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INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: WILLIAM D. ALEXANDER
Acting Associate Chief Counsel (Corporate) CC:CORP

SUBJECT: Capital Loss Transaction

This Chief Counsel Advice responds to your memorandum dated September 28, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Parent =

Subsidiary =

Year1 =

Month1 =

a =

b =

c =

d =

e =

f =

g =

h =
i =
k =
m =
n =
p =
q =
r =
s =
t =
u =
v =

You requested comments on the taxpayer's protest. Our comments are set forth below.

ISSUES

Would a court regard this as a tainted tax shelter or as a legitimate use of Subsidiary's capital to engage in the purchase of Parent's stock which was followed by the redemption of almost all of such stock for a convertible note; and the sale of the retained shares? The note was subsequently converted for more shares than were originally purchased.

CONCLUSIONS

We reiterate and incorporate by reference the analysis, conclusions and recommendations set forth in our prior FSA regarding this matter except as modified below.[1]

We also provide further comments below regarding the taxpayer's arguments before you.

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[1] Published as FSA 200009003 (October 20, 1999), 2000 TNT 44-75.

FACTS

Simplified facts are set forth below.

1. Subsidiary, a wholly owned subsidiary of Parent with ample net worth, purchased t shares of Parent's publicly traded stock on the market over a period of u months in late Year1, for $b.

2. Some c months after the stock purchases were completed, Parent redeemed q% of the stock held by Subsidiary for an out-of-the-money, zero coupon note (the "Note") convertible initially into d shares of Parent stock beginning e years from issuance.

3. Less than f months after its last stock market purchase, Subsidiary sold to a third party the remaining r% of the Parent stock from its original purchase. Subsidiary claimed a tax loss that amounts to almost q% of the original aggregate market price of all the Parent stock that Subsidiary bought.

4. Associated fees and costs of these transactions were about $g, and the financial accounting gain thereon was $h, a return of approximately s% on the invested capital of almost $i (including costs and fees).

5. Subsidiary converted the Note in Month1 into a shares (reflecting anti-dilution adjustments to the conversion rate), which it still owns.

6. Parent had extraordinary prior capital gains which it sought to shelter with the capital loss claimed in the above transaction.

7. Parent had directly bought back some k shares of its stock over the previous v years for non-tax reasons without ever using a subsidiary. After the transaction at issue, Parent resumed its historic practice of directly buying back its shares.

LAW AND ANALYSIS

The loss-creating shelter embodied in the transaction set forth above fails to meet the economic substance requirement articulated in ACM Partnership v. Commissioner, 157 F.3d 321 (3d Cir. 1998). Taxpayer's transaction involves the following abusive elements:

1. The abuse of an uneconomic rule (the basis shifting rule under § 1.302-2(c)).

2. Subsidiary's exclusion of dividend-equivalent income (redemption proceeds) received from Parent on the buyback of Parent stock in exchange for the Note. The subsequent sale outside the group of the retained shares, whose basis was

enriched by the amount paid for the redeemed stock, was for tax avoidance purposes.

3. The shifting of stock basis created stock with an artificial built-in-loss for the group seeking to shelter its unrelated capital gains, the loss corresponding to the excluded income.

4. The contrived and pre-planned steps required by the strategy (e.g., Subsidiary's purchase and the redemption with Parent's convertible Note that delayed conversion for e years) had no apparent business purpose.

5. The lack of business purpose to justify *Subsidiary's* participation in the scheme, particularly after Parent's v-year history of directly buying back nearly k shares, a practice resumed after the transaction in dispute, without involvement of a subsidiary. The board of *Parent* first decided to buy back the stock in question and then caused Subsidiary to do so for tax avoidance.

6. Subsidiary's exchange of its Parent stock for the Note, which gave rise to the ultimate tax consequences at issue, generated only "a phantom loss" that was not "economically inherent in the object of the sale" [the retained parent stock] and did not have "economic substance separate and distinct from economic benefit achieved solely by tax reduction."[2]

Subsidiary's participation was a radical departure from sensible economic action and the fundamental tax principles underlying the Code, as discussed in the prior FSA. The minuscule book gain relative to the artificial tax loss and/or the purchase price of Parent's stock provides a clear basis for a court to disallow the disputed loss as abusive. Moreover, the fact that the costs and fees associated with the transaction were more than *m* times greater than the financial gain amply illustrates that the use of Subsidiary was devoid of economic substance and should be disregarded or recast as discussed in the prior FSA. Investment strategy that is "not consistent with rational economic behavior" but for expected tax benefits lacks economic substance; serves no non-tax purpose; hence, tax benefits should be denied. ACM Partnership, 73 T.C.M. 2189, 2229 (1997).[3] Moreover, except for the tax avoidance motive, no reasonable business person would have participated in Subsidiary's transactions involving the purchase of Parent stock, redemption by the

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[2] ACM Partnership v. Commissioner, 157 F3d 231 (3d Cir. 1998).

[3] ACM was affirmed as to the disallowance of all losses other than the actual economic loss from holding the note received in the sham contingent installment sale transaction. Id.

Note, followed by conversion back into Parent stock. See also Saba Partnership, 78 T.C.M. 684, 722 (1999).

Other Comments on Protest.

The Note as an Equity Instrument.

Based upon the financial strength of Parent when it issued the Note, as well as the terms of the Note and its conversion, the Note appears to bear more indicia of debt than equity. Accordingly, we believe it would be difficult to characterize the Note as equity.

The Redemption as a Distribution to the Non-Redeeming Shareholders.

The conversion rights taken into account as stock (under § 305(d)) largely reduced or eliminated any disproportionate impact of the redemption upon the other (non-redeeming) shareholders of the parent. This is because these rights increased Subsidiary's proportionate interest in Parent after the redemption. As the protest asserts, even if there were an increase in the proportionate interests of the other shareholders, the redemption was an "isolated redemption" under § 1.305-3(b) and so was not taxable to anyone under § 305. § 1.305-3(e), Examples 10, 11, and 12.

The Conversion Rights Are Generally Not Separate Property.

The Second Circuit has held that a conversion privilege is not a separate property right.[4] In that court's view, the convertible debenture is an indivisible unit; the issuer has but one obligation to meet, either redemption or conversion. It can never be required to do both.[5] Despite this general rule,[6] the issue arises whether the conversion privilege inherent in the Note and not separate therefrom, can cause

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[4] Chock Full O' Nuts Corp. v. United States, 453 F.2d 300, 302 (2d Cir. 1971).

[5] Id. 453 F.2d at 305 (footnotes and citations omitted).

[6] In contrast to the original issue discount rules, there are provisions of the Code that implicitly bifurcate convertible debt instruments. For example, for the purpose of computing amortizable bond premium under § 171, the amount of bond premium on a convertible bond does not include any amount attributable to the conversion features of the bond, and the regulations set forth a procedure for determining the value of the conversion feature. IRC § 171(b)(1); § 1.171-1(e)(1)(iii). In addition, § 249 generally limits a corporate issuer's deduction for premium paid on a redemption of convertible debt to a normal call premium on nonconvertible debt. Thus, no deduction is allowed to the extent the repurchase premium is attributable to the value of the conversion feature.

the optioned shares embedded in the Note to attract basis (which would essentially double the tax basis of the Note in the hands of Subsidiary).

Allocation of Basis To Stock Subject To The Conversion Privilege.

There is an argument that part of Subsidiary's basis in the redeemed shares is allocated to the shares constructively held under the Note, as set forth below.

Section 1.302-3(a) states in pertinent part that "[s]ection 318(a) (relating to constructive ownership of stock) shall apply . . . in determining the percentage of stock ownership *after* the redemption." (Emphasis added.) Convertible debentures are "options" for this purpose. Rev. Rul. 68-601, 1968-2 C.B. 124. Moreover, an option that is exercisable by right only after a lapse of time (e.g., e years, as in the Note) is subject to attribution. Rev. Rul. 89-64, 1989-1 C.B. 91.

In the instant case, for purposes of § 302, Subsidiary is deemed to own the d shares of stock into which the Note is convertible, pursuant to the option attribution rules of § 318(a)(4).[7] Thus, Subsidiary is deemed to hold more shares of Parent stock after the redemption (i.e., p shares) than it owned before. This is due to the attribution to Subsidiary of the optioned shares in addition to the shares actually retained. These constructively held shares are critical to the determination under § 302(b)(1) that the redemption was essentially equivalent to a dividend. If Subsidiary's ownership of Parent stock had decreased from t shares to n shares, it would have experienced a "meaningful reduction" of its proportionate interest in Parent. United States v. Davis, 397 U.S. 301 (1970). Thus, the redemption would not have been essentially equivalent to a dividend within the meaning of § 302(b)(1) and would have qualified as a taxable exchange. However, taking into account the Parent stock that Subsidiary constructively owned, the redemption proceeds (i.e., the Note) were equivalent to a dividend under § 302.[8]

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[7] If any person has an option to acquire stock, such stock shall be considered as owned by such person. Option attribution under § 318(a)(4) does not depend on the economic value, or equity, embedded in an option. The provision does not require an examination of whether it makes economic sense to treat the option as exercised. Rather, the mere existence of an option causes it to be treated as exercised.

[8] "If a distribution is not pro rata, some of the shareholders' interests may be reduced, some may stay the same and some may even be increased. Where a shareholder's proportionate interest has increased it has been held to constitute a dividend because that circumstance is most unlike a sale. Levin v. Commissioner, 385 F. 2d 521 (2d Cir. 1967)." GCM 38357 (April 21, 1980).

Accordingly, the constructively owned stock (d shares) under the convertible Note arguably count as "remaining stock" (together with the r% of Parent stock actually retained by Subsidiary (i.e., n shares)). Consequently, the constructively owned stock is entitled to its allocable share of a "proper adjustment of the basis of the remaining stock" called for in § 1.302-2(c). Based upon the general rule that the conversion right is not property separate from the Note but an inchoate right inherent in the Note itself, basis of the redeemed shares is allocable to the Note that contains the option.

Application of Section 1059.

Based upon the fact that the earnings and profits covering the dividend-equivalent redemption were represented in the purchase price of Parent stock and therefore in the bases of such shares (in the hands of Subsidiary), the redemption proceeds should not constitute a qualifying dividend under § 1059(e)(2). This is consistent with Congressional intent. The legislative history informs that § 1059 can apply to consolidated groups particularly when the consolidated return regulations require no basis reduction, as in the instant case. S. Rep. No. 100-445, at 44 (1988). Consequently, § 1059(e)(1) should apply to reduce the purchase bases of Subsidiary for Parent stock by the amount of the untaxed dividend.

Statutory Interpretation.

Congress obviously did not anticipate, nor could it have done so, the myriad ways of "milking dividends" to create artificial losses in stock without its dividend rights. This is evidenced by the series of amendments to § 1059 after its enactment in 1984. Moreover, the "plain meaning" approach to statutory construction may not better effectuate the legislative intent or the legislative deal than a more purposive investigation and construction. As Judge Learned Hand noted in his dissent in Gilbert v. Commissioner, 248 F. 2d 399, 411 (2d Cir. 1957):

> [T]he literal meaning of the words of a statute is seldom, if ever, the conclusive measure of its scope. Except in rare instances statutes are written in general terms and do not undertake to specify all the occasions that they are meant to cover; and their "interpretation" demands the projection of their expressed purpose, upon occasions, not present in the minds of those who enacted them.

Recast Of Substance Over Form.

The prior FSA in this matter concluded that the intervening redemption via Parent's intercorporate Note occurred primarily to create a built-in loss asset through basis

shifting and for no other meaningful purpose.[9] Accordingly, the intervening redemption should be ignored. Rather, Subsidiary should be treated as if it had purchased the Note for cash and that Parent had bought back its shares from the public. The taxpayer protests the existence of authority for this recast of events, particularly the creation of steps that in form did not occur.

In Commissioner v. Court Holding, the Supreme Court held that a purported tax-free liquidating distribution of appreciated assets by a corporation and the subsequent sale of such assets by the corporation's shareholders were, in substance, a taxable sale of the assets by the corporation, followed by a liquidating distribution of the sales proceeds to the corporation's shareholders.[10] While perhaps the step-transaction doctrine cannot "invent" steps, as the taxpayer suggests, the substance-over-form doctrine is not so limited. Thus, in Court Holding, the Supreme Court "invented" a transaction, the sale of appreciated assets by the corporation, that in form, never occurred.[11] Similarly, in Martin Ice Cream Co. v. Commissioner, 110 T.C. 189 (1998), the Tax Court focused on the "negotiation substance" of a transaction to decide that a corporation's majority owner, rather than the corporation, had sold ice cream distribution rights back to the manufacturer. In Idol v. Commissioner, 38 T.C. 444 (1962), aff'd, 319 F.2d 647 (8th Cir. 1963), the facts of which were similar to Esmark[12], a case that is relied upon by the instant taxpayer in its protest, the Eighth Circuit agreed with the Service that the transaction should be treated as a taxable sale of assets by the taxpayer's wholly owned corporation, followed by a dividend of the proceeds to the taxpayer. In this case, Parent's board of directors first authorized its stock buyback

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[9] The taxpayer argues it was done this way for tax efficiency. Actually, had only the parent dealt in its own stock, it would have had the protection of § 1032.

[10] 324 U.S. 331 (1945). At the time, it avoided corporate taxation for a corporation holding appreciated assets to distribute those assets to its shareholders and have the shareholders sell the assets than to have the corporation itself sell the assets and distribute the proceeds to the shareholders. Note that the Court found that in substance for tax purposes, the corporate stock was retired not for appreciated assets but for sales proceeds; thereby creating a liquidating dividend of sales proceeds rather than appreciated corporate assets, that did not actually occur in form.

[11] See Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945).

[12] Esmark, Inc.v. Commissioner, 90 T.C. 171 (1988), aff'd without published op., 886 F.2d 1318 (7th Cir. 1989), where the Service argued unsuccessfully, that a purported redemption of parent stock in exchange for stock of a subsidiary was, in reality, a sale of the subsidiary stock.

by itself (of t shares) and only subsequently caused Subsidiary to transact the buyback for “tax efficiency.”[13]

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Please call if you have any further questions.

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[13] See Taxpayer’s Protest, p.3.