The presumption may be rebutted, however, if the taxpayer demonstrates that business reasons, unrelated to the purchase or carrying of tax-exempt obligations, dominated the transaction.

.04

2-F Taxation of Securities Transactions Scope

Generally, a purpose to carry tax-exempt obligations will be inferred, unless rebutted by other evidence, wherever the taxpayer has outstanding indebtedness which is not directly connected with personal expenditures (see section 4.02) and is not incurred or continued in connection with the active conduct of a trade or business (see section 4.03) and the taxpayer owns tax-exempt obligations. This inference will be made even though the indebtedness is ostensibly incurred or continued to purchase or carry other portfolio investments. Portfolio investment for the purposes of this Revenue Procedure includes transactions entered into for profit (including investment in real estate) which are not connected with the active conduct of a trade or business. Purchase and sale of securities shall not constitute the active conduct of a trade or business unless the taxpayer is a dealer in securities within the meaning of *section 1.471-5 of the Income Tax Regulations*. A substantial ownership interest in a corporation will not be considered a portfolio investment. For example, where a taxpayer owns at least 80 percent of the voting stock of a corporation that is engaged in the active conduct of a trade or business, the investment in such controlling interest shall not be considered to be a portfolio investment. A sufficiently direct relationship between the incurring or continuing of indebtedness and the purchasing or carrying of tax-exempt obligations will generally exist where indebtedness is incurred to finance portfolio investment because the choice of whether to finance a new portfolio investment through borrowing or through the liquidation of an existing investment in tax-exempt obligations typically involves a purpose either to maximize profit or to maintain a diversified portfolio. This purpose necessarily involves a decision, whether articulated by the taxpayer or not, to incur (or continue) the indebtedness, at least in part, to purchase or carry the existing investment in tax-exempt obligations. A taxpayer may rebut the presumption that section 265(2) of the Code applies in the above circumstances by establishing that he could not have liquidated his holdings of tax-exempt obligations in order to avoid incurring indebtedness. The presumption may be overcome where, for example, liquidation is not possible because the tax-exempt obligations cannot be sold. The presumption would not be rebutted, however, by a showing that the tax-exempt obligations could only have been liquidated with difficulty or at a loss; or that the taxpayer owned other investment assets such as common stock that could have been liquidated; or that an investment advisor recommended that a prudent man should maintain a particular percentage of assets in tax-exempt obligations. Similarly, the presumption would not be rebutted by a showing that liquidating the holdings of tax-exempt obligations would not have produced sufficient cash to equal the amount borrowed. The provisions of this paragraph may be illustrated by the following example: Taxpayer A, an individual, owns common stock listed on a national securities exchange, having an adjusted basis of \$200,000; he owns rental property having an adjusted basis of \$200,000; he has cash of \$10,000; and he owns readily marketable municipal bonds having an adjusted basis of \$41,000. A borrows \$100,000 to invest in a limited partnership interest in a real estate syndicate and pays \$8,000 interest on the loan which he claims as an interest deduction for the taxable year. Under these facts and circumstances, there is a presumption that the \$100,000 indebtedness which is incurred to finance A's portfolio investment is also incurred to carry A's existing investment in tax-exempt bonds since there are no additional facts or circumstances to rebut the presumption. Accordingly, a portion of the \$8,000 interest payment will be disallowed under section 265(2) of the Code. See section 7 concerning the amount to be disallowed.

.05

In the case of a partnership which incurs indebtedness or which holds tax-exempt obligations, the partners shall be treated as incurring or holding their partnership share of such indebtedness or tax-exempt obligations. For purposes of this Revenue Procedure, the interest of a partner in the partnership's assets and indebtedness shall be determined in accordance with his capital interest in the partnership. The purposes for which the partnership incurs any indebtedness shall be attributed to the general partners in applying section 265(2). A general partner's interest in corporate stock owned by a partnership will ordinarily be considered a portfolio investment unless the partnership meets the substantial ownership requirement of section 4.04; and (1) the partner has at least an 80 percent interest in the partnership or (2) the business of the corporation and of the partner are closely related and the partner has an interest of more than 50 percent in the partnership. A limited partnership interest will be considered as representing portfolio investment.

SEC. 5. GUIDELINES FOR DEALERS IN TAX-EXEMPT OBLIGATIONS.

01

. A dealer in tax-exempt obligations (whether a corporation, partnership, or sole proprietorship) is subject to section 265(2) of the Code where it is established that indebtedness is incurred or continued for the purpose of holding tax-exempt obligations, even though the tax-exempt obligations are held for the purpose of resale at a gain rather than for the purpose of receiving tax-exempt interest income. See *Denman v. Slayton, supra*.

02

. Where proceeds of indebtedness are directly traceable to the purchase of tax-exempt obligations by a dealer in such obligations, section 265(2) of the Code applies as specified in section 3.02. Direct tracing may occur for example, where a brokerage business maintains a municipal bond account with a bank through which it purchases and sells all of its municipal bonds, with the brokerage business incurring an indebtedness to the bank during any period in which purchases exceed receipts from sales in the account. See *Wynn v. United States, supra*. As provided in section 7, where there is such direct tracing the entire interest on the indebtedness is nondeductible under section 265(2) of the Code.

.03

Where indebtedness is incurred or continued for the general purpose of carrying on a brokerage business which includes the purchase of both taxable and tax-exempt obligations, and the use of the borrowed funds cannot be directly traced, it is reasonable to infer that the borrowed funds were used for all the activities of the business which include the purchase of tax-exempt obligations. Accordingly, section 265(2) of the Code is applicable in such circumstances. See *Commissioner v. Leslie, 413 F.2d 636 (1969), certiorari denied, 396 U.S. 1007 (1970)*. However, in such a case only an allocable portion of the interest deduction is disallowed, as provided in section 7.

04

. The purpose to purchase or carry tax-exempt obligations generally cannot be inferred where indebtedness is incurred to acquire or improve physical facilities. In such circumstances a dominant business purpose apart from the purchasing or carrying of tax-exempt obligations is sufficiently established, with the result that any inference that the indebtedness was incurred or continued for the proscribed purpose is adequately rebutted. Compare *Wisconsin Cheeseman, supra*.

SEC. 6. GUIDELINES FOR CORPORATIONS THAT ARE NOT DEALERS IN TAX-EXEMPT OBLIGATIONS.

.01

Where there is no direct evidence of the purpose to purchase or carry tax-exempt obligations (as set forth in sections 3.02 and 3.03), the rules set forth in this section shall apply to a corporation which is not a dealer in tax-exempt obligations. The purpose to purchase or carry tax-exempt obligations will generally not be inferred with respect to indebtedness incurred or continued to provide funds for carrying on an active trade or business, not involving the

2-F Taxation of Securities Transactions Scope

holding of tax-exempt obligations, unless it is determined that the borrowing was in excess of business needs. Thus the purpose may be present where the borrowings exceed the reasonable needs of business or provide funds for portfolio investments. For example, where indebtedness is incurred and the proceeds are used, directly or indirectly, to purchase tax-exempt obligations which are retained for a substantial period of time as an investment, the purpose to purchase or carry tax-exempt obligations may be inferred. Similarly, where the taxpayer invests a disproportionately large portion of its liquid assets in tax-exempt obligations and there are no facts indicating that such investment is related to the reasonable needs of the taxpayer's business operations or is required on the basis of the financial conditions prevailing with respect thereto, the required purpose may also be inferred with respect to indebtedness of the taxpayer. On the other hand, temporary, short-term, investment of working capital in tax-exempt obligations, particularly where such obligations are of a nature suited for such investment (such as 90 day tax anticipation notes), and where such investments are liquidated frequently to provide funds for use in the taxpayer's business, normally provides no basis for inferring that the purpose to purchase or carry tax-exempt obligations exists with respect to indebtedness of the taxpayer. An inference may arise, however, with respect to indebtedness which is itself short-term and is incurred other than in the normal course of the taxpayer's trade or business.

.02

Generally, the purpose to *carry* tax-exempt obligations will be inferred unless rebutted by other evidence where the taxpayer could reasonably have foreseen at the time of purchasing the tax-exempt obligations that indebtedness probably would have to be incurred to meet future economic needs of the corporation of an ordinary, recurrent variety. For example, a purpose to carry tax-exempt obligations can be inferred in a case (such as *Wisconsin Cheeseman, supra*) where the regular business pattern of a corporation shows that it would be required to borrow funds to meet its recurring needs for working capital if it bought or retained tax-exempt obligations as a long-term investment. The presumption will not apply, however, if the taxpayer demonstrates that business reasons unrelated to the purchase or carrying of tax-exempt obligations dominated the transaction. For example, the purpose to carry tax-exempt obligations generally cannot be inferred where a mortgage debt is incurred to finance a new plant which is a nonrecurrent major expenditure. In such cases, a dominant business purpose, other than the purchase or carrying of tax-exempt obligations will normally exist and, accordingly, any inference will be rebutted. On the other hand, the purpose to *carry* tax-exempt obligations can be inferred where a corporation *continues* indebtedness which it could discharge, in whole or in part, by liquidating its holdings of tax-exempt obligations without withdrawing any capital which is committed to, or held in reserve for, the corporation's regular business activities. See *Illinois Terminal Railroad Co. v. United States, supra*.

.03

The required relationship will generally not be present where the taxpayer's holdings of tax-exempt obligations are nonnegotiable obligations acquired in the ordinary course of business in payment for services performed for, or goods supplied to, state or local governments. *R.B. George Machinery Co., 26 B.T.A. 594 (1932)* (Acquiesced C.B. XI-2, 4). Similarly, it generally will not be present where such holdings are required as a condition to performing a contract to provide services or property other than money to a state or local government in the ordinary course of the taxpayer's trade or business. See *Commissioner v. Bagley & Sewall Co., 221 F.2d 944 (1955)*.

SEC. 7. PROCEDURES.

.01

When there is direct evidence under sections 3.02 and 3.03 establishing a purpose to purchase or carry tax-exempt obligations (either because tax-exempt obligations were used as collateral for indebtedness or the proceeds of indebtedness were directly traceable to the holding of particular tax-exempt obligations) no part of the interest paid or incurred on such indebtedness may be deducted. However, if only a fractional part of the indebtedness is directly traceable to the holding of particular tax-exempt obligations, the same fractional part of the interest paid or incurred on such indebtedness will be disallowed. For example, if A borrows \$100,000 from a bank and invests \$75,000 of the proceeds in tax-exempt obligations, 75 percent of the interest paid on the bank borrowing would be disallowed as a deduction.

.02

In any other case where interest is to be disallowed in accordance with this Revenue Procedure, an allocable portion of the interest on such indebtedness will be disallowed. The amount of interest on such indebtedness to be disallowed shall be determined by multiplying the total interest on such indebtedness by a fraction, the numerator of which is the average amount during the taxable year of the taxpayer's tax-exempt obligations (valued at their adjusted basis) and the denominator of which is the average amount during the taxable year of the taxpayer's total assets (valued at their adjusted basis) minus the amount of any indebtedness the interest on which is not subject to disallowance to any extent under this Revenue Procedure.

SEC. 8. INQUIRIES. Inquiries in regard to this Revenue Procedure should refer to its number and be addressed to Assistant Commissioner (Technical), Attention: T:I:C, Washington, D.C.
20224. _____

26 CFR 601.201: Rulings and determination letters

(Also Part I, Section 265; 1.265-2.) **Interest on tax-exempt obligations; clarification of terms in guidelines.** Clarification of the terms "portfolio investment" and "active conduct of trade or business" as used in guidelines for applying section 265(2) of the Code relating to interest on tax-exempt State and local obligations; *Rev. Proc. 72-18* clarified.



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APPENDIX F: Revenue Procedure 72-18 Revenue Procedure 74-8

2-F Taxation of Securities Transactions Scope

Rev. Proc. 74-8

SECTION 1. PURPOSE. The purpose of this Revenue Procedure is to clarify the second paragraph of section 4.04 of *Rev. Proc. 72-18, 1972-1 C.B. 740*, concerning the terms "portfolio investment" and "active conduct of a trade or business" as used in *Rev. Proc. 72-18*.

SEC. 2. IMPLEMENTATION. The second paragraph of section 4.04 of *Rev. Proc. 72-18* is clarified to read as follows: Portfolio investment for the purposes of this Revenue Procedure includes transactions entered into for profit (including investment in real estate) which are not connected with the active conduct of a trade or business. The purchase and sale of securities shall not constitute the active conduct of a trade or business unless the taxpayer is a dealer in securities within the meaning of *section 1.471-5 of the Income Tax Regulations*. A substantial ownership interest in a corporation engaged in the active conduct of a trade or business will not be considered a portfolio investment. For example, where a taxpayer owns 80 percent of the voting stock of a corporation that is engaged in the active conduct of a trade or business, the investment in such controlling interest will not be considered to be a portfolio investment. However, any ownership in a corporation not engaged in the active conduct of a trade or business will be considered a portfolio investment. Substantial ownership in a corporation is a question of fact which will be determined on a case-by-case basis.

26 CFR 601.201: Rulings and determination letters.

(Also Part I, Section 265; 1.265-2.)



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APPENDIX F: Revenue Procedure 72-18 Revenue Procedure 74-8

2-F Taxation of Securities Transactions Scope

Rev. Proc. 87-53

SECTION 1. PURPOSE The purpose of this revenue procedure is to modify section 6.03 of *Rev. Proc. 72-18, 1972-1 C.B. 740*, in order to implement the nonsalable standard intended by that section. Under the nonsalable standard, *section 265(a)(2) of the Internal Revenue Code* generally does not apply to a taxpayer's holdings of tax-exempt obligations acquired in the ordinary course of the taxpayer's business from state and local governments, if such obligations are not salable.

SECTION 2. BACKGROUND

.01

Rev. Proc. 72-18 provides guidelines for the application of *section 265(a)(2) of the Internal Revenue Code* to certain taxpayers holding state and local obligations the interest on which is wholly exempt from federal taxation. (Before redesignation by section 902 of the Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 1, 297, section 265(a)(2) was section 265(2).)

.02

Section 265(a)(2) of the Code provides, in part, that no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from federal income taxation. The application of section 265(a)(2) requires a determination, based on all the facts and circumstances, of the taxpayer's purpose in incurring or continuing each item of indebtedness. This purpose may be established by either direct or circumstantial evidence.

.03

Section 6 of *Rev. Proc. 72-18* provides guidelines for corporations that are not dealers in tax-exempt obligations. Section 6.03 of *Rev. Proc. 72-18* provides, "The required relationship will generally not be present where the taxpayer's

holdings of tax-exempt obligations acquired in the ordinary course of business in payment for services performed for, or goods supplied to, state or local governments. *R.B. George Machinery Co.*, 26 B.T.A. 594 (1932) (Acquiesced C.B. XI-2, 4)."

.04

R.B. George Machinery Co., stands for the proposition that section 265(a)(2) of the Code does not apply if the tax-exempt obligations held by the taxpayer are nonsalable. See *Wisconsin Cheesman, Inc. v. United States*, 388 F.2d 420, 423 (7th Cir. 1968); *Illinois Terminal Railroad Co. v. United States*, 375 F.2d 1016, 1021 (Ct. Cl. 1967). The use of the term "nonnegotiable" in section 6.03 of *Rev. Proc. 72-18* does not precisely convey the nonsalable standard established by *R.B. George Machinery Co.*

SEC. 3. APPLICATION Section 6.03 of *Rev. Proc. 72-18* is modified to read, in part, as follows: The required relationship will generally not be present when the taxpayer is unable to sell holdings of tax-exempt obligations acquired in the ordinary course of business in payment for services performed for, or goods supplied to, state or local governments. *R.B. George Machinery Co. v. Commissioner*, 26 B.T.A. 594 (1932), *acq.*, XI-2 C.B. 4 (1932); *Wisconsin Cheesman, Inc. v. United States*, 388 F.2d 420 (7th Cir. 1968); *Illinois Terminal Railroad Co. v. United States*, 375 F.2d 1016 (Ct. Cl. 1967).

SEC. 4. EFFECTIVE DATE This revenue procedure is effective for all tax-exempt obligations acquired on or after January 11, 1988.

SEC. 5. EFFECT ON OTHER DOCUMENTS *Rev. Proc. 72-18* is modified.

SEC. 6. DRAFTING INFORMATION The principal author of this revenue procedure is Mr. Ned Blanchard of the Corporation Tax Division. For further information regarding the revenue procedure contact Mr. Ned Blanchard on (202) 377-9589 (not a toll-free call).



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APPENDIX G: Revenue Procedure 81-60

2-G Taxation of Securities Transactions APPENDIX G:.syn

§ G.syn Synopsis to Appendix G: Revenue Procedure 81-60

1 PURPOSE

2 BACKGROUND

3 CHANGES

4 INFORMATION TO BE INCLUDED IN REQUESTS FOR RULINGS UNDER SECTION 368(a)(1)(E) OF
THE CODE

5 INQUIRIES

6 EFFECT ON OTHER DOCUMENTS



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APPENDIX G: Revenue Procedure 81-60

Checklist of information to be included in request for ruling under IRC Section 368(a)(1)(E)
SECTION 368(a)(1)(E) CHECKLIST QUESTIONNAIRE

2-G Taxation of Securities Transactions 1

1 PURPOSE

The purpose of this revenue procedure is to update *Revenue Procedure 78-33, 1978-2 C.B. 532*, which sets forth in a convenient checklist questionnaire the information necessary to be included in a request for a ruling relating to the recapitalization of a corporation under *section 368(a)(1)(E) of the Internal Revenue Code*.



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APPENDIX G: Revenue Procedure 81-60

Checklist of information to be included in request for ruling under IRC Section 368(a)(1)(E)
SECTION 368(a)(1)(E) CHECKLIST QUESTIONNAIRE

2-G Taxation of Securities Transactions 2

2 BACKGROUND

The Internal Revenue Service receives many requests for rulings in which the information furnished about the proposed transaction is not complete enough to permit a determination to be made. In such cases it is necessary to get additional facts from the taxpayer before the ruling request can be considered. This procedure is time consuming for both Service personnel and taxpayers and delays the issuance of the final ruling letter. This checklist will facilitate the filing of requests for rulings under section 368(a)(1)(E) of the Code by showing specific information that should be included so that the application will be as complete as possible when originally filed. However, since the information necessary to rule on a particular transaction depends upon all the facts and circumstances of that case, information in addition to that suggested in this revenue procedure may be required. Nevertheless, careful use of the checklist should avoid much needless delay and permit rulings to be issued sooner.

The authority and general procedures of the National Office of the Service and of the Office of the District Directors of Internal Revenue with respect to the issuance of advance rulings and determination letters are outlined in *Rev. Proc. 80-20, 1980-1 C.B. 633*, as amended by *Rev. Proc. 81-33, page 564*, this Bulletin. See also *Rev. Proc. 81-10, 1981-1 C.B. 647*, relating to areas in which advance rulings generally will not be issued. Careful attention to all the requirements of these revenue procedures will also serve to minimize needless delays in processing requests for rulings.



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APPENDIX G: Revenue Procedure 81-60

Checklist of information to be included in request for ruling under IRC Section 368(a)(1)(E)

SECTION 368(a)(1)(E) CHECKLIST QUESTIONNAIRE

2-G Taxation of Securities Transactions 3

3 CHANGES

.01

Section 1 has been changed to indicate that the purpose of the proposed revenue procedure is to update *Rev. Proc. 78-33*.

.02

Section 2 has been modified by substituting *Rev. Proc. 80-20*, as amended by *Rev. Proc. 81-33*, for *Rev. Proc. 72-3*, *1972-1 C.B. 698*, and *Rev. Proc. 72-9*, *1972-1 C.B. 718*. The latter have been superseded.

.03

Section 4 asks for the reason why a taxpayer thinks a checklist item is not applicable.

.04

Section 4.013 has been modified by substituting the language in section 9.06 of *Rev. Proc. 80-20* for the language from section 3.01 of *Rev. Proc. 72-3*, which has been superseded.

.05

Section 4.021(a)(6)(A) has been changed to require taxpayers to submit copies of existing stock redemption or buy-sell agreements or any such agreements to be entered into as part of the recapitalization.

.06

Section 4.021(a)(6)(B) has been modified by adding a new sentence defining what constitutes "issue price" for purposes of the preceding question.

.07

Section 4.021(a)(7) has been modified by adding a request for information as to the method of acquisition of all outstanding stock before the recapitalization.

.08

Section 4.032(a) has been modified by adding a new sentence asking whether any newly issued stock will be placed in escrow or issued under a contingent stock arrangement.

.09

Section 4.06 has been modified by adding a new sentence asking for a specific representation concerning related transactions.



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APPENDIX G: Revenue Procedure 81-60

Checklist of information to be included in request for ruling under IRC Section 368(a)(1)(E)
SECTION 368(a)(1)(E) CHECKLIST QUESTIONNAIRE

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4 INFORMATION TO BE INCLUDED IN REQUESTS FOR RULINGS UNDER SECTION 368(a)(1)(E) OF THE CODE

Each of the items included in this section should be specifically dealt with in the application even though some may not appear to be applicable. Presentation of the information required should follow the format of this revenue procedure as closely as possible with the appropriate descriptive headings. If an item is not applicable, say so and briefly explain why it is not applicable.

.01 Information regarding the corporation (the Corporation) involved in the recapitalization.

1 Identification. -- Name, taxpayer identification number, place, and date of incorporation of the Corporation.

2 Taxable year. -- State the last day of the taxable year of the Corporation.

3 Jurisdiction. -- Identify the District Office that will have audit jurisdiction over the return of the Corporation and state whether, to the best of the knowledge of the taxpayer and the taxpayer's representative, if any, the identical issue is in a return of the taxpayer (or of a related taxpayer within the meaning of section 267 of the Code, or a member of an affiliated group of which the taxpayer is also a member within the meaning of section 1504). If so, state whether the issue (1) is being examined by a District Director, (2) has been examined and the statutory period of limitation on assessment or refund of tax has not expired or a closing agreement covering the issue or liability has not been entered into by a District Director, (3) is being considered by an Appeals Office in connection with the taxpayer's return for an

earlier period, or that issue has been considered by an Appeals Office and the statutory period of limitation on assessment or refund of tax has not expired or a closing agreement covering the issue or liability has not been entered into by an Appeals Office, or (4) is pending in litigation in a case involving the taxpayer or a related taxpayer. The request must contain a statement whether, to the best of the knowledge of the taxpayer and the taxpayer's representative, the identical or similar issue has been ruled on by the Service and issued to the taxpayer or to the taxpayer's predecessor and, if so, when and with what results. If after the request is filed but before a ruling is issued, the taxpayer knows that an examination of the issue by a District Director has been started, the taxpayer must notify the National Office of such action. If a return is filed before a ruling is received from the National Office concerning the return, a copy of the request must be attached to the return. This alerts the District Office and avoids premature District action on the issue.

4 Business. -- Describe the business of the Corporation.

.02 *Description and ownership of stock and securities.*

1 Description of outstanding stock immediately before the recapitalization.

a Classes of Stock -- Furnish a complete description of each class of stock outstanding of the Corporation before the recapitalization, setting forth the rights and privileges of each class as follows:

1 Par or stated values.

2 Voting rights.

3 Liquidation rights -- State the amount per share and preferences of each class of stock upon liquidation.

4 Dividend rights (including any rights to receive stock).

(A)

State the terms, preferences and amount of the dividend distribution.

(B)

2-G Taxation of Securities Transactions 4

State whether the stock is cumulative or noncumulative.

(C)

Does the stock have a right to participate with other classes of stock? If so, explain.

(D)

State whether there are any dividends in arrears.

(E)

State the cash and stock dividend history of each class of stock for the past 5 years.

5 Conversion rights.

(A)

Is the stock convertible? If so, when?

(B)

State the class of stock or securities into which the stock is convertible.

(C)

State the rate of conversion or conversion price and whether the rate or price may change.

(D)

Will there be outstanding at the time of the recapitalization any stock options, warrants, convertible securities, or any other right that is convertible into any class of stock or securities of the Corporation? If so, explain.

6 Redemption rights.

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(A)

Is the stock redeemable or callable at the option of the Corporation? Submit copies of existing stock redemption or buy-sell agreements or any such agreements to be entered into as part of the recapitalization.

(B)

State the amount per share of stock to be received upon redemption. Does this amount exceed 110 percent of the issue price of the stock? See *section 1.305-5(b) of the Income Tax Regulations*. For purposes of the preceding question, with respect to the description of stock to be issued in the recapitalization (as requested in section 4.025 below), "issue price" means the fair market value of the stock to be surrendered in exchange for the stock subject to call by the Corporation as of the date the Board of Directors of the Corporation agreed to the exchange ratio and the terms and conditions of the stock subject to call by the Corporation with respect to its redemption price.

(C)

Do the shareholders have a right ("put") to have the stock redeemed by the Corporation? If so, state the terms and conditions.

(D)

Does the Corporation have any plan or intention to redeem or otherwise acquire any of the shares of the stock? If so, explain.

(E)

Have there been any prior redemptions or acquisitions of the stock during the last 5 years (including any open market purchases)? If so, explain in full.

7 Section 306 stock -- State whether any of the stock outstanding is "section 306 stock" within the meaning of section 306(c) and identify that stock. As to each exchanging shareholder, state the method of acquisition of all of such shareholder's stock outstanding before the recapitalization.

8 Other terms -- State any other terms or features of each class of stock.

2 Ownership of outstanding stock immediately before the recapitalization. -- Set forth the number of shares and the

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percentage of each class of stock outstanding owned by each shareholder, and the relationship between each shareholder, of the Corporation. However, if there are more than 25 shareholders, the number and percentage of shares owned by each shareholder may be limited to those shareholders owning in excess of 5 percent of the outstanding shares of each class and the total number of shareholders owning the balance of each class.

3 Description of outstanding securities immediately before the recapitalization. -- Furnish a complete description of each type of security outstanding of the Corporation that will be surrendered or exchanged in the recapitalization, setting forth the principal amount, the rights, and privileges of each type.

a Interest arrearages -- State whether there are any interest arrearages on the outstanding securities to be surrendered or exchanged. If so, explain.

4 Ownership of outstanding securities immediately before the recapitalization.-- Set forth the number of securities and the percentage of each type of security outstanding to be surrendered or exchanged owned by each security holder of the Corporation. However, if the securities are held by more than 25 security holders, the number and percentage of securities owned by each security holder may be limited to those security holders owning in excess of 5 percent of the outstanding securities of each type and the total number of security holders owning the balance of each type.

5 Description of stock to be issued in the recapitalization. -- Furnish a complete description of each class of stock of the Corporation to be issued in the recapitalization, setting forth the rights and privileges of each class. See 4.021(a)(1) through (8) above for the information to be furnished.

6 Ownership of stock immediately after the recapitalization. -- Set forth the number of shares and the percentage of each class of stock outstanding owned by each shareholder, and the relationship between shareholder of the Corporation. If the stock is held by more than 25 shareholders, the number and percentage of shares owned by each shareholder may be limited to those shareholders owning in excess of 5 percent of the outstanding shares of each class and the total number of shareholders owning the balance of each class.

7 Description of securities to be issued in the recapitalization. -- Furnish a complete description of each type of security to be issued in the recapitalization, setting forth the principal amount and the rights and privileges of each type.

8 Ownership of securities immediately after the recapitalization. -- Set forth the number of securities and the percentage of each type of security to be issued in the recapitalization to each security holder of the Corporation. However, if the type of security is held by more than 25 security holders, the number and percentage of securities owned by each security holder may be limited to those security holders owning in excess of 5 percent of the outstanding securities of each type and the total number of security holders owning the balance of each type.

.03 Information as to the plan of recapitalization.

1 Plan. -- Furnish the plan or agreement of exchange if reduced to writing (including any amendment to the articles of incorporation of the Corporation).

2 Exchange of stock and securities.

a Date of exchange -- When will the exchange take effect? Will any of the stock issued be placed in escrow or will any of the stock be issued later under a contingent stock arrangement? If so, give a full explanation.

b Exchanging shareholders -- Identify those shareholders and security holders who will exchange their stock or securities.

c Exchange -- Set forth the stock or securities to be issued and the stock or securities to be surrendered in the exchange.

(1) Will any stock or security be issued for dividend or interest arrearages? If so, explain. See *section 1.305-7(c) of the Income Tax Regulations*.

d Values -- Furnish a statement that the fair market value of the stock to be received by each exchanging shareholder will be equal to the fair market value of the stock surrendered in the exchange. If values will not be equal, provide a full explanation. (See section 356(f) of the Code.)

e Principal amount -- State the principal amount of the securities to be issued and the principal amount of the securities to be exchanged. (See sections 354(a)(2)(A) and 356(d)(2)(B) of the Code.)

f Disposition -- State whether the shareholders or security holders have any plan or intention to dispose of any of the stock or securities to be received by them in the exchange. If so, explain.

g Conversion -- If convertible preferred stock is to be received, see Section 4 of *Rev. Proc. 77-37, 1977-2 C.B. 568*, for information to be furnished.

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h Fractional shares -- State how any fractional shares will be treated in the exchange. (See *Rev. Proc. 77-41, 1977-2 C.B. 574.*)

i Other property -- State whether any property other than stock or securities of the Corporation will be involved in the recapitalization.

j Other effects of the recapitalization -- State whether the recapitalization will have any effect upon the conversion rights or other privileges of any stock, stock rights, or security of the Corporation (whether or not involved in the recapitalization). If so, explain in detail. See section 305(c) of the Code *1.305-7(c) of the Income Tax Regulations.*

.04 *Business Purpose.* -- Describe in detail the corporate business purpose or purposes for the recapitalization of the Corporation.

.05 *General.*

1 Continued operation. -- Furnish a statement whether the Corporation will continue to conduct any business operations after the recapitalization.

2 Expenses. -- Furnish a statement that the Corporation and its shareholders and security holders will each pay their own expenses, if any, incurred in connection with the recapitalization.

3 Balance sheet. -- Furnish the most recent year end balance sheet and profit and loss statement of the Corporation.

.06 *Related steps or transactions.* -- Describe any other transactions that will occur or are contemplated, whether or not considered as related to or in connection with the recapitalization. If a section 305(c) ruling is requested, is the proposed recapitalization an isolated transaction and not part of a plan to periodically increase the proportionate interest of any shareholder in the assets or earnings and profits of the Corporation? See *section 1.305-7(c) of the Income Tax Regulations.*



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APPENDIX G: Revenue Procedure 81-60

Checklist of information to be included in request for ruling under IRC Section 368(a)(1)(E)
SECTION 368(a)(1)(E) CHECKLIST QUESTIONNAIRE

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5 INQUIRIES

Inquiries in regard to this revenue procedure should refer to its number and should be addressed to the Assistant Commissioner (Technical), Attention: T:C:R, Internal Revenue Service, Washington, D.C. 20224.



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APPENDIX G: Revenue Procedure 81-60

Checklist of information to be included in request for ruling under IRC Section 368(a)(1)(E)
SECTION 368(a)(1)(E) CHECKLIST QUESTIONNAIRE

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6 EFFECT ON OTHER DOCUMENTS

Rev. Proc. 78-33 is superseded.



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APPENDIX H: Revenue Procedure 86-16

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§ H.syn Synopsis to Appendix H: Revenue Procedure 86-16

1 PURPOSE

2 BACKGROUND

3 CHANGES

4 INFORMATION TO BE INCLUDED IN REQUESTS FOR RULINGS UNDER SECTIONS 331 AND 337 OF
THE CODE

5 INQUIRIES

6 EFFECT ON OTHER DOCUMENTS



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APPENDIX H: Revenue Procedure 86-16

Checklist of information to be included in request for ruling under IRC Section 331 and 337
SECTIONS 331 and 337 CHECKLIST QUESTIONNAIRE

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1 PURPOSE

The purpose of this revenue procedure is to update *Rev. Proc. 81-52, 1981-2 C.B. 625*, which sets forth in a checklist questionnaire the information that must be included in a request for a ruling under *section 337 of the Internal Revenue Code* (and its related provision, section 331 of the Code) relating to the nonrecognition of gain or loss on sales or exchanges in connection with a complete liquidation of a corporation (Distributor). This checklist questionnaire does not deal with the special rules of section 337(e), relating to involuntary conversions, or of section 337(g), relating to cases under title 11 of the United States Code, or a receivership, foreclosure, or similar proceeding in a federal or state court.



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APPENDIX H: Revenue Procedure 86-16

Checklist of information to be included in request for ruling under IRC Section 331 and 337
SECTIONS 331 and 337 CHECKLIST QUESTIONNAIRE

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2 BACKGROUND

The Internal Revenue Service receives many requests for rulings in which the information relating to the proposed transaction is not sufficient to permit a determination to be made. In those cases, it is necessary to obtain additional facts from the taxpayer before the request for a letter ruling can be considered. Obtaining these additional facts is time consuming for both Service personnel and taxpayers and delays issuance of the ruling letter.

This checklist will facilitate the filing and processing of requests for rulings under sections 331 and 337 of the Code by showing specific information and representations to be included so that the requests will be as complete as possible when initially filed. Because the information and representations necessary to rule on a particular transaction depend upon all the facts and circumstances, information or representations in addition to those set forth in this revenue procedure may be required.

The authority and general procedures of the National Office of the Internal Revenue Service and of the Office of the District Directors of Internal Revenue with respect to the issuance of letter rulings and determination letters are outlined in *Rev. Proc. 86-1, 1986-1 I.R.B. 6*. See also, *Rev. Proc. 86-3, 1986-1 I.R.B. 26*, relating to areas in which advance rulings generally will not be issued. These revenue procedures, along with the present checklist revenue procedure, are subject to periodic updating by the Service. Therefore, careful attention should be given to ensure usage of the most current revenue procedures.

Careful attention to all requirements of these revenue procedures will aid in the timely processing of letter ruling requests.



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APPENDIX H: Revenue Procedure 86-16

Checklist of information to be included in request for ruling under IRC Section 331 and 337
SECTIONS 331 and 337 CHECKLIST QUESTIONNAIRE

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3 CHANGES

.01

Section 1 is modified to indicate that the purpose of the revenue procedure is to update *Rev. Proc. 81-52*.

.02

Section 2 is modified to state that representations are now required, and to update references to revenue procedures cited.

.03

Section 4 is substantially altered, with numerous sections being renumbered and relocated in the interest of simplification. The taxpayer must now submit standard representations using the precise language specified herein, or submit an explanation why the representations cannot be made in the requested form. Sections 4.021, 4.023, 4.025, 4.026, 4.027, 4.031, 4.032, 4.041 and 4.045 are modified accordingly. To properly reflect applicable changes, some citations to Code sections and to revenue rulings and procedures have been added or deleted. Changes include:

1

Section 4.012 now requires taxpayers to submit information concerning any prior ruling requests submitted by the

taxpayer (or predecessor) that were withdrawn in which the identical or similar issue was present.

2

Section 4.022 is added to request information concerning the liquidation of a subsidiary formerly requested in section 4.037(a). Reference to *Rev. Rul. 69-172, 1969-1 C.B. 99*, is deleted.

3

Section 4.023(a)(1)(B) is added to request information concerning covenants not to compete.

4

Section 4.033 has been modified to show changes in the recapture provisions.

5

Section 4.035 has been added to request information regarding advance payments received by Distributor.

6

Section 4.046 requires taxpayers to state whether the liquidation of Distributor will be carried out by the use of a statutory merger.

7

Section 4.05 requires taxpayers to list the specific rulings being requested and the authorities supporting the rulings.

.04

Section 5 is modified to substitute Associate Chief Counsel (Technical) for Assistant Commissioner (Technical), and CC:C:R for T:C:R.

.05

Section 6 is modified to state that *Rev. Proc. 81-52* is superseded.



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APPENDIX H: Revenue Procedure 86-16

Checklist of information to be included in request for ruling under IRC Section 331 and 337
SECTIONS 331 and 337 CHECKLIST QUESTIONNAIRE

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4 INFORMATION TO BE INCLUDED IN REQUESTS FOR RULINGS UNDER SECTIONS 331 AND 337 OF THE CODE

Each of the items in this section should be specifically dealt with in the letter ruling request. If an item is not applicable, so state and briefly explain why. Standard representations are set forth throughout this section and are highlighted by the word "representation" in boldface type. These representations are of equal importance with the other factual information requested herein. The representations function to ensure that specific statutory and judicial requirements and administrative ruling guidelines are satisfied. Each representation set forth in this section should be submitted precisely in the language requested. If a representation cannot be submitted as requested, an explanation must be given. Variations of the language of the representations may delay processing the ruling request and will not be accepted unless reasons satisfactory to the Service are submitted. Submission of the information and representations should follow the format of this revenue procedure as closely as possible, with appropriate descriptive headings. Care must be taken to ensure that all the facts relating to the transaction are submitted.

.01 Information regarding the liquidating corporation (Distributor).

1 Identification.-- Name, taxpayer identification number, and place and date of incorporation of Distributor.

2 Jurisdiction.-- Identify the District Office that will have audit jurisdiction over the return of Distributor (referred to below as "taxpayer"). State whether, to the best knowledge of the taxpayer and the taxpayer's representatives, if any, the identical issue is in a return of the taxpayer (or of a related taxpayer within the meaning of section 267 of the Code, or a member of an affiliated group of which the taxpayer is also a member within the meaning of section 1504) and, if so, whether the issue (1) is being examined by a District Director, (2) has been examined by a District Director and (a) the

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statutory period of limitation either on assessment or for filing a claim for refund or credit of tax has not expired and (b) a closing agreement covering the issue or liability has not been entered into by a District Director, (3) is being considered by an Appeals Office in connection with the taxpayer's return for an earlier period, (4) has been considered by an Appeals Office and (a) the statutory period of limitation either on assessment or for filing a claim for refund or credit of tax has not expired and (b) a closing agreement covering the issue or liability has not been entered into by an Appeals Office, or (5) is pending in litigation in a case involving the taxpayer or a related taxpayer. The request must contain a statement whether, to the best knowledge of the taxpayer and the taxpayer's representatives, the identical or a similar issue has been (i) submitted to the Service, but withdrawn before a ruling was issued, or (ii) ruled on by the Service to the taxpayer or the taxpayer's predecessor and, if so, when and with what result. If, after the request is filed but before a ruling is issued, the taxpayer knows that an examination of the issue by a District Director has been started, the taxpayer must notify the National Office of this action. If a return is filed before a ruling is received from the National Office concerning the issue that is the subject of the request for ruling, a copy of the request must be attached to the return. This alerts the District Office and avoids premature District action on the issue.

3 Business.-- Provide the following information about the Distributor: (i) a brief description of its businesses, (ii) its overall method of accounting, and (iii) its tax year.

4 Description of Distributor's capital structure and ownership of Distributor's stock.

a Description of capital structure.-- Furnish a complete description of each class of Distributor's outstanding stock (or other evidence of equity ownership) setting forth the rights and privileges of each class, including voting or nonvoting rights, dividend and liquidation preferences or limitations, and whether classified as common or preferred stock. Also describe all other outstanding interests (bonds, debentures, notes, warrants, options, etc.), and briefly explain why each of these items should or should not be considered a stock interest.

b Ownership of stock.-- State the total number of shares outstanding for each class of stock (or other equity) in Distributor, and the number of shares and percentage of each class of stock (or other equity) owned by each shareholder. However, if there are more than 25 shareholders, the statement in the preceding sentence may be limited by listing only those shareholders owning, directly or indirectly (within the meaning of section 318 of the Code), 5 percent or more of any class of stock and then stating the total number of remaining shareholders together with the total number of shares and percentages which these remaining shareholders own of each class of stock. State whether 80 percent or more of the voting power and stock in Distributor (within the meaning of section 332(b)(1) is held by a corporate shareholder (see section 337(c) of the Code and *section 1.1502-34 of the Income Tax Regulations*).

5 Filing status.-- State whether Distributor is a member of an affiliated group of corporations making a consolidated return and, if so, identify the common parent of the group.

.02 Information regarding plan of liquidation.

1 The plan of liquidation.

a Formal plan.-- State whether the plan has been, or will be, adopted by Distributor's directors and shareholders and give the date, or expected date, of approval or adoption. See *Rev. Rul. 57-140, 1957-1 C.B. 118*.

b Prior informal plan.-- Furnish any information which indicates that a plan of liquidation may have been informally adopted prior to the date set forth in 4.021(a) above. The information is not restricted to, but might include, facts indicating an informal agreement to liquidate by a significant number of shareholders, or the sale or distribution of a substantial portion of Distributor's assets prior to the formal date of adoption of the plan. See section 1.337-2(b) of the regulations and *Rev. Rul. 65-235, 1965-2 C.B. 88*. Describe any distributions to Distributor's shareholders during the 2-year period prior to the adoption of the plan of liquidation. State whether Distributor sold or otherwise disposed of any assets at a loss for federal income tax purposes, other than in the ordinary course of business, within the 2-year period preceding the date of adoption of the plan of liquidation. If so, furnish details, including the cost basis of each item and the amount for which each item was sold. If no sale or distribution of Distributor's assets has occurred, submit the following REPRESENTATION: *During the 2-year period prior to the adoption of the plan of liquidation, Distributor will not have sold any of its property of the type defined in section 337(b) of the Code, except in the ordinary course of business.*

c Rescission of a prior plan.-- State whether Distributor has ever adopted a plan of liquidation and, if so, provide full particulars regarding the abandonment or rescission of the plan. In this regard, indicate when Form 966, *Corporate Dissolution or Liquidation*, was filed in connection with the adoption of the plan, and provide pertinent dates and reasons for abandoning or rescinding the prior plan. If no prior plans were adopted submit the following REPRESENTATION: *No formal or informal plan of liquidation has ever been adopted by Distributor, except for the present plan which was [or will be] adopted on [date].*

2 Liquidation of Distributor's subsidiary.-- State whether any subsidiary of Distributor was, or will be, liquidated in connection with the liquidation of Distributor. If so, submit details. If a ruling is requested that such liquidation will qualify under section 332 of the Code, see *Rev. Proc. 81-68, 1981-2 C.B. 723*.

3 Sales or other dispositions of assets pursuant to the plan.

a Sales pursuant to the plan.

1 General description.-- Describe the assets to be sold pursuant to the plan of liquidation and the consideration to be received for the assets. If a sales agreement has not yet been entered into, approximate the assets to be sold and the

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consideration to be received (if reasonably possible to do so). For sales pursuant to the plan, submit copies of sales contracts (or agreements in principal regarding these sales). State whether sales contracts are executory, contingent, or consummated.

A Stock in trade.-- Briefly describe the stock in trade or inventory (as defined in section 1.337-3(a) of the regulations) of Distributor, and state whether it will be sold. If substantially all the stock in trade or inventory of Distributor will be sold to one person in one transaction, furnish details concerning this sale. See section 337(b) of the Code and section 1.337-3 of the regulations.

B Covenants not to compete.-- If consideration is being received by Distributor or its shareholders for an agreement not to compete, provide full details concerning the agreement and the reporting of proceeds.

2 Method of payment.-- State the expected method of payment of the assets being sold. Summarize all pertinent portions of existing sales contracts (or agreements in principal regarding sales) relating to the method of payment.

3 Information regarding each purchaser of Distributor's assets (Purchaser).-- Identify each Purchaser, if known, and indicate whether Purchaser is an individual, partnership, corporation, or other entity. State whether there was, or will be, any transfer or sale of Distributor's assets to an entity that is wholly or partly owned by Distributor or Distributor's shareholders. If so, furnish full details concerning the transaction, including the type and percentage of the ownership interests involved. In this regard, note that section 4.0117 of *Rev. Proc. 86-3* indicates the Service will not ordinarily issue rulings on the application of section 337 of the Code to a corporation upon the sale of property (in connection with its liquidation) to another corporation, where more than a nominal amount of the stock (that is, more than 20 percent in value) of both the selling corporation and the purchasing corporation are owned by the same shareholders. Submit the following REPRESENTATION: *The liquidation of Distributor will not be preceded or followed by the reincorporation in, or transfer or sale to, a recipient corporation (Recipient) of any of the business or assets of Distributor, if persons holding more than 20 percent in value of the stock in Distributor also hold more than 20 percent in value of the stock in Recipient. For purposes of this representation, ownership has been determined by application of the constructive ownership rules of section 318, as modified by section 304(c)(3). Compare Rev. Ruls. 84-2, 1984-1 C.B. 92, and 61-156, 1961-2 C.B. 62.*

b Other dispositions of assets pursuant to the plan.-- Describe any other disposition of assets (for example, involuntary conversions), which will occur during the prescribed liquidation period, which the Distributor intends to treat as sales or exchanges pursuant to section 337 of the Code. Furnish complete details concerning these items.

4 Distribution of assets.

a Assets distributed directly to shareholders.

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1 Description of assets.-- Describe the assets to be distributed directly to Distributor's shareholders.

2 Dates.-- Indicate when this distribution will be made.

b Assets distributed to an escrow or partnership on the liquidation of Distributor.

1 Description of assets.-- Describe the assets to be distributed to the escrow or partnership.

2 Description of escrow or partnership.-- Fully describe any escrow or partnership, including its partners and operation, receiving assets on Distributor's liquidation.

3 Dates.-- Indicate when this distribution will be made.

c Assets distributed to a liquidating trust.-- State whether the plan of liquidation requires the use of a liquidating trust, or if the use of a liquidating trust is otherwise contemplated. See *Rev. Ruls. 80-150, 1980-1 C.B. 316, and 72-137, 1972-1 C.B. 101*.

1 Description of assets.-- Describe the assets to be distributed to the liquidating trust.

2 The trust.-- Describe whether the use of the trust is permitted under applicable law, the powers and identity of the trustee, and the time period during which the trust will remain in existence.

3 Dates.-- Indicate when this distribution will be made.

4 Reasons.-- Give the reasons for using a liquidating trust.

5 Classification of the trust.-- In issuing a ruling under sections 331 and 337 of the Code in a situation where a liquidating trust is used, it is the practice of the Service to state in the ruling letter that the ruling is valid only if the trust

is not an association taxable as a corporation under section 301.7701 of the Procedure and Administration Regulations. However, if Distributor desires a ruling concerning the classification of the trust under section 301.7701, the ruling request should so indicate and it should include an additional copy of the entire ruling request. See *Rev. Proc. 82-58, 1982-2 C.B. 847*.

5 Assets retained.

a Description of assets.-- Fully describe any assets to be retained by Distributor subsequent to the 12-month period beginning on the date of adoption of the plan of liquidation. See section 1.337-2(b) of the regulations. If no assets will be retained, submit the following REPRESENTATION: *All assets of Distributor will be distributed in complete liquidation of Distributor within the 12-month period beginning on the date of adoption of the plan of liquidation.*

b Reason for retention.-- If assets will be retained beyond the 12-month period, set forth the reasons for their retention. Specifically, state whether any assets will be retained to satisfy claims of any shareholders with respect to their stock.

c Description of claims.-- Describe the claims to be satisfied with the retained assets.

d Period of retention.-- State whether the balance of the assets retained will be distributed as soon as all claims are satisfied.

6 Redemption and cancellation of Distributor's stock.

a Redemption of all stock.-- State whether all the outstanding stock of Distributor will be redeemed and cancelled.

b Non pro rata redemption.-- If the property to be used in redemption of Distributor's stock will not be distributed in exact proportion with the percentage of shares owned by each shareholder, submit reasons and details. See *Rev. Rul. 79-10, 1979-1 C.B. 140*.

c Shareholder and Distributor in dual capacity.-- Submit the following REPRESENTATION: *No part of the consideration to be received by any shareholder of Distributor will be received by the shareholder as a creditor, employee, or in some capacity other than that of a shareholder of Distributor.*

7 Status of liquidation.

a Status.-- Submit the following REPRESENTATION: *Pursuant to the plan of complete liquidation, Distributor will cease to be a going concern and its activities will be limited to the winding up of its affairs, paying its debts, and distributing any balance of its assets to its shareholders.* (See Rev. Rul. 60-50, 1960-1 C.B. 150.) If there is more than one liquidating distribution, furnish the following REPRESENTATION: *The status of liquidation will exist at the time of the first liquidating distribution and will continue until the final liquidating distribution is made.*

b Fair market value of assets.-- Submit the following REPRESENTATION: *The fair market value of Distributor's assets will exceed its liabilities both on the date of adoption of the plan of liquidation and at the time the first liquidating distribution is made.*

c Corporate charter.-- State whether Distributor intends to abandon its corporate charter. See Rev. Ruls. 60-50, 1961-1 C.B. 150, and 54-518, 1954-2 C.B. 142.

.03 *Recognition of gain or income to Distributor.* In order to determine whether gain or income will be recognized to Distributor upon the distribution of property, submit statements or representations with respect to the following:

1 Unreported or anticipatory assignment of income.-- State whether Distributor has any assets which represent earned but unreported income to Distributor, such as receivables being reported on a such basis, unfinished construction contracts, commissions due, or other similar assets. If Distributor has any assets representing earned but unreported income, state whether Distributor will distribute these assets to its shareholders or dispose of them in some other manner. If none of these assets are being distributed, submit the following REPRESENTATION: *No distribution of assets representing earned but unreported income will be made by Distributor to its shareholders in the liquidation.*

2 Reserve for bad debts.-- Submit the following REPRESENTATION: *Distributor does [or does not] maintain a reserve for bad debts.* See Rev. Rul. 78-279, 1978-2 C.B. 135.

3 Installment obligations and recapture provisions.-- State whether Distributor is selling, distributing to its shareholders, or otherwise disposing of (i) any installment obligations (section 453B of the Code), (ii) any property described in the recapture provisions of the Code including, but not limited to, sections 47, 291(a), 337(f), 341(f), 617(d), 897(d), 904(f), 1245(a), 1248(f), 1250(c), 1252(a), 1254, or 1255, (iii) any property for which the taxpayer obtained a deduction (see *Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1982); Rev. Rul. 74-396, 1974-2 C.B. 106; Rev. Rul. 61-214, 1961-2 C.B. 60), or (iv) any property described in sections 1256 or 1276. If installment obligations will be distributed, describe the nature and terms of the obligations. State how the shareholders intend to treat payments received on the installment obligations. State the effect of sections 453(h) and 453B(d)(2) of the Code on

Distributor's distribution.

4 Partnership interests.-- State whether Distributor will distribute to the shareholders any partnership interests representing property specified in sections 4.031, 4.032, or 4.033, above. See section 386 of the Code.

5 Advance payments.-- State whether Distributor has any items constituting prepaid subscription income, prepaid dues income, advance payments for goods, or payments received for services to be performed in the future. See sections 455 and 456 of the Code, *section 1.451-5 of the regulations*, and *Rev. Proc. 71-21, 1971-2 C.B. 549*.

.04 *General*

1 Other transactions.-- Submit the following REPRESENTATION: *The liquidating distribution(s) described in this ruling request is an isolated transaction and is not related to any other past or future transaction*. Alternatively, state whether there have been, or will be, any related transactions and, if so, briefly describe these other transactions and fully explain their relationship to, and impact on, the present transaction. See section 9.06 of Rev. Proc.

2 Financial statements.-- Submit a copy of the most recent balance sheet of Distributor.

3 Copy of plan.-- Submit a copy of the plan of liquidation adopted or to be adopted.

4 Collapsible corporation.-- In issuing a ruling under sections 331 and 337 of the Code, it is the practice of the Service to state in the ruling letter that the ruling under section 331 is valid only if section 341(a) is not applicable and that the ruling under section 337 is valid only if Distributor is not a collapsible corporation as defined in section 341(b) (or is not considered a collapsible corporation pursuant to section 341(e)(4)). See *Rev. Proc. 86-3, 1986-1 I.R.B. 26*, section 4.0117.

5 Section 333 of the Code.-- Submit the following REPRESENTATION: *The shareholders of Distributor will not elect to have section 333 of the Code apply to this liquidation*. See section 337(c)(1)(B).

6 Applicability of merger statutes.-- State whether the liquidation of Distributor will be carried out by the use of a statutory merger.

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7 Additional statements.-- See *Rev. Proc. 86-1* for additional information and statements that must be submitted with all ruling requests, including statements required under sections 9.02 and 9.09 (relating to instructions to taxpayers).

8 Requested Rulings.-- List the rulings being requested in the exact wording desired, and provide statutory, regulatory, or other authority for their issuance.

9 Taxpayer's memorandum.-- Submit the information required by section 9.08 of *Rev. Proc. 86-1* (relating to relevant authorities regarding the tax results of the transaction).



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Taxation of Securities Transactions

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APPENDIX H: Revenue Procedure 86-16

Checklist of information to be included in request for ruling under IRC Section 331 and 337
SECTIONS 331 and 337 CHECKLIST QUESTIONNAIRE

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5 INQUIRIES

Inquiries in regard to this revenue procedure should refer to its number and should be addressed to the Associate Chief Counsel (Technical), Attention: CC:C:R, Internal Revenue Service, Washington, D.C. 20224.



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APPENDIX H: Revenue Procedure 86-16

Checklist of information to be included in request for ruling under IRC Section 331 and 337
SECTIONS 331 and 337 CHECKLIST QUESTIONNAIRE

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6 EFFECT ON OTHER DOCUMENTS

Rev. Proc. 81-52 is superseded.



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APPENDIX I: Revenue Ruling 93-76

2-I Taxation of Securities Transactions APPENDIX I:.syn

§ I.syn Synopsis to Appendix I: Revenue Ruling 93-76

475 MARK TO MARKET ACCOUNTING METHOD FOR DEALERS IN SECURITIES



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Taxation of Securities Transactions

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APPENDIX I: Revenue Ruling 93-76

Guidelines for application of IRC Section 475

(Rev. Rul. 93-76, 1993-2 C.B. 235 as modified and clarified by Rev. Rul. 94-7, 1994-1 CB 151, and clarified, modified, partially obsoleted, and superseded by Rev. Rul. 97-39, 1997-2 C.B. 62)

2-I Taxation of Securities Transactions 475

475 MARK TO MARKET ACCOUNTING METHOD FOR DEALERS IN SECURITIES

Mark-to-market accounting method for dealers in securities. This ruling provides guidance to enable taxpayers to comply with the mark-to-market requirements of section 475 of the Code. *Rev. Ruls. 94-7 and 93-76* clarified, modified, partially obsoleted, and superseded.

Rev. Rul. 97-39

PURPOSE

This revenue ruling provides guidance under *section 475 of the Internal Revenue Code* to enable taxpayers to comply with the mark-to-market requirements of section 475. *Rev. Rul. 93-76, 1993-2 C.B. 235* (which was previously modified by *Rev. Rul. 94-7, 1994-1 C.B. 151*), is clarified, modified, partially obsoleted, and superseded.

LAW

Section 475 of the Code was enacted on August 10, 1993, in the Omnibus Budget Reconciliation Act of 1993 (the "1993 Act"), section 13223, 1993-3 C.B. 1, 69. It requires mark-to-market accounting treatment for certain securities held by a "dealer in securities" as defined in section 475(c)(1). This requirement is effective for all taxable years ending on or after December 31, 1993. Section 475 was amended on August 5, 1997, in the Taxpayer Relief Act of 1997 (the "1997 Act"), section 1001(b) (redesignating old section 475(e) as section 475(g) and adding new section 475(e) and (f) to allow dealers in commodities and traders in securities and commodities to elect mark-to-market accounting, effective for taxable years ending after August 5, 1997). This revenue ruling is limited to issues arising under the 1993 Act and does not address issues arising under the 1997 Act.

Section 475(a) sets forth two mark-to-market rules. First, any security that is inventory in the hands of a dealer must be included in inventory at its fair market value. Second, any security that is not inventory in the hands of a dealer and that

is held at the close of any taxable year is treated as sold by the dealer for its fair market value on the last business day of that taxable year, and any gain or loss is required to be taken into account for that taxable year.

Section 475(b)(1) provides that the mark-to-market rules do not apply to: (1) any security held for investment; (2) any evidence of indebtedness that is acquired (including originated), or any obligation to acquire an evidence of indebtedness that is entered into, by a dealer in the ordinary course of its trade or business, but only if the evidence of indebtedness or obligation to acquire an evidence of indebtedness is not held for sale; (3) any security that is a hedge with respect to a security that is not subject to the mark-to-market rules; and (4) any security that is a hedge of a position, right to income, or liability that is not a security in the hands of the taxpayer. Under section 475(b)(2), a security must be clearly identified in the dealer's records as being covered by one of the exceptions described in section 475(b)(1) before the close of the day on which the dealer acquired, originated, or entered into the security.

In addition to the identification requirements in section 475(b), section 475(c)(2)(F)(iii) requires a dealer in securities to identify a position that is not a security described in section 475(c)(2)(A)-(E), but that is treated as a security because it is a hedge with respect to such a security.

ISSUES AND HOLDINGS

Issue 1: If a taxpayer is not otherwise a dealer in securities within the meaning of section 475(c)(1) but, nevertheless, timely identifies all of its securities as being covered by one of the exceptions in section 475(b)(1), does that "protective identification" cause the taxpayer to be treated as a dealer?

Holding 1: No. A taxpayer that is not a dealer in securities within the meaning of section 475(c)(1) does not become a dealer in securities or create an inference that it is a dealer in securities by making a protective identification of its securities.

Issue 2: Is a bank or an insurance company excepted from the mark-to-market rules on the grounds that it is, per se, not a dealer in securities within the meaning of section 475(c)(1)?

Holding 2: No. A bank or an insurance company is subject to the mark-to-market rules if its activities bring it within the definition of a dealer in securities in section 475(c)(1). For example, many banks are dealers because they regularly originate and sell loans. As another example, an insurance company that regularly makes and sells policyholder loans is a dealer for purposes of section 475.

Issue 3: If a taxpayer's sole business consists of trading in securities (that is, the taxpayer does not purchase from, sell to, or otherwise enter into transactions with customers), is the taxpayer a dealer in securities within the meaning of section 475(c)?

Holding 3: No. A taxpayer whose sole business consists of trading in securities is not a dealer in securities within the meaning of section 475(c) because that taxpayer does not purchase from, sell to, or enter into transactions with, customers in the ordinary course of a trade or business.

Issue 4: Does the classification of a security under financial accounting principles, including FASB Statement No. 115 (Accounting for Certain Investments in Debt and Equity Securities), determine whether the security qualifies for one of the exceptions to the mark-to-market rules under section 475(b)(1)?

Holding 4: No. The classification of a security under financial accounting principles is not dispositive of the treatment of the security for federal income tax purposes. For example, for purposes of section 475, a security may in certain cases qualify for the held-for-investment exception to the mark-to-market rules even though, under applicable financial accounting principles, the security is classified as available for sale.

Issue 5: Does an identification of a security as "held for investment" under section 1236 serve to identify that security as "held for investment" (within the meaning of section 475(b)(1)(A)) or as "not held for sale" (within the meaning of section 475(b)(1)(B))?

Holding 5: No. Taxpayers may choose not to identify under section 475(b)(2) some or all of the securities that they identify under section 1236(a)(1). (For a transitional rule applicable to securities held as of the close of the last taxable year ending before December 31, 1993, however, see *section 1.475(b)-4(a) of the Income Tax Regulations*.) Accordingly, even if a section 1236 identification has been made, an identification of a security or hedge is a valid identification for purposes of section 475(b)(2) only if it contains a specific reference to section 475; this specific reference, however, may be effected by any reasonable method. For instance, certain accounts may be identified in such a way that placing a security or hedge in the account identifies the security or hedge for purposes of both section 1236(a)(1) and section 475(b)(1)(A), (B), or (C). See Holding 6 below. See Holding 15 below for a transitional rule that requires less specificity for identification of securities held by certain taxpayers that were not dealers in securities under section 1.475(c)-1T (as contained in 26 CFR part 1 revised April 1, 1996).

Issue 6: Is a dealer in securities required to use a special procedure to comply with the identification requirements under section 475?

Holding 6: No. Unless the Commissioner otherwise prescribes, a dealer may comply with the identification requirements under section 475 using any reasonable method (see, for example, guidance concerning identification requirements under sections 988(a)(1)(B), 1221, 1236(a)(1), and 1256(e)(2)(C)). The identification, however, must be made on, and retained as part of, the dealer's books and records. The dealer's books and records must clearly indicate the specific security or hedge being identified, and the identification must clearly indicate that it is being made for purposes of section 475. Alternatively, the dealer may identify specific accounts as containing only securities or hedges that are covered by a particular exception, so that placing a security or hedge in the account identifies the security or hedge as being covered by that exception. Under section 1.475(b)-2(a), an identification need not distinguish between an exception under section 475(b)(1)(A) (concerning certain securities held for investment) and one under section 475(b)(1)(B) (concerning securities not held for sale). Exceptions under either of these provisions, however, must be distinguished from exceptions under section 475(b)(1)(C) (concerning securities held as hedges).

In addition, rather than identifying specific securities or accounts as being covered by an exception described in section 475(b)(1), a dealer may comply with the identification requirement under section 475(b) by clearly indicating the specific securities or accounts that are not covered by a particular exception (that is, indicating that they are covered by some other exception or that they are not exempt) and identifying all other securities or accounts as being covered by a particular exception.

For example, a dealer may place on its books and records a statement that, unless otherwise identified, all of its securities for which an identification is still timely (including securities yet to be acquired) are identified as exempt under either section 475(b)(1)(A) or (B). This statement is effective to identify under section 475(b)(1)(A) or (B) each security covered by its terms unless, before the expiration of the period during which the security may be timely identified, the dealer identifies it as not exempt or as exempt under section 475(b)(1)(C).

Analogously, under *Rev. Rul. 64-160, 1964-1* (Part I) C.B. 306, modified by *Rev. Rul. 76-489, 1976-2* C.B. 250, dealers can identify specified accounts as containing only securities held for investment for purposes of section 1236(a)(1). Accordingly, dealers can satisfy the identification requirements of section 475(b)(2) by unambiguously indicating that all of the securities in one or more of these accounts are also described, for example, in section 475(b)(1)(A) or (B). Once such an identification of an account is made, placing a security in the account identifies the security not only as being "held for investment" for purposes of section 1236 but also as being described in the applicable subparagraph of section 475(b)(1).

Issue 7 in *Rev. Rul. 93-76* concerned transitional identification issues for securities acquired, originated, or entered into between August 10, 1993, and October 31, 1993. As the transition period has now ended, *Issue 7* is obsolete and is not reprinted in this revenue ruling.

Issue 8: If a dealer in securities originates or acquires an evidence of indebtedness in the ordinary course of a trade or business, are there any exceptions to the requirement that the dealer make an identification under section 475(b)(2) before the close of the day on which it originates or acquires the security?

Holding 8: Yes. Pending further guidance, if a financial institution (as defined in section 265(b)(5)) originates or acquires an evidence of indebtedness in the ordinary course of a trade or business, an identification of the evidence of indebtedness is timely if it is made in accordance with the dealer's accounting practice, but no later than 30 calendar days after the date of origination, or acquisition, by the financial institution. The preceding sentence applies to any dealer in securities for evidences of indebtedness that are mortgage loans.

Also, pending further guidance, a dealer in securities that enters into commitments to acquire mortgage loans may identify those commitments as being held for investment if the dealer acquires the mortgage loans and holds the mortgages as investments. This identification of commitments to acquire mortgage loans must be made in accordance with the dealer's accounting practice, but no later than 30 calendar days after the date of acquisition of the mortgage loans.

Issues 9, 10, and 11 discussed transitional issues concerning proper identification, computation of adjustments, and the period over which to spread any adjustments, for taxable years that included December 31, 1993. As the transition period has now passed, *Issues 9, 10, and 11* are obsolete and are not reprinted in this revenue ruling.

Issue 12: May a taxpayer use an amended return to make an election under section 1.475(c)-1(c)(1)(ii) (which concerns taxpayers that purchase securities from customers but make no more than negligible sales of securities)?

Holding 12: For any taxable year for which an original federal income tax return is filed after October 31, 1997, an election under section 1.475(c)-1(c)(1)(ii) must be made on an original federal income tax return that is filed on or before the due date (including any extensions of time) for that return. For any taxable year for which an original federal income tax return was filed on or before October 31, 1997, an election under section 1.475(c)-1(c)(1)(ii) also may be made on an amended return filed not later than October 31, 1997. Not later than December 15, 1997, compliance with section 475 must be reflected on an original or amended return for every other taxable year which is subject to the election and the original return for which is due on or before October 31, 1997. Note that amended returns must be filed before the expiration of the statute of limitations on assessment under section 6501(a).

As is noted in *Holding 17* below, a taxpayer subject to more than one exemption must affirmatively elect out of all applicable exemptions to be treated as a dealer in securities.

Issue 13: If a taxpayer wishes to use an amended return to make an election out of the customer paper exemption under section 1.475(c)-1(b)(4)(i)(B), by what date must the taxpayer file the amended return?

Holding 13: Section 1.475(c)-1(b)(4)(i)(B) provides a June 23, 1997, deadline to make the customer paper election on an amended return. *Notice 97-37, 1997-27 I.R.B. 8*, provides that additional guidance will extend that deadline. Accordingly, that deadline to file an amended return is extended to October 31, 1997. Not later than December 15, 1997, compliance with section 475 must be reflected on an original or amended return for every other taxable year which is subject to the election and the original return for which is due on or before October 31, 1997. Note that amended returns must be filed before the expiration of the statute of limitations on assessment under section 6501(a).

Issue 14: What is the general rule for identifying a security as excepted from mark-to-market accounting?

Holding 14: For a security to be exempt from mark-to-market accounting, the taxpayer must make an identification that is timely under section 475(b)(2), which generally requires a security to be identified before the close of the day on which it is acquired. For the only current exceptions to this rule, see Holding 8 above (identifications of securities by financial institutions and dealers in mortgages), section 1.475(b)-1(b)(4)(ii)(A) (identification of securities to which section 1.475(b)-1(b)(1) ceases to apply), and Holding 15 below (special identification rules for taxpayers not treated as dealers under section 1.475(c)-1T). For information about the required specificity of the identification, see Holding 5 above.

Issue 15: If a taxpayer makes an election out of either section 1.475(c)-1(b)(1) (customer paper exemption) or section 1.475(c)-1(c)(1) (negligible sales exemption) and the election has the effect of causing the taxpayer to be treated as a dealer in securities for a taxable year starting before the date the taxpayer filed the documentation effecting the election (date of the election), how does the taxpayer identify securities that were acquired before the date of the election?

Holding 15: A special identification regime applies to taxpayers that satisfy the following criteria:

First, the taxpayer is making an election out of the customer paper exemption, the negligible sales exemption, or both.

Second, the taxpayer was not treated as a dealer in securities under section 1.475(c)-1T (as contained in 26 CFR part 1 revised April 1, 1996).

The special identification regime applies only to securities ("transition securities") for which an identification would have been timely under the general rule (described in Holding 14 above) only if made on or before October 31, 1997. In applying the preceding sentence, a taxpayer may choose to substitute any earlier date that is on or after December 24, 1996. To make this substitution, the taxpayer must place in its books and records no later than October 31, 1997, an unambiguous statement that the taxpayer chooses to apply the general identification rule described in Holding 14 for all securities acquired on or after the specific date selected by the taxpayer.

Under the special identification regime, a transition security was properly identified as exempt for the purposes of section 475(b)(2) or (c)(2)(F)(iii) if the information that is contained in the taxpayer's books and records and that was entered substantially contemporaneously with the date of acquisition of the transition security supports a conclusion that the transition security was described by section 475(b)(1)(A), (B), or (C). This rule applies even if the information in the books and records does not meet the specificity that Holding 5 generally requires for identification. The status of a transition security that was acquired before the first day of the taxable year for which the election is being made is determined by examining the books and records as of the last day of the preceding taxable year.

The taxpayer must, by October 31, 1997, place in its books and records a statement resolving ambiguities, if any, concerning which transition securities are properly identified within the meaning of the preceding paragraph. Any information that supports treating a transition security as being described in section 475(b)(2) or (c)(2)(F)(iii) must be applied consistently.

A taxpayer, in determining whether a transition security must be identified, must apply the following principles: if the transition security was identified under section 1.1221-2 or section 1256(e) and the item being hedged is described in section 475(b)(1)(C)(i) or (ii), the section 1.1221-2 or section 1256(e) identification constitutes an identification for purposes of section 475(b)(2); and, if the item being hedged was ordinary property, as defined in section 1.1221-2, and the taxpayer did not identify the transition security as a hedging transaction, the transition security cannot be identified under section 475(b)(1)(C).

If a taxpayer made a protective identification (as described in Issue 1 above) of a transition security, and subsequent to

the protective identification the taxpayer makes an election that causes the taxpayer to be a dealer in securities for purposes of section 475, the protective identification is recognized and the taxpayer is subject to the general rules governing identifications for all transition securities that were eligible to be timely identified after the date that the taxpayer began making protective identifications. Thus, if a transition security was properly and timely identified as exempt from being marked to market and remains eligible for the exemption claimed, that transition security is not marked to market even though section 475 applies to the taxpayer. If a transition security was properly and timely identified and thereafter ceases to be held for investment or as a hedge, see section 475(b)(3). If a transition security was not eligible to be identified as exempt, see section 475(d)(2).

Issue 16: If an issuer of an evidence of indebtedness has the right to prepay at any time without a penalty (for example, a revolving credit card balance), does that right preclude that indebtedness from having a fair market value that is greater than the face value of the obligation?

Holding 16: No. Securities must be marked to fair market value based on all the facts and circumstances. For example, in light of contractual interest rates and general payment history on customer obligations, the fair market value of a customer obligation may be greater than the face amount, even if the customer has the right to repay the debt at its face amount at any time.

Issue 17: If a taxpayer would meet the definition of a dealer in securities under section 475 but otherwise satisfies more than one exemption from dealer status, must the taxpayer elect out of all applicable exemptions to be a dealer in securities for the purpose of section 475?

Holding 17: Generally, a taxpayer must make an election out of all applicable exemptions in order to be treated as a dealer under section 475. A taxpayer subject to multiple exemptions from section 475 must file all the documentation required to elect out of each applicable exemption. Sometimes, the documentation required for one election satisfies all of the filing requirements for another election. For example, if a taxpayer is subject to both the customer paper exemption under section 1.475(c)-1(b) and the negligible sales exemption under section 1.475(c)-1(c), the taxpayer may make an election under section 1.475(c)-1(b)(4) that is effective as of January 1, 1993, and timely file an amended 1993 federal income tax return using mark-to-market accounting for securities. The amended 1993 return itself represents an election out of the negligible sales exemption.

Issue 18: How does a taxpayer that is in its first year of existence elect out of an exemption from dealer status under section 475?

Holding 18: If a taxpayer decides for its first year of existence to make an election out of the negligible sales exemption to account for securities on a mark-to-market basis, the taxpayer should attach to its original return for that first year the following statement: "[Insert name and taxpayer identification number of the taxpayer] hereby elects not to be governed by section 1.475(c)-1(c)(1)(i) of the income tax regulations for the taxable year ending [describe the last day of the year] and for subsequent taxable years." If a taxpayer decides for its first year of existence to make an election out of the customer paper exemption or to make the intragroup-customer election, the taxpayer must meet the requirements of section 1.475(c)-1.

Issue 19: Which changes of accounting method are covered by the consent provisions of section 13223(c)(2) of the 1993 Act?

Holding 19: Under section 13223(c)(2) of the 1993 Act, certain changes of accounting method are treated as made with the consent of the Commissioner. This treatment extends only to a change in method that was effected by a taxpayer who (1) became a dealer for the taxable year that includes December 31, 1993, merely by virtue of the passage of the 1993 Act, and (2) who accounted for securities as a dealer under section 475 on its original federal income tax return for that year. Consent for other changes of method to comply with section 475 must be obtained either on a

taxpayer-by-taxpayer basis or as part of automatic consent contained in published guidance. See *Rev. Proc. 97-43*, page 12, this Bulletin.

Issue 20: If a taxpayer is accounting for securities by marking them to market under section 475(a), may the taxpayer, without the consent of the Commissioner, file a federal income tax return for a later taxable year that does not account for securities on a mark-to-market basis?

Holding 20: No. Once a taxpayer has used the section 475 mark-to-market method as its method of accounting for securities, the taxpayer may not change that method of accounting without obtaining the consent of the Commissioner. See section 446(e). Unless the Commissioner otherwise prescribes, to request consent the taxpayer must comply with the requirements of *Rev. Proc. 97-27*, 1997- 21 *I.R.B. 10*. For example, if a taxpayer accounts for securities by marking them to market because the taxpayer made more than negligible sales of securities and in a later year makes only negligible sales of securities, the taxpayer must obtain the consent of the Commissioner to change its method of accounting for securities. If a taxpayer made no more than negligible sales of securities but, pursuant to section 1.475(c)-1(c)(1)(ii), accounted for securities on a mark-to-market basis and the taxpayer makes no more than negligible sales of securities in a subsequent year, the taxpayer must obtain the consent of the Commissioner to change its method of accounting for securities. Especially in the latter example, consent for the change will be granted only in unusual circumstances.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 93-76 as modified by *Rev. Rul. 94-7*, is clarified, modified, partially obsoleted, and superseded. *Notice 97- 37*, 1997-27 *I.R.B. 8*, is obsoleted.

PROSPECTIVE APPLICATION

Pursuant to section 7805(b), if an identification is made on or before June 30, 1997, and the identification complies with the requirements set forth in the third paragraph of Holding 6 of *Rev. Rul. 93-76*, the identification will not be treated as failing to satisfy the requirements of section 475(b)(2) solely on the grounds that it failed to identify the operative subparagraph of that provision.

PAPERWORK REDUCTION ACT

The collections of information contained in this revenue ruling have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 *U.S.C. 3507*) under control number 1545-1558.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collections of information in this revenue ruling are in sections 26 *CFR 1.475(b)-2*, 26 *CFR 1.475(b)-4*, and 26 *CFR 1.475(c)-1*. This information is required to facilitate the administration of section 475 of the *Internal Revenue Code*. This information will be used to facilitate audits of taxpayers that elect to not be governed by certain exemptions under section 475 of the Code. The collections of information are required to obtain a benefit. The likely respondents are business or other for-profit institutions.

The recordkeeping burden described in Holding 6 was reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 *U.S.C. 3507*) under control number 1545-1496.

The estimated total annual recordkeeping burden described in Holding 15 is 450,000 hours.

The estimated annual burden per recordkeeper varies from 15 hours to 45 hours, depending on individual circumstances, with an estimated average of 22.5 hours. The estimated number of recordkeepers is 20,000.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Pamela Lew and Robert B. Williams of the Office of the Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling contact Ms. Lew at (202) 622-3950 or Mr. Williams at (202) 622-3960 (not toll-free calls).