Stock Sales and Share Lending

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Ben Franklin is generally credited with the now universal maxim, "In this world nothing can be said to be certain, except death and taxes." If Ben were alive today, he might include a third certainty: a perpetual increase in the complexity of the Internal Revenue Code. Mr. Franklin also wanted our national bird to be the turkey.

Even though there has been much lip service paid to simplifying the Code, each year without fail Congress enacts countless new statutes, and amends countless existing ones. This has led to the current state of affairs, where tax planning has become almost mandatory, even for simple transactions. Yet, tax planning is no guarantee that a transaction will be respected by the IRS.

Indeed, on February 2, 2007, the IRS released a Generic Legal Advice, disagreeing with a taxpayer's reporting of a complex plan to sell stock, coupled with a share lending agreement. [*See* AM 2007-004.] (Note that a Generic Legal Advice is a relatively new form of advice issued by the Associate Chief Counsel from various field offices.) The taxpayer had undertaken a transaction similar to the transaction described in, and respected by, Rev. Rul. 2003-7, 2003-1 CB 363. In both the Generic Legal Advice and the ruling, the issue was whether a variable price contract for the sale of stock and a share lending agreement, both involving the same parties and pertaining to the same shares, when viewed together, resulted in a current sale of stock.

The Transaction

An individual ("Seller") held common stock in publicly traded XYZ corporation. When XYZ's stock had a fair market value of $20 ("the Execution Date"), Seller entered into an arm's-length sales contract with an unrelated third party ("Purchaser"), in which Seller received $1,600 upon execution. In return, Seller promised to deliver to Purchaser three years later ("the Valuation Date") a number of XYZ shares to be determined by a formula.

Under the formula, if the market price of XYZ stock was less than $20 on the Valuation Date, Purchaser would receive 100 shares. If the market price were at least $20, but under $25, Purchaser would receive a number of shares having a total market value equal to $2,000. If the market price exceeded $25, Purchaser would receive 80 shares of common stock. Notwithstanding the formula, Seller could deliver cash in lieu of shares.

In order to secure Seller's obligations, Seller pledged 100 shares of XYZ stock to Purchaser, the maximum number of shares Seller could be required to deliver. Seller effected the pledge by transferring the shares to an unrelated third-party trustee. Under the pledge agreement, Seller retained the right to vote the pledged shares and to receive dividends. However, the pledge agreement allowed the trustee to loan the pledged shares to Purchaser (or another person at Purchaser's direction). After the Execution Date, Purchaser executed the share lending agreement, borrowing all 100 shares from the pledge account, and then selling them to a third party. The shares were unrestricted, having both dividend and voting rights.

Benefits and Burdens

The taxpayers did not report the transaction, believing it to be a share loan. The IRS saw things differently, arguing that the transaction was a sale. The IRS found support for its position in many places. Its analysis begins in Code Sec. 1001, which provides that an amount is realized when there is a sale or other disposition of property. Although Code Sec. 1001 refers to a "sale or other disposition," that phrase is not defined in the Code.

Over the years, the courts have developed a test for identifying a sale or other disposition of property. The test focuses on the transfer of the benefits and burdens associated with the ownership of that property. [*Grodt & McKay Realty, Inc.*, 77 TC 1221, Dec. 38,472 (1981).] The test is factual in nature, requiring a consideration of the parties' intent (ascertained from documents and actions) to shift the rights and obligations of the property from one person to another.

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

Some factors to consider include (1) who has the opportunity for gain from an increase in value; (2) who bears the risk of loss from a decrease in value; (3) who has the right to vote the shares; (4) who has the right to receive dividends; and (5) who has dominion and control over the stock, including the right to sell the stock. [*F.C. Hall*, 15 TC 195, 200, Dec. 17,818 (1950), *aff'd*, CA-9, 52-1 USTC ¶9229, 194 F2d 538 (1952).]

In *K. Hope*, 55 TC 1020, Dec. 30,685 (1971), *aff'd*, CA-3, 73-1 USTC ¶9168, 471 F2d 738 (1973), the taxpayer wanted to dispose of a large block of corporate stock. Under an arrangement with an investment bank, the taxpayer transferred possession of the stock to the bank in return for cash. The bank sold a portion of the block to the public, retaining the proceeds as its fee and held the remainder. Previously, the taxpayer had transferred options for the remainder of the shares to his brother and two other individuals. These options granted the holders the right to purchase the stock for an amount equal to the amount of cash the bank paid and the right to vote for corporate directors.

Later, the taxpayer became dissatisfied with the sale price and sued for rescission. The litigation was not concluded until the subsequent tax year, and the taxpayer did not report the sale, arguing that the transfer was not a completed sale in that year. Holding that the transaction was a completed sale in the year of transfer, the court stated:

> [T]he petitioner sold ... [the] stock to [the bank] as an agent for several purchasers as well as for its own account. The sale was completed when title and possession of the certificates were transferred to [the bank], and the petitioner received payment in full ... . The petitioner received the money from the sale without any restrictions on his use or disposition of those funds. [*Hope*, 55 TC, at 1029.]

Offsetting Contracts

Turning back to the "loan" transaction in AM 2007-004, the sales contract, pledge agreement and share lending agreement related to the same XYZ stock. Seller's obligation to deliver shares on the Valuation Date under the sales contract was completely offset by Purchaser's obligation to return identical shares under the share lending agreement. The sales contract and the share lending agreement counteracted each other. Accordingly, the IRS said that all of these contracts had to be considered together to determine whether ownership transferred on the Execution Date.

As of the Execution Date and throughout the transaction, Purchaser had the right to most of the gain from the appreciation of the shares and bore all of the risk of loss. Purchaser had the right to sell, pledge or re-pledge the shares to a third party, and, when sold, the shares were completely unencumbered to the third party. On the Execution Date, Seller received full payment in cash for the shares and Purchaser had unfettered use of the shares.

As contemplated on the Execution Date, when Purchaser was to take actual possession at a later date, the shares would be unrestricted and freely transferable with voting and dividend rights. However, under the pledge agreement, Purchaser had the ability to enter into a share lending agreement with the trustee to loan the pledged shares to Purchaser (or another person at Purchaser's direction). Collectively, all of this made the IRS conclude that Purchaser acquired and held nearly all of the benefits and burdens of ownership in the pledged shares on the Execution Date so that the transaction was a completed sale under Code Sec. 1001 on that date. The fact that Purchaser did not take actual possession did not affect the IRS's conclusion, since Purchaser had the ability to control the pledged shares.

Rev. Rul. 2003-7

It is instructive to review Rev. Rul. 2003-7, 2003-1 CB 363, since it describes a similar variable price stock purchase transaction. In that ruling, a shareholder enters into an agreement with a bank to receive a fixed amount of cash, and simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies depending on the value of the shares on the delivery date. To secure the shareholder's obligations, the shareholder pledges the maximum number of shares for which delivery could be required, transferring the shares to an unrelated third party as trustee. Under the trust agreement, the shareholder retains the right to vote the pledged shares, to receive dividends from the pledged shares and to substitute cash or other shares for the pledged shares upon delivery.

Contrary to the 2007 generic legal advice, the 2003 ruling concludes that a shareholder does not sell or dispose of the stock under Code Sec. 1001 at the time the agreement is executed. In addition to the shareholder's continuing right to receive dividends, the shareholder had a right, unrestricted by agreement or economic circumstances, to reacquire the shares by delivering cash or other shares. The transfer to a trustee unrelated to the bank (and the ability to reacquire the very same shares from the trustee) demonstrates that the shareholder, rather than the bank, had dominion and control over the shares.

Unlike the transaction described in Rev. Rul. 2003-7, the transaction in AM 2007-004 had two components: a variable prepaid forward contract and a share lending agreement. Considered together, these two components transferred dominion and control to the Purchaser. On the Execution Date, Seller pledged the shares to Purchaser by transferring the shares to a third-party trustee. Because the pledge agreement entitled Purchaser to borrow all of the pledged shares, Purchaser had unconstrained control over the shares. Indeed, Purchaser transferred full control over the shares to a third party. Consequently, the IRS thought the transaction was not analogous to Rev. Rul. 2003-7.

Economic Realities

One could argue that the focus of this analysis should be on the sales contract by itself, and that there is no authority to integrate the sales contract with the pledge agreement and the share lending agreement. Interestingly, though, the IRS did not actually integrate the three agreements. When assessing the economic realities of a transaction, the courts will consider the offsetting nature of related contracts.

For example, in *Helvering v. LeGierse*, SCt, 41-2 USTC ¶10.029, 312 US 531 (1941), an individual entered into two contracts with an insurance company, one styled as a single-premium life insurance contract, the other as a standard annuity contract. The taxpayer conceded that the insurance contract would not have been issued without the annuity contract. The Supreme Court determined that the two contracts must be considered together and that, together, they failed to spell out any element of insurance risk.

In fact, the court found that the contracts acted as opposites, counteracting each other so that in combination, the risk customarily inherent in an insurance contract was neutralized. The Court did not integrate the two contracts and hold that there was really only a single contract. Instead, it looked to the economic realities and found lacking the risk necessary for insurance. As a result, the contract was treated as something other than a life insurance contract.

Like the contracts in *LeGierse*, the sales contract and the share lending agreement in AM 2007-004 could have been entered into independently. In reality, they involved the same parties and the same shares, and were connected by the pledge agreement. Following the Supreme Court's lead, the IRS considered them together. Together, they transferred almost all of the rights and obligations associated with the ownership of the XYZ shares to Purchaser on the Execution Date.

Open Transaction Doctrine

For sake of completeness, the IRS considered the open transaction doctrine. That doctrine relieves a taxpayer from reporting income that may never be received. The doctrine was derived from the seminal case, *Burnet v. Logan*, 283 US 404 (1931), where the taxpayer owned stock in a corporation which, in turn, held a leasehold interest in a mine.

The taxpayer sold the stock for cash plus an agreement to receive from the purchaser 60 cents per ton on all ore apportioned to the corporation. There was no provision for a maximum or minimum tonnage. Because the taxpayer's capital investment might never be recovered, the contractual promise to pay per ton was too contingent and speculative to determine the value received by the taxpayer. Thus, the Court determined that the annual payments received under the agreement should be apportioned first as return of capital and later as profit.

Today, the IRS generally tries to minimize the scope of the open transaction doctrine, arguing that it is only applicable when it is not possible to determine the value of either of the assets exchanged. In an arm's-length transaction, an asset with an unascertainable value is presumed to be worth the value of the property for which it was exchanged. [*T.C. Davis*, SCt, 62-2 USTC ¶9509, 370 US 65 (1962).]

Focusing solely on the sales contract in AM 2007-004, Seller appears to have transferred an indeterminate amount of XYZ stock, so that the fair market value of the property transferred by Seller appears to be indeterminate. However, when the components of the transaction are considered together, the Seller actually transferred all of the stock on the Execution Date and simultaneously received cash and the right to receive a variable amount of identical stock in the future. Nothing is indeterminate.

The stock is publicly traded and has a readily ascertainable fair market value. The amount realized includes the amount of cash received by Seller plus the value of the right to receive a variable amount of identical stock in the future. Gain can be determined because the value of the right received by Seller must be equal to the value of the stock transferred on the Execution Date less the amount of cash received. Accordingly, the IRS found that the open transaction doctrine does not apply.

Conclusion

In Generic Legal Advice AM 2007-0004, the IRS methodically demonstrates its position that a contract for the sale of stock and a share lending agreement, both of which involve the same parties and pertain to the same shares, result in a current sale of the shares. This advice displays the IRS flexing its muscles and extending its authority to complex transactions that might have gone unscrutinized in an earlier era. Perhaps a transaction as complex as this one is not likely to become a trap for the unwary. However, practitioners should be cautious, as this could be the unveiling of a newer and bolder IRS.

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