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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR PHOEBE L. NEARING, LMSB ASSOCIATE AREA COUNSEL (DETROIT) CC:LM:MCT:DET
Attn: Robert Bloink

FROM: LON B. SMITH
ACTING ASSOCIATE CHIEF COUNSEL CC:FIP

SUBJECT: Sale of Securities for Future Delivery

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LEGEND

Corporation A =
Corporation B =
Shareholders A =
Shareholders B =
Conduit A =
Conduit B =
Instruments =
Share =
Exchange A =
Exchange B =
Year 1 =
Year 2 =
Year 3 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
a =
b =
c =
d =
e =
f =
g =
h =
i =
j =
k =
l =
m =
n =
o =
p =
q =
r =
s =
t =
u =
v =
w =
x =
y =
z =
aa =

bb	=
cc	=
dd	=
ee	=
ff	=
gg	=
hh	=
ii	=
jj	=
kk	=
mm	=
nn	=

ISSUE

Whether the transaction at issue should be treated as a sale in Year 1, with the result that Shareholders A and B must recognize gain in that year.

CONCLUSION

Based on the facts presented, it appears that Conduits A and B transferred the benefits and burdens of Share ownership to Instrument holders in Date 1. Accordingly, because Conduits A and B are flow-through entities, Shareholders A and B must recognize gain from the sale of the Shares in Year 1.

FACTS

Corporation A is a privately held company. The majority of the stock is held by Shareholders A and Shareholders B (collectively referred to as "Shareholders"), who are cash basis taxpayers. Shareholders A and B also owned, through Conduit A and Conduit B, respectively, a controlling interest in Corporation B.[1]

In Year 1, Shareholders A and B sought to raise capital by selling a minority interest in Corporation B. Shareholders decided to raise the capital by selling Instruments, a derivative security keyed to the market performance of Corporation B Shares. Accordingly, on Date 2, Shareholders A and B, through Conduits A and B, respectively, sold a Instruments for $b per Instrument for a total of $c. The Instruments were registered on the Exchange A.

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[1] We have assumed for purposes of this Field Service Advice that Conduits A and B are in fact flow-through entities with the result that gain or loss realized by the Conduits flows through to Shareholders A and B, respectively.

The Instruments were issued by an independent trust (the "Trust') that had a term of d years and d months. The Trust was a grantor trust for Federal income tax purposes, and each Instrument holder was deemed the owner of a pro rata portion of the Trust's assets. The Trust assets consisted of zero coupon Treasuries with staggered maturities and agreements from Conduits A and B to provide a specified number of Corporation B Shares on or shortly after Date 4 (the "exchange date").

Each Instrument entitled a holder to an initial quarterly distribution of $e and subsequent quarterly distributions of $f during the term of the Trust. The quarterly distributions represented an aggregate annual distribution of $g, or a h percent return on a holder's initial investment of $b per Instrument. The yield on the Instruments was higher than the actual dividend yield on the Shares, which was projected to be $i and $j for fiscal Year 1 and Year 2, respectively.

On the exchange date, each Instrument holder was entitled to receive a specified number of Corporation B Shares. The number of Shares each Instrument holder received was based on the market price of Corporation B Shares on the exchange date. If the market price of a Share was between $k and $l, an Instrument holder would receive a number of Shares having a market value equal to its initial investment of $b per Instrument. If the market price of a Share was less than $k on the exchange date, an Instrument holder would receive m Shares per Instrument. Thus, the Trust would be required to distribute n Shares to Instrument holders. If the market price of a Share exceeded $l on the exchange date, an Instrument holder would receive o Share per Instrument. In this instance, the Trust would be required to distribute p Shares to Instrument holders. The Instrument holders would receive cash in exchange for fractional Shares.

In Date 1, Conduits A and B received $c from the issuance of the Instruments. Of this amount, $q was used to pay costs associated with the issuance, and $r was transferred to the Trust. The Trust used approximately $s of the amount it received to purchase zero coupon Treasuries with varied maturities to fund its obligations to pay quarterly distributions on the Instruments. In Date 1 the Trust paid $t (the remaining $u, less an allowance for Trust administration costs) to Conduits A and B pursuant to a purchase agreement dated Date 2. The purchase agreement obligated Conduits A and B to provide the Trust with Corporation B Shares ranging in number between p and n Shares. These Shares were used to satisfy the Trust's obligations to the Instrument holders on the exchange date.

The Conduits had a basis of $v per Share. Each Share of Corporation B equaled w percent of a share of Corporation B common stock, which traded on the Exchange B, and in which the Conduits had a basis of $x per share. Therefore, if on the exchange date the Share price was below $k, the Conduits would have had to deliver n Shares with an aggregate basis of $y. This would have produced a gain of $z. If, however, the Share price on the exchange date exceeded $l, the

Conduits would have had to deliver p Shares with an aggregate basis of $aa. This would have resulted in a gain of $bb ($c less $aa). If the Share price ranged between $k and $l on the exchange date, the Conduits would have had to deliver between p and n Shares with an aggregate basis of between $aa and $y. Accordingly, the Conduits would have realized in the aggregate a gain ranging between $z if the market price per Share on the exchange date was closer to $k, and $bb if the Share market price was closer to $l.

Under the terms of a collateral agreement also entered into on Date 2, Conduits A and B agreed to pledge the maximum deliverable number of Shares (approximately n), and to grant Trust a perfected security interest in these Shares, as security for the Conduits' obligations to provide the specified number of Shares on the exchange date. However, if the Conduits elected, they could provide instead substitute collateral consisting of U.S. Government obligations equal to cc percent of the value of the maximum deliverable Shares.

Pursuant to the Instrument prospectus, and the purchase and collateral agreements, Conduits A and B retained the right to vote and to receive dividends and other distributions with respect to the pledged Shares and common stock of Corporation B until receipt of the Shares or common stock by the Instrument holders upon termination of the Trust. Conduits A and B intended to sell only a minority interest in Corporation B through the Instrument transaction and thus retain control of the corporation. The prospectus also specified that upon termination of the Trust, the Instrument holders would receive Shares of Corporation B, or if an Instrument holder elected, the equivalent in shares of Corporation B common stock. The Instrument holders did not have an option to receive cash (except in exchange for fractional shares).

Neither Shareholders A nor Shareholders B reported any gain in connection with this transaction on their Year 1 Federal income tax return.

LAW AND ANALYSIS

Section 451 provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. In the case of a cash basis taxpayer, items of gross income are taxable in the year received.

In Hope v. Commissioner, 55 T.C. 1020 (1971), aff'd, 471 F.2d 738 (3d Cir. 1973), cert. denied, 414 U.S. 824 (1973), the Tax Court concluded that a sale of stock was completed on the date that (1) title and possession of the certificates were transferred by the seller to the purchaser, and (2) the seller received payment in full. Hope, 55 T.C. at 1029.

Here, Shareholders A and B received through the Conduits the full purchase price and transferred de facto Shares of Corporation B to the Instrument holders in Date 1. Conduits A and B received payment in full in Year 1 with no restriction on the use of the money. The Conduits pledged the Shares as security for their obligations under the purchase agreement and registered the Shares in the name of the Trust to perfect the security interest granted to the Trust. The collateral agreement allowed the Conduits to post substitute collateral for the Shares provided that the substitute collateral consisted of U.S. Government obligations equal to cc percent of the value of the maximum deliverable Shares. It seems highly unlikely that the Conduits would elect to acquire and pledge U.S. Government securities in excess of $dd when they could more economically pledge Shares on hand. Thus, because the Conduits were fairly limited in surrendering anything but the Shares as collateral, it appears that the Shares were transferred de facto to the Instrument holders in Date 1.

An examination of the benefits and burdens of ownership also leads to a conclusion that the stock was sold in Date 1. For Federal income tax purposes, a sale occurs when the benefits and burdens of ownership are transferred from the seller to the purchaser. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981) and Lowe v. Commissioner, 44 T.C. 363, 369 (1965). The question of when a sale occurs is essentially one of fact that must be resolved by an examination of all of the facts and circumstances, no single one of which is controlling. Baird v. Commissioner, 68 T.C. 115, 124 (1977).

In determining whether the benefits and burdens of ownership have shifted, courts have considered various factors. These factors include: (1) Whether the sale price was fixed; (2) whether a significant amount of the agreed price has been paid; (3) the descriptive terms used in the agreement; (4) whether an effective date has been agreed upon fixing a specific time for recognition of the rights and obligations of the parties; (5) whether the purchaser bears the risk of loss and opportunity for gain; (6) whether legal title has passed; (7) the intention of the parties; and (8) the probability that the transaction would be consummated. See Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. at 1237-38; Clodfelter v. Commissioner, 48 T.C. 694, 700-01 (1967), aff'd. 426 F.2d 1391 (9th Cir. 1970); and Maher v. Commissioner, 55 T.C. 441, 451-52 (1970), aff'd in part and remanded in part 469 F.2d 225 (8th Cir. 1972), nonacq. 1977-2 C.B. 2. Not all of the factors listed above must be present for the transaction to be treated as a sale. Maher, 55 T.C. at 452.

Applying the above legal standard to the facts of this case, we conclude that the transaction was in substance a sale in Year 1 when the Shareholders transferred the benefits and burdens of ownership of the Shares to the Instrument holders. First, the sales price was fixed at $c. Second, the Conduits received cash for the entire amount in Year 1 with no restriction on the disposition or use of the

funds. Third, the prospectus and purchase and collateral agreements used "sale/purchase" terminology. For example, the "sellers" (Conduits A and B) agreed to "sell" and the "purchaser" (the Trust) agreed to "purchase." Fourth, the prospectus and the agreements specified Date 1, as the date money changed hands, and Date 4, or soon thereafter, as the date the Instrument holders would receive the Shares free and clear of any restrictions.

Fifth, as between the Conduits and the Instrument holders, the latter bore the greater risk of loss and opportunity for gain to the extent Share prices on the exchange date were less than $k or greater than $l. Specifically, if the Share price exceeded $l (ee percent appreciation over an Instrument holder's initial investment) on the exchange date, an Instrument holder would realize an economic gain. For example, if on the exchange date a Share was trading at $ff, an Instrument holder would receive o Share with a value of $gg. This represents a hh percent return on the initial investment of $b. On the other hand if the Share price on the exchange date was less than $k (or ii percent of a holder's initial investment), an Instrument holder would receive m Shares per Instrument. Thus, the Instrument holder bore the risk of depreciation below jj percent of the initial value. For example, if on the exchange date Shares are trading at $x, an Instrument holder would receive m Shares with a value of $kk. Under this scenario, an Instrument holder would realize an economic loss of mm percent. In the most extreme case, if on the exchange date, the Share price was nn, the Instrument holders would receive nothing.

Sixth, although formal title did not pass to the Instrument holders in Year 1, the latter did receive a first priority perfected security interest and a first lien on the maximum deliverable Shares. And even though the Conduits could have elected to provide substitute collateral, as discussed above, the requirement of posting U.S. Government securities equal to cc percent of the maximum deliverable Shares made such an election unlikely. This leads to the final two indicia of ownership - namely, the parties' intentions, and the probability that the transaction would be consummated. The facts indicate that Shareholders A and B intended to sell, and the Instrument holders intended to purchase, a minority interest in Corporation B. The prospectus and the purchase agreement specified that upon termination of the Trust, the Instrument holders would receive actual Shares or stock in Corporation B, not cash (except in the case of fractional shares). In addition, given that the Instrument holders made full payment in Date 1, and received a first priority perfected security interest in the Shares or the substitute collateral, and further given that the Conduits' future performance (delivery of the Shares) was not contingent on any additional actions of the Instrument holders, there was a substantial probability that the transaction would be consummated in Date 3. It appears highly unlikely that any of the parties would have walked away or been allowed to walk away from the deal.

Conduits A and B retained the right to vote and receive dividends and distributions with respect to the Shares; however, we do not view these facts as dispositive of the issue in this case. First, Shareholders A and B intended to sell only a minority interest in Corporation B and thus retain control of the corporation. Accordingly, had the Instrument holders been entitled to vote their pro rate Shares beginning in Date 1, Conduits A and B still would have possessed control over Corporation B. Second, although Conduits A and B retained the right to receive dividends and distributions with respect to the Shares, the Instrument holders received a quarterly amount in lieu of dividends or other distributions. In fact the annual distribution of $g per Instrument that the Conduits guaranteed the Instrument holders exceeded the amounts that Corporation B projected it would distribute. Specifically, Corporation B projected that annual distributions per Share would be $i and $j for fiscal Year 1 and Year 2, respectively.

Based on the facts presented, we conclude that Conduits A and B sold the Shares in Year 1 in exchange for the $c that the Conduits received in the aggregate in that year. Because the Conduits were flow-through entities, Shareholders A and B should have recognized their pro rata share of the gain in Year 1, the year of receipt.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Please call if you have any further questions.

By: WILLIAM COPPERSMITH
Branch Chief
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