DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (LMSB),

ATTN:
CC:LM:RFP:

FROM: Lewis K Brickates, Senior Technician Reviewer
CC:CORP:4

SUBJECT:

/Basis Shift (302/318 Loss Importation)

This Field Service Advice responds to your memorandum dated April 9, 2001. In accordance with section 6110(k)(3) of the Internal Revenue Code, this Field Service Advice should not be cited as precedent.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

LEGEND

TP =

FC =

FB =

Promoter =

X =

Country A =
Country B =

BC =

Year 1	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
Date 14	=
Date 15	=
Date 16	=
Date 17	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
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m	=
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p	=
q	=
r	=
s	=
t	=
u	=
v	=
w	=
x	=

y	=
z	=
aa	=
bb	=
cc	=
dd	=
ee	=
ff	=
gg	=
hh	=
ii	=
jj	=
kk	=
ll	=
mm	=
nn	=
oo	=
pp	=
qq	=
rr	=
ss	=
tt	=
uu	=
vv	=

ISSUES

1. Whether FC, in substance, owned the shares of FB stock that were redeemed.

2. If FC is treated as having properly acquired the shares of FB stock that were redeemed, whether FB's redemption of its stock held by FC is an exchange or a distribution to which section 301 applies.

3. If FB's redemption of its stock held by FC is deemed to be a distribution to which section 301 applies, whether TP's adjustment to his basis in FB stock was a "proper adjustment" within § 1.302-2(c) of the Income Tax Regulations.

4. If TP's adjustment to his basis in FB stock was a "proper adjustment", whether TP's stock loss was not a bona fide loss with the result that the purported stock loss is disallowed under section 165.

5. If TP's adjustment to his basis in FB stock was a "proper adjustment," whether TP acquired control of FC with a principal purpose of avoiding or

evading Federal income tax with the result that the purported stock loss is disallowed under section 269.

6. Whether section 482 applies to reallocate any FB stock basis or loss claimed attributable to FC's basis in the FB stock to FC.

7. A. Whether the stock loss may be disallowed because the transaction as a whole lacks economic substance and business purpose apart from tax savings.

   B. Whether the sham entity doctrine should apply to recharacterize the transaction by disregarding the existence of FC as an entity separate from its owner or TP's warrants as options.

SUMMARY OF CONCLUSIONS

1. FC did not, in substance, own the shares of FB stock that were redeemed.

2. Even if FC is treated as having properly acquired the shares of FB stock that were redeemed, the redemption should be treated as a payment in exchange for the stock, not as a dividend distribution.

3. Even if the redemption was treated as the distribution of a dividend, the addition of FC's basis in its FB stock to the basis of the FB stock held by TP is not a "proper adjustment" as contemplated under Treas. Reg. § 1.302-2(c).

4. Even if TP's adjustment to his basis in FB stock was a "proper adjustment," TP's stock loss was not a bona fide loss with the result that the purported stock loss is disallowed under section 165.

5. Even if TP's adjustment to his basis in FB stock was a "proper adjustment," TP acquired control of FC with a principal purpose of avoiding or evading Federal income tax with the result that the purported stock loss is disallowed under section 269.

6. Any FB stock basis or loss claimed that is attributable to FC's basis in the FB stock must be reallocated to FC under section 482.

7. A. The stock loss may be disallowed because the transaction as a whole lacks economic substance and business purpose apart from tax savings.

   B. The sham entity doctrine should apply to recharacterize the transaction because FC should be disregarded as an entity separate from its owner and TP's warrants are not options.

FACTS

In Year 1, TP, an individual subject to U.S. tax, sold stock in X, a Subchapter S corporation, and realized gain of approximately $a from his sale of X stock.

FC was a corporation organized under the laws of Country A on Date 1 (date when the Memorandum of Association of FC was registered and filed with the Registrar of Companies in Country A). It is unclear whether TP directly participated in FC's organization. FC had authorized a total of b shares at $c par value each. As noted in the FSA request, only d shares were issued and outstanding. These shares were wholly owned by FP, a party unrelated to TP or FB and not subject to U.S. tax. At the present time, the identity of the shareholders of FP is also unclear.

FB was a publicly-held bank organized in Country B. FB, with its international network of offices, engaged in consumer and business banking.

Promoter, an independent investment advisor registered under the 1940 Investors Act, acted as investment advisor to both FC and TP.

On Date 2, Promoter sent TP a letter describing the steps TP should take to initiate a "direct and indirect leveraged stock purchased strategy" utilizing Promoter as the investment advisor. This investment strategy was to be conducted through FC, which was described as a "special purpose investment vehicle" and set up to carry out the transaction described below.

On Date 3, TP purchased from FC a warrant for e bearer shares of FC stock, representing g percent (greater than 50 percent) of the total issued stock of b shares if exercised, for $f. The warrant granted TP the right either to purchase all e FC shares or to surrender, or cash settle, the warrant for an amount based on FC's net asset value (defined as FC's assets less FC's liabilities). If, at the time TP surrendered the warrant, the net asset value was equal to or less than the initial value (amount received by FC for the warrant), the put value would be equal to the net asset value. If the net asset value was greater than the initial value, the put value would equal the sum of (1) the initial value plus (2) h percent of the excess of the net asset value less the initial value. Exercise or put of the warrant required i days written notification. The warrant's expiration date was Date 7.

On Date 4, TP purchased from FB j bearer shares of FB stock for $k.

On Date 5, FC entered into an agreement with FB to purchase shares of FB. FC made a l percent leveraged acquisition of m bearer shares of FB stock at a purchase price of BCn (Country B currency) per share or a total of BCo (approximately equal to $p). Under the terms of the agreement, FB retained possession of the bearer shares and payment was delayed until the settlement date of Date 13. As part of the agreement, FC sold to FB a call on m FB shares with an initial strike price of BCq and a strike reset price of BCr, if the price of the shares fell below BCq. The premium for the call was BCs a share. The call also had an integrated forward feature: FB was required to pay BCt to FC for each day the share price exceeded the following levels:

Date 6 to Date 7 (inclusive):	BCu
Date 8 to Date 9 (inclusive):	BCv
Date 10 to Date 11 (inclusive):	BCw
Date 12 to Date 13 (inclusive):	BCx

If at any time the share price fell below the reset strike price, FB would pay to FC an amount equal to BCt multiplied by the number of days prior to the share price falling below the strike reset price.

Finally, on the same date, as part of the agreement, FC purchased from FB, a put on m FB shares with a strike price of BCr. The premium for the put was BCy.

The initial strike price of the call was approximately z percent of the price of the shares (BCn). Both the strike reset price of the call and the put strike price were aa percent of the price of the shares. The options were European-style options and were exercisable on the same date FC purchased the FB shares, Date 13. FC purchased the FB shares for BCn. The combination of the call and the put constituted a collar with a spread of bb percent of the current share price.

On Date 13, FB exercised its call option from FC for BCcc per share. On the same day, TP purchased options to acquire m bearer shares of FB stock for $dd. TP treated FB's exercise of the call option as a redemption. Since TP's ownership of the FC stock warrant purportedly represented an g percent ownership interest in FC, TP treated FC as owning all stock that TP owned directly or indirectly pursuant to section 318(a)(5)(A). Thus, under section 302(d), TP treated the redemption of FB stock held by FC as a dividend. Pursuant to Treas. Reg. § 1.302-2(c), TP then allocated FC's basis of approximately $p to his j shares of FB stock and to his option to acquire m shares of FB stock based on their relative fair market values as of Date 13. TP increased his basis in the j shares of FB stock to $ee and his basis in the option to acquire m shares of FB stock to $ff.

On Date 14, TP sold his FB option to acquire m bearer shares of FB stock for $gg, generating a tax loss of approximately $hh.

On Date 15, TP surrendered his FC share purchase warrant for a put value of $ii, generating a tax loss of approximately $jj.

On Date 16, TP sold kk of his j bearer shares of FB stock for $ll, generating a tax loss of $mm.

TP used the total tax losses to offset the approximate $a gain from his sale of stock in X.

LAW AND ANALYSIS

ISSUE 1: Whether FC, in substance, acquired the shares of FB stock that were redeemed.

In general, federal income tax consequences of a transaction are governed by the substance of that transaction. See Gregory v. Helvering, 293 U.S. at 470. For a transaction to be treated as a sale, the transaction must, in substance, be a sale. 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).

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 party; (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., 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 the factors listed above must be present for the transaction to be treated as a sale. Maher, 55 T.C. at 452.

An analysis of a few of the factors listed above initially suggest that ownership of the FB shares has been transferred to FC. For instance, since the transaction was structured as a sale, the agreed price was paid by FC and the terms of the agreement indicated the transaction was a sale. Also, legal title to the FB shares did pass to FC. Furthermore, a specific date was agreed upon fixing the time for recognition of the rights and obligations of the party, and the sale price was fixed.

However, a more detailed analysis of other terms of the purported sale suggest otherwise. As between FB and FC, FB bore the risk of loss and opportunity for gain. By entering into the put and call, FC gave 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 gave up a portion of the opportunity for gain above the strike price of the call. When the price of the FB shares exceeded the strike of the call, FB was able to exercise the call and any appreciation of the shares would inure to FB. However, the integrated forward feature acted to transfer a portion of the appreciation on the shares back to FC if the share price rose above the levels specified above. FC also retained exposure to the risk of loss between the strike price of the call and put. However, when the options were first entered into, the strike of the call was BCq and the strike of the put was BCr. At that point, the spread of the collar (BCq-BCr) was only bb percent of the share price. Furthermore, since the strike price of the call was below the current price of the shares, FC forfeited some of the opportunity for gain outside the spread. As previously mentioned, FC did have some opportunity for gain outside the spread through the integrated forward feature. Also, given that the put was significantly out-of-the-money, FC retained little risk of loss on the shares. Therefore, FB, not FC, bore the risk of loss and the opportunity for gain.

In addition, FC and FB arguably did not intend for a sale of the shares to occur. When the options were entered into, the exercise price of the call was below the current price of the shares. The fact that the call was in-the-money suggests that there may have been a high probability that FB would exercise the call and retain ownership of the shares.

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

In some cases, a collar on shares may act 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 term 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 were very short term and were 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 acquired ownership of the shares. The collar negated any ownership acquired through the purchase of the shares.

Furthermore, a 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 sold an in-the-money call, which, following the reasoning of Rev. Rul. 85-87, may be equivalent to a contract to sell the shares. Therefore, FC entered into a contract to sell the shares before they were purchased from FB. Had FC owned the shares, the transaction could be argued to be a sale of the shares. Since FC did not own the shares when the call option was sold, FC may be viewed as never having obtained possession of the shares. In addition, FB bought an in-the-money call, the equivalent, under Rev. Rul. 85-87, of a contract to buy. In essence, FB has contracted to buy back the shares before having sold them, which suggests FB never sold 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 (2d Cir. 1967). Here the initial seller of the shares, FB, also purchased a call on the same shares, so FB should not be treated as selling the shares. If FB did not sold the shares, FC never owned the shares. Thus, if the shares were never owned by FC, the redemption is precluded.

ISSUE 2: If FC is treated as having properly acquired the shares of FB stock that were redeemed, whether FB's redemption of its stock held by FC is an exchange or a distribution to which section 301 applies.

A. Law.

A redemption of stock is 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. Section 317(b). If the redemption is any one of the four described in section 302(b), the redemption will be treated as a distribution in part or full payment in exchange for the stock. Section 302(a). If the redemption fails to satisfy any of these tests, section 302(d) provides that the redemption will be treated as a distribution of property governed by section 301. Those redemptions which qualify for exchange treatment include (1) redemptions that are not essentially equivalent to a dividend; (2) redemptions that are substantially disproportionate; and (3) redemptions that completely terminate the shareholder's equity interest in the corporation.[1] Section 302(b)(1), (2) and (3).

Section 318 provides constructive ownership rules in determining a shareholder's stock ownership for purposes of determining whether a redemption satisfies the conditions of one of the paragraphs of section 302(b). Section 302(c). If any person owns, directly or indirectly, 50 percent or more in value of a corporation stock, such person is deemed to own the stock that such corporation owns, directly or indirectly, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation. Section 318(a)(2)(C). If any person owns, directly or indirectly, 50 percent or more in value of a corporation's stock, such corporation is deemed to own the stock that such person owns, directly or indirectly. Section 318(a)(3)(C). Finally, if any

[1] The fourth type of redemption (inapplicable in this case) that qualifies for exchange treatment is in connection with a partial liquidation by a corporation. Section 302(b)(4).

person has an option to acquire stock, that person is deemed to own such stock. Section 318(a)(4).

The step transaction doctrine has been applied to the characterization of a stock redemption under section 302. This judicial doctrine is a rule of substance over form that treats a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused towards a particular result. Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987). Where a taxpayer has embarked on a series of transactions that are in substance a single, unitary, or indivisible transaction, the courts have disregarded the intermediary steps and have given credence only to the completed transaction. See Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652, 654 (5^{th} Cir. 1968). In the case of a complete termination of the shareholder's interest, the termination need not result solely from the redemption, but rather from a combination of the redemption and other stock dispositions. Zenz v. Quinlivan 213 F.2d 914 (6^{th} Cir. 1954) (integrating a sale and redemption of stock to prevent dividend treatment); see also Rev. Rul. 77-226, supra (holding that an integrated plan comprised of the partial redemption of stock, followed by the sale of the remainder of the stock to an unrelated third party, was a complete termination under section 302(b)(3)). The Zenz rationale is also applicable in determining whether a redemption is essentially equivalent to a dividend under section 302(b)(1). McDonald v. Commissioner, 52 T.C. 82, 87 (1969). Finally, the Service has approved the Zenz approach to section 302(b)(2) analyses. See Rev. Rul. 75-447, 1975-2 C.B. 113. The Zenz approach should also apply to a related termination of the stock ownership of a person whose stock ownership is attributed to the redeemed shareholder.

B. Analysis.

On the facts here, as part of the integrated plan, TP terminated his stock ownership in FB shortly after the redemption. Indeed, that termination was the purpose of all the steps. The individual steps of the transaction took place according to a prearranged plan and required careful timing and documentation. Detailed instructions were given to each participant to execute various steps of the transaction. These transaction documents demonstrate that (i) various steps were carefully timed to trigger artificial attribution (e.g., TP's simultaneous acquisition of out-of-the-money options to acquire e shares of FB stock on the date of FB's redemption of FC's e shares of FB stock); (ii) both FC and TP intended to dispose of the respective FB shares and options after a relatively short holding period; and (iii) TP intended to dispose of the FC warrants soon after the artificial attribution was no longer required to assert the benefit of dividend treatment for FC.

If the redemption is viewed as a complete termination of FC's interest in FB, then the tax consequences of the redemption would be a sale or exchange under section 302(b)(3) to which FC would recover its basis, and, therefore, there would be no foundation to apply the attribution rules under section 318 and the basis shifting rule under Treas. Reg. § 1.302-2(c). Additionally, depending upon the fair market value of the FB stock and out-of-the-money options on the date TP subsequently disposes of such stock and options, TP could recognize gain. In other words, TP would neither realize nor recognize the claimed loss on the transaction.

ISSUE 3: If FB's redemption of its stock held by FC is deemed to be a distribution to which section 301 applies, whether TP's adjustment to his basis in FB stock was a "proper adjustment" within Treas. Reg. § 1.302-2(c).

A. Law.

Treas. Reg. § 1.302-2(c) provides that, where a redemption is treated as a dividend distribution, "proper adjustment" will be made to the basis of other stock held or treated as held by the redeemed shareholder. Treas. Reg. § 1.302-2(c) does not provide that, where a redemption is treated as a dividend distribution, basis will, in all cases, shift to such other stock. The regulations provide examples of proper adjustments. In Example 1, a corporation redeems 50 percent of a sole shareholder's stock. The redemption is treated as a dividend distribution, and the basis of the redeemed stock is added to the retained stock. Example 2 involves a situation in which a corporation's stock is held equally by a husband and wife, the husband's stock is completely redeemed, but the redemption is treated as a dividend distribution; the basis of the wife's stock in that corporation is increased by the husband's basis in the redeemed stock. Example 3 clarifies Example 2 by providing that, if the husband had retained any stock, his basis in the redeemed shares would have transferred to the basis of the shares of stock he retained.

A similar result is provided in the case of a dividend distribution under section 304. See Treas. Reg. § 1.304-2(c) Example (1) (providing that a shareholder who owns stock in both the acquiring corporation and the sold corporation ("issuing corporation") and is treated as receiving a dividend upon the sale of stock in a section 304 transaction may add its basis in the sold stock to the basis of the stock in the acquiring corporation); Rev. Rul. 71-563, 1971-2 C.B. 175 (providing that a shareholder who directly owns stock *only* in the issuing corporation and is treated as receiving a dividend upon the sale of stock in a section 304 transaction may add its basis in the sold stock to the basis of the stock that it retains in the issuing corporation). Rev. Rul. 70-496, 1970-2 C.B. 74, however, provides that basis shifting is not permitted where a shareholder that is treated as receiving a dividend distribution in a section 304 transaction holds no stock directly in the acquiring corporation, illustrating that basis can disappear in cases where there is no appropriate shift.

B. Analysis.

TP claims that Example 2 of Treas. Reg. § 1.302-2(c) provides for a shifting of basis in these cases, but the transaction at issue is distinguishable from that of Example 2 in Treas. Reg. § 1.302-2(c) in important ways. Although not explicitly stated, the example deals with the paradigm case involving taxpayers subject to U.S. tax on the distribution. In this situation, the redeeming shareholder is fully taxed, at ordinary rates, and without the benefit of any basis offset. Moreover, it is clear the rule is intended as a form of equitable relief--preserving, as near as possible, the benefit of the basis for the taxpayer.

In this transaction, on the other hand, TP attempts to generate basis through transactions lacking business purpose and economic substance, and then shifts that basis from a person not subject to U.S. tax to a person that is subject to U.S. tax. The redeemed shareholder, FC, because it is not (and it must be assumed it never will be) subject to U.S. tax, is wholly indifferent to the U.S. tax treatment of the distribution and the loss of basis. FC is not in need of equitable relief. Indeed, by applying this equitable relief provision where none is necessary, there is an unintended windfall to TP claiming the shifted basis and thus increasing his basis in his FB stock. Accordingly, a basis shift in this case is not a “proper adjustment.”

In addition to the reasons discussed above, the basis adjustment sought in the present case is not a “proper adjustment” within the meaning of Treas. Reg. § 1.302-2(c) because, as discussed in Issue 7 below, the transaction as a whole lacks economic substance.

<u>ISSUE 4: If TP’s adjustment to his basis in FB stock was a “proper adjustment”, whether TP’s stock loss was not a bona fide loss with the result that the purported stock loss is disallowed under section 165.</u>

Section 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Treas. Reg. § 1.165-1(b) provides that to be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and Treas. Reg. § 1.165-11 (relating to disaster losses), actually sustained during the taxable year. Treas. Reg. § 1.165-1(b) further states that only a bona fide loss is allowable and that substance and not mere form shall govern in determining a deductible loss. <u>See</u> <u>also</u> <u>ACM Partnership v. Commissioner</u>, 157 F.3d 231, 252 (3d Cir. 1998), <u>cert. denied</u>, 526 U.S. 1017 (1999) (“Tax losses such as these . . . which do not correspond to any actual economic losses, do not constitute the type of ‘bona fide’ losses that are deductible under the Internal Revenue Code and regulations.”).

As discussed below, the transaction lacks economic substance. The transaction is no more than a series of contrived steps that effect an artificial loss on TP’s disposition of FB stock. The stock loss is not bona fide and does not reflect actual economic loss. Consequently, the loss should be disallowed under section 165.

ISSUE 5: If TP's adjustment to his basis in FB stock was a "proper adjustment", whether TP acquired control of FC with a principal purpose of avoiding or evading Federal income tax with the result that the stock loss is disallowed under section 269.

A. Law.

Section 269 provides that if any person acquires, directly or indirectly, control of a corporation and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance may be disallowed.

The first requirement is that a "person" be involved. "Person" is broadly defined as an individual, trust, estate, partnership, association, company, or corporation. Treas. Reg. § 1.269-1(d).

The next requirement is that the person acquire control of a corporation. Section 269(a) defines "control" as the ownership of stock representing at least 50 percent of the total combined voting power of all classes of stock or at least 50 percent of the value of all classes of stock. The "acquisition of control," however, may be direct or indirect. Acquisition of control occurs when one or more persons acquire beneficial ownership of stock representing the requisite control. Treas. Reg. § 1.269-5(a). That is, so long as the person has beneficial ownership of the equity of the corporation, record ownership is unnecessary. See Ach v. Commissioner, 358 F.2d 342, 346 (6th Cir. 1966) (holding that beneficial ownership constituted ownership within section 269 and record ownership was unnecessary); Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025, 1031 (1976) (finding that traditional ownership attributes such as legal title, voting rights, and possession of stock certificates were not conclusive as to the ownership of stock); Rev. Rul. 70-638, 1970-2 C.B. 71 (citing Ach, holding that acquisition of control occurred when beneficiaries of a trust acquired both direct stock ownership in the corporation and indirect ownership as beneficiaries of the trust). The ownership of stock should represent the ownership of the equity of a corporation and reflect a risk investment. Thus, the acquisition of stock means that the purchaser has assumed the risks of an investor in equity. See John Kelly Co. v. Commissioner, 326 U.S. 521, 530 (1946); Zilkha and Sons, Inc. v. Commissioner, 52 T.C. 607, 613 (1969), acq., 1971-1 C.B. xvi; Rev. Rul. 68-18, 1968-1 C.B. 5.

Furthermore, such equity ownership must reflect effective control over the business and management of the corporation. In Briarcliff Candy Corp. v. Commissioner, T.C. Memo 1987-487, the court considered whether section 269 applied to a loss corporation's ("petitioner") acquisition of a profitable subsidiary ("target"). As part of the transaction, the target underwent a recapitalization. The petitioner acquired stock representing at least 50 percent of the total combined voting power of all classes of stock entitled to vote and the parent corporation of the target acquired convertible junior preferred shares, which, if converted, would have represented 95 percent of the total combined voting power over the target. The court found that it was questionable whether the petitioner had acquired control for purposes of section 269 given that the parent corporation maintained effective control over the business and management of the target. This finding suggests that a holder of convertible securities, and presumably similar equity stakes such as options, may be considered to have acquired control if the holder has effective control over the business and management of the acquired corporation.

Finally, an option holder also may be viewed as acquiring control and assuming the benefits and burdens of ownership of the corporation's stock if the option holder has furnished or will furnish substantially all of the funds at risk (other than a nominal amount contributed by the legal owner) and only the option holder's investment (not that of the legal owner) will appreciate or depreciate. <u>See</u>, <u>e.g.</u>, <u>Tennessee Natural Gas Lines v. Commissioner</u>, 71 T.C. 74, 83 (1978), <u>acq</u>., 1979-2 C.B. 2.; Rev. Rul. 82-150, 1982-2 C.B. 110 (concluding that a holder of deep-in-the-money options is the owner of the referenced property).

The final requirement of section 269 is that the acquisition of control must have occurred for the principal purpose of evasion or avoidance of Federal income tax. If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose. Treas. Reg. § 1.269-3(a). This determination is a factual one which requires a subjective evaluation of the taxpayer's motives. <u>See</u> <u>Briarcliff Candy Corp.</u>, <u>supra</u>.

B. <u>Analysis</u>.

In this transaction, TP, an individual, is clearly a "person" for purposes of section 269.

TP has also acquired requisite control of FC. First, TP clearly acquired beneficial ownership of FC stock. Although TP acquired options to convert the FC warrants into FC stock, the options represented at least 50 percent of FC's total combined voting power of all classes of stock. In addition, TP exercised effective control over the business and management of FC. FC did not appear to have engaged in any appreciable activity other than the transactions required to generate the inappropriate tax benefit afforded to TP. That is, FC's "business" activities were solely for the benefit of TP. Finally, TP assumed the benefits and burdens of ownership because TP provided all of the funds at risk and only TP's investment will appreciate or depreciate. Based on FC's financial statements for the year ending Date 17 (the only financial statement that TP alleged he was able to secure), FC had only $<u>nn</u> in assets (consisting of cash, accounts receivable and a promissory note). Although the financial statements reflect a period after which TP extinguished his interest in FC, there is no indication that FC engaged in any activity other than this transaction or that TP relied on any FC financial statements other than those provided to the Service. As noted above, TP paid $<u>f</u> to acquire FC warrants and would have had to pay a strike price of approximately $<u>oo</u> to convert the FC warrants into FC stock. Thus, TP would have paid a total of $<u>pp</u> to purchase warrants and convert them into stock representing an g percent interest in a company with nominal assets excluding TP's investment. Similarly, if TP puts the FC warrants back to FC, TP would also receive the liquidation value of FC. Regardless of whether TP exercised his put right, TP would be entitled to any appreciation or would suffer any depreciation in the value of FC's assets. Thus, TP acquired the requisite control over FC.

Finally, TP acquired control over FC for the principal purpose of avoiding or evading Federal income tax. Based on the documents provided to us, TP has not shown any other valid and substantiated purpose for engaging in the transaction other than for the avoidance or evasion of Federal income tax. In addition, the transaction and the various steps of the transaction had no economic substance and had relatively insignificant economic consequences, as discussed more fully below. Thus, even if TP's adjustment to his basis in FB stock was a "proper adjustment," since TP acquired control over FC for the principal purpose of avoiding or evading Federal income tax, the loss resulting from the sale of FB stock and options should be disallowed under section 269.

ISSUE 6: Whether section 482 applies to reallocate any FB stock basis or loss claimed attributable to FC's basis in the FB stock to FC.

A. Law.

Section 482 was designed to prevent the artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises. Commissioner v. First Security Bank of Utah, N.A., 405 U.S. 394, 400 (1972); Barford v. Commissioner, 194 F.3d 782, 786 (7th Cir. 1999); Charles Town, Inc. v. Commissioner, 372 F.2d 415, 419 (4th Cir. 1967), cert. denied, 389 U.S. 841 (1967); Ach v. Commissioner, 42 T.C. 114, 125 (1964), aff'd,. 358 F.2d 342 (6th Cir. 1966), cert. denied, 385 U.S. 899 (1966). Cf. H.R. Rep. No. 2, 70th Cong., 1st Sess., 16-17. Section 482 provides in relevant part:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or to clearly reflect the income of any of such organizations, trades, or businesses . . . (emphasis added).

This allocation authority extends to the allocation of asset basis as well. Treas. Reg. § 1.482-1(a)(2).

Section 482 permits a reallocation to be made between two or more trades or businesses. In order for an allocation to be made under section 482 between TP and FC, TP must be engaged in activities which constitute a separate trade or business from FC. Whether an individual's activities can constitute a trade or business for purposes of section 482 is a factual determination. See Rollins v. Commissioner, T.C. Memo. 1993-643. In order to make this factual determination, it should be ascertained whether TP engaged in business activities and the trading of investments on his own behalf, rather than being a passive investor. If the Service can establish that TP did engage in such business and active investment activities on his own behalf, he will be deemed to satisfy the trade or business requirement of section 482.

Section 482 imposes two additional requirements regarding the entities: (1) ownership or control must exist in some manner among the entities, and (2) the same interests must possess the control. TP and FC must be found to be controlled by the same interests if section 482 is to apply to the basis shift transaction that took place between them.

1. Control.

The regulations under section 482 define control to include any kind of control, regardless of whether such control is direct or indirect or legally enforceable. Treas. Reg. § 1.482-1(i)(4). Case law supports the regulation's definition of control, indicating that it is actual and practical control which counts in the application of section 482 rather than record ownership or legally enforceable control. Ach, 42 T.C. at 125; Grenada Industries, Inc. v. Commissioner, 17 T.C. 231, 254 (1951), aff'd, 202 F.2d 873 (5th Cir. 1953), cert. denied, 346 U.S. 819 (1953), acq. in part and nonacq. in part, 1952-2 C.B. 2, 5; 1972-2 C.B. 2. See also Appeal of Isse Koch & Co., Inc., 1 B.T.A. 624, 627, *acq.* 1925-1 C.B. 2 ("Control not arising or flowing from means legally enforceable may be just as effective in evading taxation as if founded on the most formal and readily enforceable legal instrument."); DHL Corp. v. Commissioner, T.C. Memo 1998-461 (1998) (holding that foreign investors did not have section 482 control over a corporation despite their ability to appoint a majority of its board of directors because domestic shareholders retained the ability to control day-to-day operations and major events); Charles Town, 372 F.2d at 419 (holding that two shareholders were in control of a corporation in which they only owned two percent of the outstanding stock because of their possession of effective and practical control over the corporation).

Consequently, according to both the section 482 regulations and the applicable case law, none of the participants in this basis shift transaction is required to have legal control of another participant through majority ownership of that other participant's voting stock for control to exist as defined under section 482. The Service has the authority to determine whether control exists by considering the reality of the control situation and examining whether the same interests effectively control the participants to the transaction, rather than basing the control determination solely on the taxpayer's percentage of ownership of voting stock or legal right to direct the participant's actions.

a. TP's control of FC through actual ownership of the majority of FC's stock pursuant to Rev. Rul. 82-150.

Instead of actually owning in form a majority interest of the stock of FC, TP owned a warrant to purchase g percent of its stock. However, TP can be deemed to have actually owned g percent of the stock of FC in substance through his possession of the warrant. In Rev. Rul. 82-150, 1982-2 C.B. 110, the Service attributed actual ownership of the stock underlying a warrant to a warrant holder. The warrant holder, a U.S. citizen, paid 70x dollars for an option to purchase all of the stock of a newly formed foreign corporation which had been capitalized with 100x dollars. The U.S. taxpayer had the right to exercise the option by paying 30x dollars. The Service ruled that because the taxpayer had obtained the right to purchase for 30x stock in a foreign corporation worth 100x, the taxpayer should be treated as actually owning the stock for purposes of sections 551 and 951 of the Code. The Service reasoned that the taxpayer had assumed the risks of an investor in equity because in substance, 100 percent of the funds used to capitalize the foreign corporation and which were placed at risk were furnished by the taxpayer.

Similarly, in the instant transaction, TP should be treated as owning g percent of the stock of FC. The facts, as discussed above, appear to indicate that the $f TP paid to purchase the warrant constituted k percent of the capitalization of FC and FC's sole source of funds. Upon FC's entering into the stock purchase transaction with FB, it was solely TP's $f that was at risk. Like the taxpayer described in Rev. Rul. 82-150, TP's investment in FC was subject to the risk of depreciation upon a decline in the value of the FB stock claimed to be owned by FC, meaning that TP can similarly be deemed to have assumed the benefits and burdens of the ownership of the FC stock. Pursuant to Rev. Rul. 82-150 and the authorities cited therein, TP can be treated as actually owning a majority interest in FC, which would result in his possessing control of FC for purposes of section 482.

b. The existence of a control group through a common plan to shift the FB stock basis to TP

When control does not exist through a taxpayer's majority ownership of a participant's voting stock or a legally enforceable agreement delegating the power to direct an entity's actions, the regulations provide alternatively that control results from the action of two or more taxpayers acting in concert with a common goal or purpose. Treas. Reg. § 1.482-1(i)(4). A presumption of control arises under the regulations if income and deductions have been arbitrarily shifted. Treas. Reg. § 1.482-1(i)(4). Case law is in accord with the regulation's presumption of control through the arbitrary shifting of income or deductions. DHL Corp., T.C. Memo 1998-461 at 100 (When the interests controlling one entity and those controlling another have a common interest in shifting income from the former to the latter, entities may be considered commonly controlled.). See also Dallas Ceramic Co. v. United States, 598 F.2d 1382, 1389 (5^{th} Cir. 1979) (holding that the government correctly argued that proof of a shifting of income between two corporations establishes a presumption of common control under Treas. Reg. § 1.482-1(a)(3) (1968)-predecessor to current section 482 regulations); Hall v. Commissioner, 294 F.2d 82, 85 (5^{th} Cir. 1961) (finding presumption of control under section 29.45-1 of Regulation 111-predecessor to current section 482 regulations).

In determining whether section 482 control exists, the Service may apply the presumption of control provided for in Treas. Reg. § 1.482-1(i)(4) and in the applicable case law. For the presumption to apply, the Service has the burden of establishing that income or deductions have been arbitrarily shifted between the parties. See Dallas Ceramic Co., 598 F.2d at 1389.

From the facts provided to us, FC's basis in FB shares was arbitrarily shifted to TP. As a result of the Treas. Reg. § 1.302-2(c) basis shift, TP increased the basis of his j FB shares by $qq of FC's $p basis in his FB shares. The basis increase allowed TP to claim a ($mm) loss on the subsequent sale of kk of his j FB shares, which substantially exceeded his original cost basis in the shares of $rr. Absent this basis increase, TP would have had to claim an $ss gain on the stock sale. Additionally, TP increased the basis of his FB option by the remaining $tt of FC's FB stock basis, allowing TP to claim an additional loss on the option sale amounting to ($tt). The end result of the basis shift was that TP was able to claim losses of ($uu) in excess of his economic investment in the FB shares and the FB call option.

FC and FB acted in concert with TP with the common goal of shifting these significant capital loss deductions to TP. The existence of the in-the-money call option and the put option meant that it was highly likely that FC would not retain ownership of the FB stock and that FB would ultimately redeem the stock to allow a potential basis shift to take place. Furthermore, the facts appear to indicate that this basis shift transaction was prearranged by Promoter to allow TP to claim a substantial tax loss on FB shares in excess of his economic investment. FB's exercise of the call option was timed to take place prior to the close of the Year 1 taxable year, providing FB and FC with the ability to aid TP in offsetting the $a gain he previously realized from the sale of his X stock. FC's and FB's simultaneous entry into the delayed settlement purchase of the FB stock and the call option sale made it possible for FC to shift its substantial basis in the FB shares to TP upon the stock redemption without FC having to make a significant cash outlay.

Because an arbitrary shifting of loss deductions appears to have occurred between FB, TP and FC through the basis shift, FB, FC and TP are presumed to be part of the same control group for the purposes of section 482 pursuant to Treas. Reg. § 1.482-1(i)(4) and the applicable case law.

Once it has been determined that control exists among the participants, section 482 next requires that the same interests possess the requisite control to permit the Commissioner to make a reallocation.

2. The same interests.

The regulations provide no guidance as to what the term “the same interests” means under section 482. Case law has indicated that in using the term “the same interests,” Congress intended to include more than “the same persons” or “the same individuals.” Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979) (holding that different persons with a common goal or purpose for arbitrarily shifting income can constitute “the same interests” for purposes of section 482). See also B. Forman Co., Inc. v. Commissioner, 453 F.2d 1144 (2d Cir. 1972), cert. denied, 407 U.S. 934 (1972) (rejecting Tax Court’s view that two independently owned corporations acting in concert together to make interest-free loans to a jointly owned corporation did not constitute the same interests within the meaning of section 482); South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-95 (5th Cir. 1966), cert. denied, 386 U.S. 1016 (1967). Cf. Appeal of Rishell Phonograph Co., 2 B.T.A. 229, 233-34 (1925). But see The Lake Erie and Pittsburg Railway Co. v. Commissioner, 5 T.C. 558 (1945), acq. 1945 C.B. 5, acq. withdrawn 1965-1 C.B. 5.

Case law indicates that the legal standard for determining whether “the same interests” control an entity is identical to the standard applied to determine whether control of an entity exists. Therefore, if different entities are found to have a common goal to shift income or deductions among each other, not only will control of the entities exist, but the entities will also constitute “the same interests” for the purpose of section 482. As previously discussed, there appears to exist a common plan among FB, TP, FP and FC to shift deductions to TP. Consequently, FB, TP, FP and FC constitute “the same interests” under section 482, meaning that the Service may reallocate the basis of the FB stock to prevent the evasion of taxes or to clearly reflect income. See GAC Produce Co., Inc. v. Commissioner, T.C. Memo 1999-134 (holding that section 482 applied to allocate income between related parties where an unrelated entity contracted separately with each of the controlled parties to effect an artificial shifting of income between the related entities).

B. Analysis.

Generally, there are two alternative bases to apply section 482 to a transaction: (1) prevention of the evasion of tax, and (2) the clear reflection of income.

1. Economic Substance/Tax Evasion Standard.

When analyzing potential tax avoidance aspects of a transaction, the Commissioner will respect the transaction’s contractual terms if consistent with the true economic substance of the transaction. Treas. Reg. § 1.482-1(d)(3)(ii)(B). The economic substance standard of the regulations overlaps with the economic substance and sham transaction doctrines developed in case law which allow the Service to consider the economic realities of a transaction and disregard transactions lacking a business purpose and entered into solely for tax avoidance motives.[2] However, the section 482 regulations expand upon case law guidance by providing additional guidance. Specifically, the regulations provide the following:

> The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, great weight will be given to the actual conduct of the parties, and the respective legal rights of the parties . . . . If the contractual terms are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

Treas. Reg. § 1.482-1(d)(3)(ii)(B). Thus, section 482 provides an alternative approach to challenging a transaction for lack of economic substance by providing additional criteria under which to apply the economic substance and sham inquiries to the parties' conduct and not restricting the Service's allocation authority to instances of "colorable" or "sham" transactions. We note that in the context of this transaction (and similar tax shelter transactions), this allocation authority would exist only where there is a common tax avoidance scheme among the participants to shift income and/or deductions arbitrarily. (Note that the prior sentence does not apply to the alternative theory discussed above for establishing control (the ability to direct the actions of certain participants)).

Under the first section 482 analysis, the economic substance of a transaction is analyzed by focusing on the parties' actual conduct; the economic risks purportedly transferred; and whether, from a business perspective, the transaction makes objective business sense. See Treas. Reg. § 1.482-1(d)(3)(ii)(B). Where the economic substance of a transaction is inconsistent with the parties' purported characterization, the Service may disregard the contractual terms underlying the transaction and treat the transaction consistent with its economic substance. This treatment may result in a denial of deductions arising from the transaction at issue.

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[2] See Gregory v. Helvering, 293 U.S. 465 (1935); Knetsch v. Commissioner, 364 U.S. 361 (1960) (interest deductions disallowed where nothing of substance could be realized from the transaction other than a tax deduction); Frank Lyon Co. v. United States, 435 U.S. 561, 572 (1978) ("The simple expedient of drawing up papers" is not controlling for tax purposes when the objective economic realities of a situation are to the contrary); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985) (transaction is a sham where taxpayer is motivated by no business purpose other than obtaining tax benefits in entering a transaction and where transaction has no economic substance because no reasonable possibility of profitability exists); ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999) (transaction devoid of economic substance cannot be the basis for a deductible loss).

See e.g. B. Forman, 453 F.2d at 1160-61; Medieval Attractions N.V. v. Commissioner, T.C. Memo 1996-455.

The parties have attempted to characterize this transaction as involving a purchase of m shares of FB stock. However, the true substance of this transaction is not consistent with the parties' characterization of it as a stock purchase transaction. On the date that FC purchased its FB shares for $p, it only had $f of funds. Consequently, FC did not have the financial capacity to pay the purchase price of the stock. However, because of the delayed settlement agreement, FC was able to offset its purchase obligation for the m FB shares by the payments FB was required to make under the call option. Because TP's $f was the only source of funds for FC, the only way FC could meet its payment obligation was if FB offset FC's payment obligation by redeeming the stock through its exercise of the call option. The deferral of the settlement date until the exercise date of the call option allowed FC to retain a $p basis in the stock without the corresponding obligation of having to make a substantial cash investment.

Therefore, in substance, FC did not truly purchase the FB stock. Because FB's right to receive payment for the shares did not arise until the exercise date of the call option and the call option was likely to be exercised to allow an offsetting of the purchase price, FB can be viewed as remaining the true owner of the shares, rather than FC. Pursuant to the authority of Treas. Reg. § 1.482-1(d)(3)(ii)(B), the Service may disregard the contractual terms of the transaction which occurred between FB and FC, which the parties deemed to be a stock purchase, because their conduct is not indicative of a purchase actually occurring. Disregarding the purported stock purchase transaction would result in denying FC a basis in the m FB shares. Consequently, FC would have no basis to shift to TP and could not apply the provisions of Treas. Reg. § 1.302-2(c). Accordingly, the loss TP claimed on the sale of his FB shares which was solely attributable to FC's shifted basis will be disallowed and TP will have to recognize a gain of $ss on the FB stock sale. Additionally, TP's basis in the call option will be reduced to his original basis of $dd, reducing his loss on the option to $gg.

2. Clear Reflection of Income Standard.

Even in the absence of tax avoidance motives, the Commissioner may make a section 482 allocation if necessary to clearly reflect income. The Commissioner has the authority to make a section 482 allocation even if doing so would prevent the application of another provision of the Code. In National Securities Corp. v. Commissioner, 137 F.2d 600, 602 (3d Cir. 1943), cert. denied, 320 U.S. 794 (1943), the court acknowledged that application of section 45 (the predecessor statute to section 482) would necessarily result in a conflict with the literal requirements of another provision of the Code yet concluded that the application of section 45 should not be denied despite violating another provision of the Code.

Other cases are in accord with National Securities Corp. that section 482 may be applied to clearly reflect income despite apparent conflict with the provisions of another section of the Code. See Dolese v. Commissioner, 811 F. 2d 543, 546 (10th Cir. 1987) (Commissioner has broad discretion under section 482 to correct distortion of income occurring through the strict application of other provisions of the Code and may invoke section 482 to reallocate income derived from the disposition of property previously acquired in a nonrecognition transaction). See also Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214, 215-16 (2nd Cir. 1952), cert. denied, 344 U.S. 874 (1952) (Commissioner properly applied section 482 to reallocate deductions associated with property acquired in a reorganization to transferee to clearly reflect income); Aiken Drive-In Theater Corp. v. U.S., 281 F.2d 7, 9-11(4th Cir. 1960); Foster v. Commissioner, 756 F.2d 1430, 1433 (9th Cir. 1985), cert. denied, 474 U.S. 1055 (1986) (Commissioner may invoke section 482 to reallocate income derived from the disposition of property previously acquired in a nonrecognition transaction).

In the instant case, the shifting of FC's FB stock basis to TP's FB shares and call option resulted in a distortion of income which should prevent the potential application of Treas. Reg. § 1.302-2(c). TP was able to claim substantially larger tax losses than he economically sustained as a result of the basis shift. FC's combined sale of the call option and purchase of the put option made it highly likely that FB would ultimately redeem the stock prior to the close of the taxable year. This result was economically necessitated. For instance, if the price of the FB shares rose above the call option strike price of BCq or fell below BCq and above BCr, FB would have been economically compelled to exercise the call option and redeem the stock. However, if the stock price fell below BCr, FC would have been economically compelled to exercise the put and cause FB to redeem the stock. Therefore, the redemption was virtually certain to occur, allowing TP and FC the ability to attempt to apply the provisions of Treas. Reg. § 1.302-2(c) to cause a basis shift. Given that at the inception of the basis shift transaction, it was virtually certain that TP would be able to claim a substantial loss on the sale of his FB shares and call option through his augmented basis, it is apparent that permitting the application of Treas. Reg. § 1.302-2(c) would result in a distortion of income. Accordingly, under the analysis adopted in the National Securities Corp. line of cases, the Service may disregard the application of Treas. Reg. § 1.302-2(c) and allocate the basis of the FB stock back to FC to clearly reflect income.

ISSUE 7: Whether the transaction may be disregarded, in whole or in part, under the economic substance doctrine.

The incidence of taxation depends on the substance of a transaction. Gregory v. Helvering, 69 F.2d 809 (2d Cir. 1934), aff'd 293 U.S. 465 (1935); Commissioner v. Court Holding, 324 U.S. 331 (1945). In evaluating the validity of a transaction, courts typically attempt to determine, first, whether a transaction genuinely occurred or whether it was merely "papered" in order to generate unwarranted tax benefits. Transactions that are found to be factual shams are, of course, disregarded. See, e.g., Malden Knitting Mills v. Commissioner, 42 T.C. 769 (1964). A transaction that is found to have genuinely occurred must be analyzed further to determine whether it possessed economic substance. Because the sham in fact analysis is highly factual, the discussion following the economic substance analysis assumes that each of the steps of the transaction genuinely occurred.[3]

A. Disregarding the transaction as a whole under the economic substance doctrine.

1. Law.

Generally, an economic substance analysis looks to the subjective business purpose and the objective profit potential of the transaction. See Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184 (1983), aff'd in relevant part, 752 F.2d 89 (4th Cir. 1985); ACM Partnership v. Commissioner, 157 F.3d 231 at 247 (3d Cir. 1998). These two aspects of the economic substance inquiry do not constitute a rigid two-step test, but rather represent related factors, both of which inform the analysis. ACM, supra at 247.

Various articulations of the subjective prong of the economic substance analysis have been set forth by the courts. See, e.g., ACM, 73 T.C. Memo. at 2217 (whether the transaction is "rationally related to a useful nontax purpose . . . in light of the taxpayer's economic situation and intentions"); ACM, 157 F.3d at 253 ("whether the transaction was intended to serve any useful non-tax purpose"); Rice's Toyota World, 752 F.2d at 91 (whether "the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering in the transaction"); Yosha v. Commissioner, 861 F.2d 494, 501 (7th Cir. 1988) ("Judges can't peer into people's minds or 'weigh' motives . . . . Rather, the usual approach is to focus the analysis on whether any non-tax goals or functions were or plausibly could have been served by the action."). The common thread of these articulations, however, is whether the transaction had a business purpose other than obtaining tax benefits.

Like the subjective prong of the economic substance analysis, the phrasing of the objective test has varied among the different courts. For example, the Tax Court in ACM articulated the objective prong as requiring that there be "a reasonable expectation that the non-tax benefits would be at least commensurate with the transaction costs." 73 T.C.M. at 2217. The Third Circuit, on appeal of the same case, repeatedly searched for "any practical economic effects" of a transaction, other than the creation of income tax benefits by examining the taxpayer's financial condition before and after the transaction. ACM, 157 F.3d at 248-52. Under the Fourth Circuit's expression of the objective prong in Rice's Toyota World, a transaction has no economic substance where "no reasonable possibility of profit exists." 752 F.2d at 91. See also Friendship Diaries, Inc. v. Commissioner, 90 T.C. 1054, 1062 (1988) (transaction could not have resulted in

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[3] We recommend that the facts of each case be evaluated to determine whether each step of the transaction actually occurred. If not, a sham-in-fact argument may be available.

“economic profit”). Cf. Killingsworth v. Commissioner, 864 F.2d 1214, 1218 (5th Cir. 1989) (objective analysis involved examination of the “profit making potential”). While the specific articulation of the objective prong has differed among the courts, the fundamental principle is that a transaction must have real and practical economic effects other than the creation of income tax benefits to satisfy the objective aspects of the sham analysis. See Sochin v. Commissioner, 843 F.2d 351, 354 (9th Cir. 1988). Central to this notion is that where the profit derived from the transaction is “infinitesimally nominal and vastly insignificant when considered in comparison with the claimed [tax benefit],” the existence of a profit does not automatically preclude a finding that the transaction failed the objective prong of the economic substance analysis. See Sheldon v. Commissioner, 94 T.C. 738, 768 (1990); Chernin v. Commissioner, 89 T.C. 986, 993 (1987).

To the extent that only certain steps of the transaction are disregarded or recharacterized under the economic substance doctrine, the substance of the remaining steps of the transaction should be analyzed before applying the applicable statutory provisions to determine the tax consequences associated with the remaining steps. See, e.g., American Electric Power v. United States, 136 F. Supp. 2d 762 (S.D. Ohio 2001); In re CM Holdings, 254 B.R. 578, 2000-2 U.S. Tax Cas. (CCH) P50,791 (D. Del. 2000).

Finally, to the extent a transaction is devoid of "nontax substance," courts have refused to recognize the tax consequences of the transactions (including promoter fees and related expenses) because they do not appreciably affect the taxpayer's beneficial interest except to reduce its tax. Knetsch v. United States, 364 U.S. 361, 366 (1960). Accordingly, to the extent that the transaction is a sham in substance, in whole or in part, any tax benefits, fees or expenses, related thereto, may be disallowed.

2. Analysis.

Additional facts should be developed before applying the objective and subjective tests of the economic substance doctrine, discussed above, to the transaction. However, based on the available facts, it appears that the transaction lacked economic substance. In the present situation, TP had an unrelated capital gain of approximately $a. On Date 2, Promoter sent TP a letter describing the steps TP should take to initiate a “direct and indirect leveraged stock purchased strategy” utilizing Promoter as the investment advisor. Through participation in this “strategy,” TP was able to sell its FB option to acquire m bearer shares of FB stock for a purported tax loss of approximately $hh as well as sell kk of its j bearer shares of FB stock for $ll, generating a purported tax loss of $mm (leaving the remaining shares with a purported built-in loss of approximately $vv). The close relationship between the original tax gain of $a and the total purported losses (both claimed and built-in) of $hh, $mm, and $vv suggest that TP did not enter into this transaction for a business purpose. As the 10th Circuit has recognized, “correlation of losses to tax needs coupled with a general indifference to, or absence of, economic profits may reflect a lack of economic substance.” Keeler v. Commissioner, 243 F.3d

1212, 1218 (10th Cir. 2001) citing Freytag v. Commissioner, 89 T.C. 849, 877-78 (1987).

Generally, the transaction, in whole or in part, appears to fail the subjective economic substance prong because there does not seem to have been any useful non-tax purpose for entering into the transaction or certain steps thereto (e.g., TP's acquisition of FC warrants, FC's leveraged acquisition of FB stock with an equity collar, and TP's acquisition of out-of-the-money options to purchase FB stock). Similarly, the transaction appears to fail the objective economic substance prong because TP's profit potential with respect to the transaction, in whole or in part, is insignificant compared to the anticipated losses claimed by TP in connection with the transaction or certain steps thereto. Moreover, there does not seem to have been any practical economic effects of the transaction, in whole or in part, other than the creation of a tax loss for TP. Thus, based on the facts developed to date, the transaction may be viewed as a sham in substance, in whole or in part, and, to the extent the transaction is a sham in substance, any tax benefits, fees or expenses, related thereto, may be disallowed.

B. Applying the sham entity doctrine to disregard the existence of FC as an entity separate from its owner.

1. Law.

Another application of the economic substance doctrine is the sham entity doctrine. The sham entity doctrine may apply to disregard FC and treat FP (or TP, to the extent that TP is treated as the owner of FC under the substance over form analysis, discussed above) as engaging in the activities purportedly carried on by FC.

The determination of whether an organization is an entity separate from its owners for federal income tax purposes is a matter of federal tax law and does not depend upon whether the organization is recognized as an entity under local law. Section 301.7701-1(a)(1) of the Procedure and Administration Regulations. A corporate entity formed under local law is recognized as an entity for federal income tax purposes if its purpose is the equivalent of business activity or the corporation conducts business activities. See Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-39 (1943). Courts have understood the reference to the term "business activity" in Moline to exclude an activity whose sole purpose is tax avoidance. See ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 512 (D.C. Cir. 2000).

2. Analysis.

The facts demonstrate that FC and FP were formed for the sole purpose of engaging in the transaction and that the only day-to-day activities of FC and FP were likely to have been limited to those that related to the transaction. Because there does not appear to be any useful non-tax purpose for forming FC and/or FP or for FC's participation in the leveraged acquisition of FB stock and/or the redemption of such stock, the sham entity doctrine may apply to disregard the existence of FC and/or FP as an entity separate from its owner.[4] See ASA Investerings Partnership v. Commissioner, T.C. Memo. 1998-305.

If FC is disregarded as an entity separate from its owner, the tax consequences of the remaining steps of the transaction will depend upon whether TP, instead of FP, is the owner of FC under the "control" analysis discussed in Issue 5. If FP is the owner of the FC stock, then the attribution rules of section 318 would not apply to treat the FB stock and options owned by TP as owned by FP. Thus, the tax consequences would be as follows: (i) the redemption would be characterized as a sale or exchange under section 302(b)(3) to which FP would recover its basis; (ii) the basis shifting rule under Treas. Reg. § 1.302-2(c) could not apply; and (iii) depending upon the fair market value of the FB stock and out-of-the-money options on the date TP subsequently disposes of such stock and options, TP could recognize gain. Again, TP would neither realize nor recognize the claimed loss on the transaction.

Alternatively, if TP is the owner of the stock of FC, then TP (not FC or FP) entered into the highly leveraged acquisition transaction with FB to acquire the FB stock and TP's FB stock was redeemed by FB. Under the analysis described above, the tax consequences of the redemption and sale of TP's FB stock and options may be viewed as a sale or exchange under section 302(b)(3) to which gain or loss applies. Again, TP would neither realize nor recognize the claimed loss on the transaction.

Case Development, Hazards and Other Considerations

[redacted]

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[4] Also, FC may have been formed as a conduit for the payment of fees to Promoter and accommodating parties to the transaction whose sole design appears to have been to allow TP to avoid federal income tax.

[redacted]

Please call Lisa K. Leong at (202) 622-7530 if you have any further questions.

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