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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (FINANCIAL SERVICES)
ATTN: CC:LM:FS:

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SUBJECT: Forward Contract – Basis Shifting Tax Shelter Cases

This Chief Counsel Advice responds to your memorandum dated November 19, 2001. In accordance with section 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND

a =
b =
c =

ISSUES

1. Whether, by entering into a forward contract and a collar on Foreign Bank stock as described below, Foreign Corporation, in substance, acquired the shares of Foreign Bank.
2. Assuming that Foreign Corporation acquired ownership of shares of Foreign Bank stock, whether the exercise of the call option on Foreign Bank shares by a subsidiary corporation of Foreign Bank qualifies as a redemption as defined in section 317(b).

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SUMMARY OF CONCLUSIONS

1. By entering into a forward contract and a collar on Foreign Bank stock as described below, Foreign Corporation, in substance, did not acquire the shares of Foreign Bank.
2. Assuming that Foreign Corporation acquired ownership of shares of Foreign Bank stock, the exercise of the call option on Foreign Bank shares by a subsidiary corporation of Foreign Bank does not qualify as a redemption as defined in section 317(b).

FACTS

Notice 2001-45, 2001-33 I.R.B. 120, announced that the Service will challenge transactions identified as section 302 basis shifting tax shelters and disallow the federal income tax benefits purportedly derived from such transactions. Notice 2001-45 provides a brief description of the steps undertaken in the typical section 302 basis shifting tax shelter.¹ This Chief Counsel Advice focuses on two of the several steps involved in the shelter: (1) the purported acquisition of Foreign Bank ("FB") shares by Foreign Corporation ("FC") and (2) the subsequent "redemption" of those shares by FB. Thus, a discussion of the facts relating specifically to these two steps is provided herein.

FC enters into an agreement with FB to purchase a certain number of bearer shares of FB. The terms of the agreement are similar to what would be in a forward contract: FB retains possession of the bearer shares and payment is delayed until some future date ("the settlement date").² As part of this transaction, FC and FB also enter into call and put options.³ Specifically, FC sells to FB a call option on the same number of FB shares allegedly acquired by FC. The call option

¹ See also factual discussion in FSA 200201012 (Oct. 1, 2001); FSA 200202057 (Oct. 11, 2001); and CC-2002-001 (Oct. 19, 2001).

² See the sources cited supra note 1. Although the sources refer to FC's purported acquisition of FB shares as a "loan" or a "leveraged acquisition," certain significant terms of the acquisition agreement described in these sources are the same as or similar to those that would appear in the context of a forward contract, i.e., delivery and payment for a specific quantity of a financial instrument at a specified future date.

³ The November 19, 2001 memorandum describes the put and call options as "matching." That term may be misleading because, as described in the memorandum and herein, the strike prices of the options are not equal. It should be clarified that generally there is a a percent spread between the strike price of the call and the strike price of the put.

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is a European-style option that is exercisable on a single day (the settlement date), and the grantor of the option receives a premium. The strike price of the call is typically set at b percent of the forward contract price. The call option also has a strike price reset feature: if the actual price of the shares falls below the strike price during the holding period, the strike price is adjusted downward to c percent of the forward contract price. In addition, the call has an integrated forward feature: FB is required to pay varying amounts to FC for each day the actual share price exceeds predetermined levels. If at any time the actual share price falls below the reset strike price, FB pays to FC an amount equal to some amount multiplied by the number of days prior to the actual share price falling below the strike reset price. Finally, as part of the agreement, FC purchases from FB, on the same date, a put on the same number of FB shares. The put is also a European-style option exercisable only on the settlement date, and the grantor of the option receives a premium. The strike price of the put is typically set at c percent of the forward contract price.

On the settlement date, FB purportedly exercises the call option on its bearer shares from FC. The November 19, 2001 memorandum indicates, however, that in certain cases, a broker/dealer subsidiary of FB, rather than FB itself or its branch, exercises the call option. The U.S. taxpayer treats this particular transaction as a redemption within the meaning of section 317(b) and then applies section 302 to determine whether the redemption should be treated as a distribution in part or full payment in exchange for stock under section 302(a) or as a distribution of property governed by section 301.

LAW AND ANALYSIS

ISSUE 1: Whether, by entering into a forward contract and a collar on FB stock as described above, FC, in substance, properly acquired the shares of FB stock that were redeemed.

In general, federal income tax consequences are governed by the substance of a transaction. See Gregory v. Helvering, 293 U.S. at 470. A sale has not occurred if the benefits and burdens of ownership have not passed to the purported purchaser. See Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981). Thus, if the benefits and burdens have not passed to FC, FC did not properly acquire ownership of FB stock.

While some facts suggest a sale has occurred, further analysis of the transaction suggests otherwise. Generally, as between FB and FC, FB bears the risk of loss and opportunity for gain. By entering into the put and call options, FC gives up a portion of the opportunity for gain in return for protection from the risk of loss. In exchange for the elimination of risk of loss below the strike price of the put, FC gives up a portion of the opportunity for gain above the strike price of the call. When the price of FB shares exceeds the strike price of the call, FB is able to

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exercise the call and any appreciation of the shares inures to FB. However, the integrated forward feature acts to transfer a portion of the appreciation on the shares back to FC if the share price rises above the levels specified. FC also retains exposure to the risk of loss between the strike price of the call and put. However, when the options are first entered into, the spread of the collar is only a percent of the share price. If the share price falls to the reset strike price (as it generally does in these cases), there is no spread on the collar. Furthermore, since the strike price of the call is below the current price of the shares, FC forfeits some of the opportunity for gain outside the spread. As previously mentioned, FC does have some opportunity for gain outside the spread through the integrated forward feature. Therefore, FB, not FC, bears the risk of loss and the opportunity for gain.

It could also be argued that the parties (FC and FB) do not intend for a sale of the shares to occur. When the options are entered into, the exercise price of the call is below the current price of the shares. The fact that the call is in the money suggests that there may be a high probability that FB will exercise the call and retain ownership of the shares. Furthermore, given the coterminous settlement of the forward contract and the call option, it appears that the parties never intend to transfer the shares to FC.⁴ The transaction appears to have been accomplished through offsetting balance sheet entries.

Although not all the factors point towards the conclusion that the transaction is not, in substance, a sale, the opportunity for gain and risk of loss, the intention of the parties, and the probability that the call will be exercised, support the conclusion that FC never purchased the shares from FB.

There is support for an argument that a collar on shares acts to transfer ownership of those shares. See Penn-Dixie Steel Corp. v. Commissioner, 69 T.C. 837 (1978); Rev. Rul. 72-543, 1972-2 C.B. 87. In Penn-Dixie Steel Corp., the taxpayer sought to treat a collar transaction as a sale, in part, because the possibility that a put and call would not be exercised was so remote that it should be ignored. The taxpayer had purchased stock and then sold a put and bought a call on the stock. The court disagreed with the taxpayer but assumed, without deciding, that there may have been a different result had the put and call both been exercisable and expired on the same date. The court also indicated that if the terms of the put and call had been shorter the result may have been different. See Penn-Dixie Steel Corp., 69 T.C. at 844. FC's put and call are very short term and are both exercisable on the same date. Based on Penn-Dixie Steel Corp., by entering into the collar before purchasing the FB shares, FC, in substance, never

⁴ The November 19, 2001 memorandum, at the top of page 6, suggests that the retention of possession of shares by FB necessarily equates to FB continuing as owner of the shares. Possession does not equate to ownership, though it may be a factor that courts would consider.

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acquires ownership of the shares.⁵ The collar negates any ownership acquired through the purchase of the shares.

Furthermore, a purported put option on stock may be treated as a sale of the stock when the option is certain to be exercised based on the economics of the option. Rev. Rul. 85-87, 1985-1 C.B. 268, treats a taxpayer that sold a significantly in-the-money put as entering into a contract to buy the shares. The revenue ruling determined there was no substantial likelihood the put would not be exercised based on the term of the put, the premium paid, the historic volatility in the value of the stock, and the difference between the strike price of the put and the price of the shares at the time the put was entered into. Here FC sells an in-the-money call, which, following the reasoning of Rev. Rul. 85-87, arguably may be equivalent to a contract to sell the shares. Therefore, it could be argued that FC enters into a contract to sell the shares before they are purchased from FB. Had FC owned the shares, the transaction could be argued to be a sale of the shares. Since FC does not own the shares when the call option is sold, FC can be viewed as never having acquired the shares. Alternatively, FB buys an in-the-money call, the equivalent, under Rev. Rul. 85-87, of a contract to buy. In essence, FB contracts to buy back the shares before having sold them, which arguably suggests FB never sells the shares to FC.

Finally, a transaction involving a sale of shares followed by the seller of the shares purchasing a call on those shares may not be treated as a sale of shares. See Comtel Corp. v. Commissioner, 376 F.2d 791 (1967). Here the initial seller of the shares, FB, also purchases a call on the same shares, so FB arguably should not be treated as selling the shares. If FB does not sell the shares, FC never owns the shares.

Thus, in analyzing the substance of the transaction as a whole, FC never acquires ownership of FB shares.

ISSUE 2: Assuming that FC acquired ownership of shares of FB stock, whether the exercise of the call option on FB shares by a subsidiary corporation of FB qualifies as a redemption as defined in section 317(b).

The memorandum dated November 19, 2001 indicates that in certain transactions identified as section 302 basis shifting tax shelters, a subsidiary

⁵ The November 19, 2001 memorandum, in the second full paragraph on page 5, suggests that the transaction as a whole, i.e., the forward contract entered into simultaneously with the call and put options, may be recast into “a single cash-settled derivative contract.” The two parts of the transaction should not be recast into a new transaction in order to conclude that stock has not been transferred, particularly given that there is no authority for recasting routine commercial transactions into a “derivative.”

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corporation of FB purportedly acquires FB stock from FC by exercising the call option between FB and FC.⁶ The U.S. taxpayer treats this acquisition as a redemption of FB stock. For purposes of determining whether an acquisition of FB stock by FB's subsidiary from FC should be treated as a distribution in part or full payment in exchange for stock under section 302(a) or as a distribution of property governed by section 301, unless otherwise indicated, the acquisition must be a redemption as defined in section 317(b). Thus, if the acquisition is not a redemption as defined in section 317(b), the acquisition is not subject to the section 302 analysis.

Section 317(b) defines a "redemption of stock" as, for purposes of Part I of Subchapter C of the Code (sections 301-318), an acquisition by a corporation of its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock. See also S. Rep. No. 1622, 83d Cong., 2d Sess. at 252 (1954) (containing nearly identical language). "Property" is defined as money, securities, and any other property, excluding stock (or rights to acquire stock) in the corporation making the distribution. Section 317(a); S. Rep. No. 1622, 83d Cong., 2d Sess. at 252 (1954); Treas. Reg. § 1.317-1. No other terms contained in the definition of "redemption of stock" are defined.

It is a well-established principle of statutory interpretation that "the words of statutes -- including revenue acts -- should be interpreted where possible in their ordinary, everyday senses." Hanover Bank v. Commissioner, 369 U.S. 672, 687 (1962) (citing Crane v. Commissioner, 331 U.S. 1, 6 (1947)). In interpreting such words, pertinent legislative history may be considered. Id. Such interpretation, however, "cannot add to or alter the words employed to effect a purpose which does not appear on the face of the statute." Id.

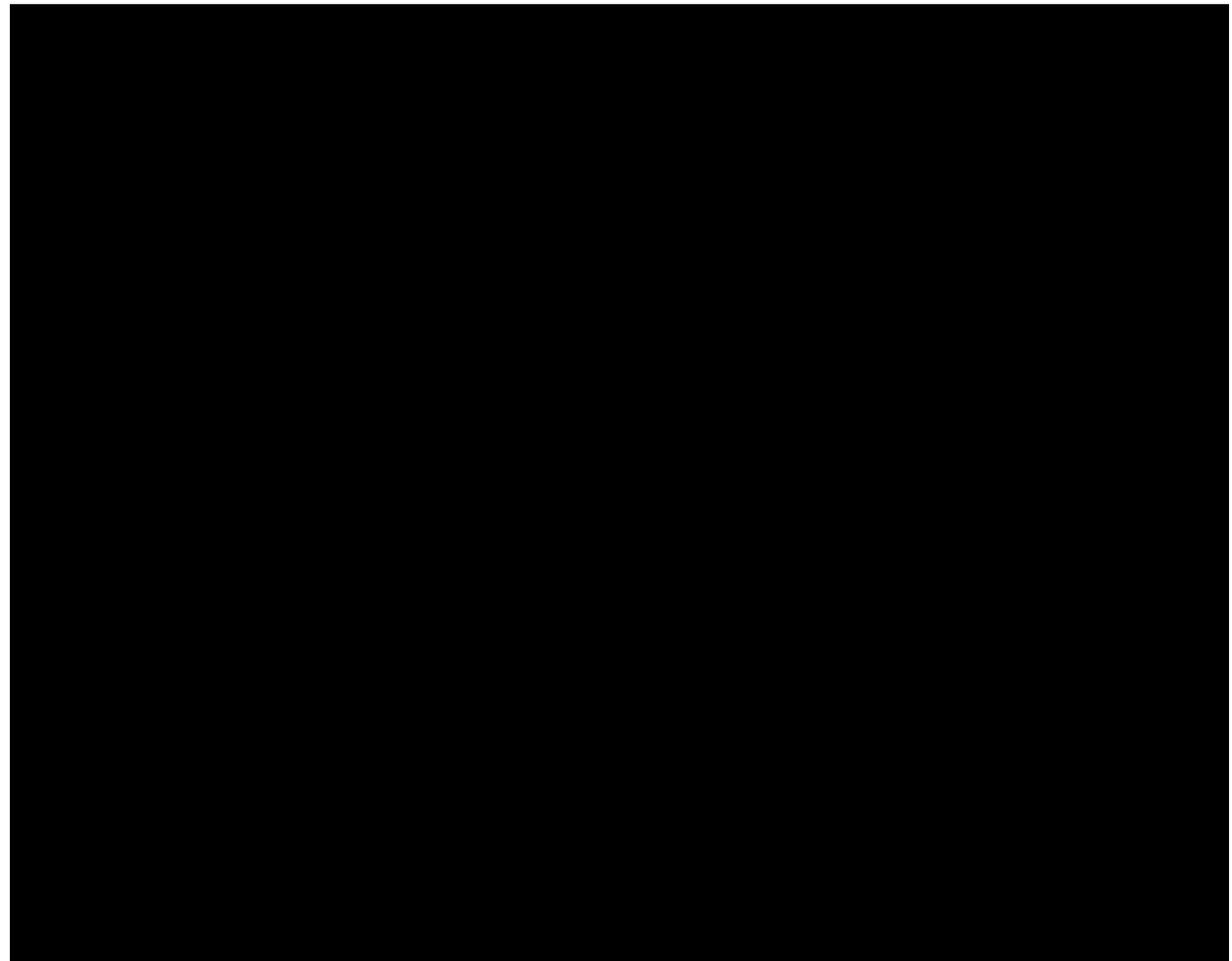
The statute at issue here, section 317(b), is unambiguous. The provision clearly provides that the corporation must acquire its own stock in order to be treated as having redeemed the stock as defined in section 317(b) and being subject to the section 302 analysis. Neither the statute, the interpretative Treasury regulations thereunder, nor the legislative history permit acquisitions of stock by corporations other than the corporation that issued the stock to meet the threshold definitional requirements of a redemption. Notwithstanding this, the Code provides for exceptions to the requirement that a redemption as defined in section 317(b) occur in order for section 302 to apply. Certain transactions are treated as bypassing the definitional requirements of section 317(b) and are deemed subject

⁶ For purposes of this discussion, the subsidiary corporation of FB is presumed not to be a disregarded entity as described in § 301.7701-2(c)(2) of the Procedure and Administration Regulations.

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to section 302.⁷ On the other hand, there are instances where transactions literally meeting the definitional requirements of section 317(b) are not treated as redemptions.⁸ The acquisition of stock at issue here, however, does not implicate any exception to the unambiguous definition in section 317(b). Therefore, assuming that FC in substance acquired shares of FB stock, the acquisition of FB stock by a subsidiary corporation of FB from FC is not a redemption under section 317(b) and is thus not subject to the section 302 analysis.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



⁷ See, e.g., section 304 (treating certain stock acquisitions by related corporations as redemptions subject to the application of section 302).

⁸ See, e.g., Treas. Reg. § 1.83-1(b)(2) (not treating the forfeiture of restricted employer stock back to the employer as a "redemption" of that stock within the meaning of section 317(b), even though the form of the transaction satisfies the statutory definition).

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