INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) Nos.: 305.02-00; 307.02-00; 482.22-02; 482.22-03; 9999.97-00
CASE MIS No.: TAM-162881-02/CC:CORP:B6

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:
March 20, 2003

LEGEND:

Distributing =

S5 =

S8 =

S9 =

Controlled =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Month 1 =

Month 2 =

Year 1 =

Year 2 =

$a =

$b =

$c =

$d =

x% =

y =

ISSUES:

1) Whether Controlled's sale of certain of its warrants to S9 constitutes a bargain sale of the warrants within the meaning of section 482 of the Internal Revenue Code.

2) If Controlled's sale of the warrants constitutes a bargain sale, whether the transaction should be recast under Rev. Rul. 69-630 as a cash distribution of the bargain portion of the sale to the common parent followed by a capital contribution of such cash to S9.

CONCLUSION:

1) Controlled's sale of the warrants does not constitute a bargain sale because the sale was at arms' length.

2) Alternatively, if the sale is treated as a bargain sale within the meaning of section 482, the bargain portion of the sale is treated as a stock dividend under section 305 and the basis consequences of the stock dividend (generally zero basis to distributee) are determined under section 307.

FACTS:

Prior to the transaction described below, Distributing was the common parent of an affiliated group of corporations filing a consolidated Federal income tax return. Distributing owned x% of the stock of Controlled (which was more than 80%) and the public owned the rest. Distributing also owned all of the stock of S5, which owned all of the stock of S8, which owned all of the stock of S9.

Shortly after receiving a private letter ruling (PLR 8908075) dated December 2, 1988 (and supplemented by a private letter ruling (PLR 8926061) dated April 4, 1989),[1] and pursuant to its terms, Distributing announced that it would distribute its Controlled stock pro rata and Controlled would pay a cash dividend to its shareholders of $a per share.

In order to finance part of the cash dividend, Controlled planned to sell warrants to Distributing or an affiliate of Distributing.[2] The warrants were convertible into a special class of Controlled stock. This stock was identical to the Controlled common stock except that it was entitled to only y of a vote per share. The price of the warrants was determined by a formula based on the average value of the Controlled common stock during a specified period ending on a specified date prior to the announcement of the distribution. Shortly after the announcement described above, and several months before the Controlled stock distribution, Distributing's investment banker, an independent third party, valued the warrants, in the aggregate, at $b.

Prior to the transfer of the warrants, their value increased substantially. As of Date 1, Distributing's investment banker valued the warrants, in the aggregate, at $c. Nevertheless, Controlled sold the warrants to S9 for the original stated price of $b.

On Date 2 Distributing distributed the stock of Controlled to its shareholders pro rata.

On Date 3, S9 distributed the warrants to S8. S9 deferred the gain that it otherwise would have recognized as a result of this distribution. On Date 4, S8 sold the warrants to S5. In Month 1 of Year 1 S5 sold some of the warrants to a group of underwriters. In Month 2 of Year 2, S5 sold the remaining warrants back to Controlled.

The sale of the warrants by S5 outside the group triggered S9's deferred gain. S9's amount realized is $d. The issue is whether S9's aggregate basis in the Controlled warrants is $b or $c.

LAW AND ANALYSIS:

Taxpayer's Argument

The Taxpayer argues that the bargain sale principles of Rev. Rul. 69-630, 1969-2 C.B. 112, apply to the sale of the warrants. In Rev. Rul. 69-630, individual A owns all of the stock of corporations X and Y. A caused X to sell property to Y for less than an arm's

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[1] The terms used in this Technical Advice Memorandum to describe the parties are identical to those used in the original and supplemental private letter rulings, updated to reflect changes in the corporate structure of Distributing since the issuance of these letters.

[2] Controlled sold other securities to other affiliates of Distributing to finance the rest of the cash dividend.

length price. Applying section 482, the ruling held that the income of X will be increased to reflect the arm's length price of the property sold to Y. The ruling further held that the basis of the property in the hands of Y will also be increased to reflect the arm's length price. Finally, the ruling held that the amount of such increase will be treated as a distribution to A, the controlling shareholder, with respect to his stock of X and as a capital contribution by A to Y.

Applying the principles of Rev. Rul. 69-630 to its case, the Taxpayer argues that: (1) S9 would be treated as having paid $c for the warrants (for which Controlled would not recognize any gain), thus resulting in S9's obtaining a $c basis in the warrants, (2) Controlled would be treated as having distributed the difference between what it was deemed to have received ($c) and what it actually received ($b) to Distributing as a cash distribution with respect to its Controlled stock, and (3) Distributing would be treated as having made a capital contribution of such amount to S5, which will be treated as having contributed such amount to S8, which will be treated as having contributed such amount to S9.

The Appeals Officer's Arguments

The Appeals Officer ("A.O.") makes several arguments challenging taxpayer's analysis. First, the A.O. disputes the aggregate value of $c as of Date 1 as the correct fair market value of the warrants on that date. The A.O. notes that the warrants were convertible into a new class of Controlled common stock, which would dilute, and thus reduce, the value of the outstanding Controlled stock. The A.O. also notes that the new class of Controlled common stock would only have y of a vote per share. This reduced voting power would also reduce the value of such stock. This reduction in the value of the Controlled stock would also reduce the value of the Controlled warrants.

Second, the A.O. distinguishes Rev. Rul. 69-630 because in that case the selling corporation included the deemed sales price in income. By contrast, in this case, Controlled would not recognize any gain upon the receipt of property in exchange for the warrants. Thus, the A.O. argues that if such amount is not included in income, it cannot be added to the basis of the warrants.

Finally, the A.O. argues that, under Treas. Reg. section 1.1502-31 (as in effect for the years at issue), the basis of property received in a distribution is determined under old section 301(d)(2)(B). Old section 301(d)(2)(B) provides that the basis of property in the hands of the recipient is the sum of the adjusted basis of the property in the hands of the distributing corporation plus the amount of gain recognized by the distributing corporation. Under the current facts, the basis of the warrants in the hands of the distributing corporation is zero and since the distributing corporation recognized no gain on the distribution, such basis remains zero.

Analysis

We agree with the result advocated by the A.O., but on different grounds.

Issue One

A threshold issue in this case is whether Controlled's sale of the warrants constitutes a bargain sale. If it does not, there is no need to determine the consequences of the transaction under the recast principles of Rev. Rul. 69-630. For the reasons explained below, we conclude that the sale not a bargain sale.

At the time the terms of the warrants were written, the parties agreed that $b was the fair market value of the warrants. The parties secured an opinion from Distributing's investment banker, an independent third party, that $b was in fact the aggregate fair market value of such warrants. In that case, they are bound by that valuation. See Doctor's Bldg. Hospital, Inc. v. U.S., 83-2 USTC ¶9669 (S.D. Tex 1983).
Thus, at the time of the agreement, there was no bargain element to the acquisition of the warrants because the parties were operating at arms' length. See Nestle Holdings, Inc. v. Commissioner, 152 F. 3d 83 (1998).

Moreover, the warrant agreement did not contain a provision for adjusting the purchase price of the warrants should it go up (or down) between the time of the agreement and the time of the sale. Thus, there is no authority for the taxpayer to recalculate the purchase price based on its alleged fair market value at the time of the sale.[3]
Under this analysis, there is no need to recast the transaction or make collateral adjustments to account for a bargain element, when there is no bargain element. In particular, the Service is only allowed to recast a transaction or series of steps if the form of those steps does not reflect their substance. See, e.g., Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd, 886 F.2d 1318 (7th Cir. 1989), Turner Broadcasting System, Inc. v. Commissioner, 111 T.C. 315 (1998). In this case, as noted above, at the time of the agreement, it is uncontested that the consideration for the warrants equaled their fair market value. Thus, there is no basis for the Service to recast the transaction in this case, even if it were so inclined.

In addition, even if the form of the transaction does not reflect its substance, the taxpayer is generally precluded from attempting to recharacterize its own transaction. See Taiyo Hawaii Co., Ltd. v. Commissioner, 108 T.C. 590 (1997). See also Elrod v. Commissioner, 87 T.C. 1046, 1066 (1986); Pritchett v. Commissioner, 63 T.C. 149, 171 (1974) (citing Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959), aff'g, 29 T.C. 129 (1957)); Estate of Durkin v. Commissioner, T.C. Memo. 1992-325, supplemented by 99 T.C. 561, 572 (1992); and Estate of Corbett v. Commissioner, T.C. Memo. 1996-255. Thus, even if the taxpayer is correct that the acquisition of the warrants was

[3] Under this analysis, since the price of the warrants at the time of the sale is irrelevant, we do not address the A.O.'s argument challenging the taxpayer's valuation of the warrants at the time of the sale.

a bargain sale, taxpayer is precluded from making this argument.

Issue Two

Even if Controlled's sale of the warrants constitutes a bargain sale, we agree with the A.O. that Rev. Rul. 69-630 is distinguishable, but for a different reason.

Rev. Rul. 69-630, and other similar authorities, deal with the bargain sale of property. In the current case, Controlled is not selling property, but its own warrants. Warrants (and stock) of a corporation are treated differently under the Code from property. Under section 317(a), warrants are not considered property for purposes of certain specified Code sections, including section 301. In other words, there are specific sections of the Internal Revenue Code dealing with such instruments. These sections are exceptions to the general provisions of the Code dealing with sales or distribution of property.

For example, if Rev. Rul. 69-630 did apply, the first collateral adjustment is a deemed distribution of the bargain amount from the seller to the common parent. In the case of property, the applicable Code section is 301. In the case of a corporation's own warrants, there is a specific Code section which addresses that - section 305. This specific Code section overrides the application of the general rule of section 301.

If Rev. Rul. 69-630 does not apply, then the most straightforward analysis is to treat the transaction as a sale of warrants from Controlled to S9 to the extent of the consideration paid by S9 to Controlled, with the remainder of the warrants treated as having been distributed by Controlled to Distributing. Under section 305(a), Distributing's receipt of the warrants would be tax-free. In addition, Distributing's basis in the warrants would be determined under section 307. In this case, since Distributing has represented that the value of the warrants deemed distributed is less than 15% of the value of the underlying stock, section 307(b) would apply. Under that provision, Distributing would have a zero basis in these warrants.

Distributing would then be treated having contributed the warrants ultimately to S9, as described above. S9's zero basis in the warrants it ultimately received from Distributing would be added to the amount, $b, that it paid Controlled for warrants. Thus, S9's aggregate basis in the warrants is $b.[4]

CAVEAT

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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[4] Because our analysis under sections 305 and 307 achieves the same result as the A.O.'s consolidated return argument, we do not need to address it here.