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Internal Revenue Service
Memorandum**

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subject: Whether a Purchaser of a Corporation's Stock Should be Treated as the Tax Owner for Purposes of Determining whether the Corporation is a Member of the Purchaser's Affiliated Group under Section 1504

This memorandum, under generalized facts as described below, sets forth the legal analysis to be considered during your examination of whether a parent corporation is the tax owner of a subsidiary's stock for purposes of determining whether the subsidiary is a member of the parent's affiliated group under section 1504(a). This document may not be used or cited as precedent.

ISSUE

Whether a parent corporation was the tax owner of a subsidiary's stock when the parent engaged in a purported purchase of the subsidiary stock from an unrelated counterparty in exchange for the parent's debt instrument, the terms of which entitled the counterparty to exchange the instrument into the same class and quantity of subsidiary stock as that originally transferred and, thereby, effectively retain all of the potential for gain and a substantial portion of the risk of loss with respect to the stock.

CONCLUSION

The parent corporation was not the tax owner of the subsidiary's stock. Thus, the subsidiary was not a member of the parent corporation's affiliated group and may not join in the parent group's consolidated return.

FACTS

Parent is the parent of an affiliated group of corporations that files a consolidated federal income tax return. Company has a single class of common stock outstanding that is publicly traded on an exchange. Company has an established history of paying quarterly dividends on its common stock.

Prior to the transaction described below, Parent directly owned a majority of the vote and value of Company's common stock, and Counterparty, a party unrelated to Parent or Company, directly owned a minority of the vote and value of Company's common stock. The remaining Company common stock was widely held by unrelated investors.

Parent entered into a stock purchase agreement with Counterparty (the "Purchase Agreement") under which Counterparty agreed to convey all of its shares of Company stock (the "Exchange Shares") to Parent solely in exchange for a debt instrument (the "Instrument") issued by Parent. Subsequently, on the Acquisition Date, Parent and Counterparty consummated the exchange.

The principal amount of the Instrument equaled the exchange traded price of Company common stock on the Acquisition Date (the "Exchange Price") multiplied by the number of Exchange Shares conveyed by Counterparty to Parent pursuant to the Purchase Agreement. The term of the Instrument was greater than six years and the effective yield was less than one third of the comparable yield at which Parent would have issued a fixed rate debt instrument with terms and conditions similar to those of the Instrument but without the right to exchange the Instrument for Company shares as described below.

Under the terms of the Instrument, Counterparty had an unconditional right to exchange the Instrument for the Exchange Shares over a multiple-day period ending before the second anniversary of the Acquisition Date (the "Exchange Period"). The Instrument was exchangeable into the same number of shares of Company stock as that originally transferred, regardless of the exchange traded price of Company stock at any time during the Exchange Period.

In addition to exercising its right during the Exchange Period, Counterparty had the right to exchange the Instrument at any time prior to the Exchange Period if: (i) Company declared a non-cash or non-stock dividend; or (ii) Company declared cash dividends in excess of thresholds set slightly above historic norms (collectively, the "Exchange Events"). If Counterparty did not exercise its exchange right, the Instrument

matured at the expiration of its term for its principal amount plus any accrued but unpaid interest. Parent had no right to call the Instrument.

In connection with the Purchase Agreement, Parent and Counterparty also entered into a pledge agreement (the "Pledge Agreement"), under which Parent pledged the Exchange Shares to Counterparty as collateral for the Instrument. Legal title to the Exchange Shares was transferred to an entity related to Counterparty ("Agent") as of the Acquisition Date. In general, under the Pledge Agreement, neither Parent nor Counterparty could sell, assign, or otherwise dispose of the Exchange Shares; nor could either party lend, grant any option, create any lien with respect to the Exchange Shares, or enter any agreement to effectuate the same, except in the event of default. However, Parent could substitute other identical shares of Company stock for the Exchange Shares by delivering them to the Agent.

The Pledge Agreement obligated Parent to deliver possession of the Exchange Shares to Agent, and upon an event of default, Counterparty had the right to have the Exchange Shares transferred into its name or into the name of its assignee. Unless there was an event of default, Parent had the right to vote and give consent with respect to the Exchange Shares. In addition, Parent had the right to receive cash dividends paid on the Exchange Shares.¹ Counterparty had the right to receive and retain as collateral all non-cash dividends, and any such dividends received by Parent were to be held for the benefit of Counterparty and, upon demand, delivered to Counterparty as collateral.

The Pledge Agreement terminated under varying circumstances, one of which was Counterparty's failure to elect to exercise its exchange right. Upon termination, Parent had the right to any remaining collateral.

LAW AND ANALYSIS

The term "sale" is defined generally as a transfer of property for money or a promise to pay money. Commissioner v. Brown, 380 U.S. 563, 571 (1965); Torres v. Commissioner, 88 T.C. 702, 720 (1987); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981). In form, under the Purchase Agreement, Counterparty sold its Company common stock to Parent on the Acquisition Date. However, for federal income tax purposes, the substance of a transaction, rather than its form, controls. Frank Lyon Co. v. United States, 435 U.S. 561, 572-73 (1978). Therefore, it must be determined whether Parent, as the purported purchaser of the Company stock pursuant to the Purchase Agreement, possessed meaningful benefits and burdens associated with stock ownership, or whether Counterparty retained these benefits and burdens so that ownership of the Company stock never passed to Parent. See Corliss v. Bowers, 281 U.S. 376, 378 (1930). This is a question of fact that is determined from the

¹ Note that Parent's entitlement to *all cash dividends* paid by Company was effectively limited by Counterparty's ability to accelerate the timing of its exchange right when Company declared quarterly dividends in excess of a certain amount per share.

intention of the parties as established by the written agreements read in light of the attending facts and circumstances. Calloway v. Commissioner, 135 T.C. 26, 33 (2010); Grodt & McKay, 77 T.C. at 1237. Thus, when considering whether a sale between Counterparty and Parent has taken place, the analysis of the transaction extends not only to the Purchase Agreement, but to all agreements relating to the transaction, including the Pledge Agreement, the Instrument, and the Note Purchase Confirmation.

The determination of tax ownership is a pragmatic inquiry based upon substance and realities. See Commissioner v. Segall, 114 F.2d 706, 709 (6th Cir. 1940). In general, a party to a sales transaction acquires tax ownership of property when the party, although not necessarily the holder of legal title, bears and enjoys the predominant benefits, burdens, and risks of owning the property. See Grodt & McKay, 77 T.C. at 1237-38. When evaluating whether the benefits and burdens of ownership have passed, courts have considered a variety of factors. No one factor is necessarily determinative, and the weight of each factor depends upon the surrounding facts and circumstances. H.J. Heinz Co. v. United States, 76 Fed. Cl. 570, 582 (2007). Thus, the nature of the transaction and the type of property involved may affect the relative importance afforded to a particular factor. See Torres, 88 T.C. at 721.

Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981), is a seminal case on the factors relevant to the determination of whether a transfer of the benefits and burdens of ownership has occurred. As the Tax Court stated in that case, “[s]ome of the factors that have been considered by courts in making this determination are: (1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damages to the property; and (8) which party receives the profits from the operation and sale of the property.” Grodt & McKay, 77 T.C. at 1237-38.

In the context of a transfer of stock, courts have found the following factors particularly relevant in determining tax ownership: (1) which party has the opportunity to share in gain from an appreciation in value of the stock and bears the risk of loss from a decline in value of the same; (2) which party has legal title to, and the ability to dispose of, the stock; (3) which party has the right to vote the stock; and (4) which party has possession of the stock. See Anschutz v. Commissioner, 135 T.C. 78, 105 (2010), aff’d, 664 F.3d 313 (10th Cir. 2011). Courts have also focused upon the right to receive dividends. See Calloway, 135 T.C. at 34-35; Pacific Coast Music Jobbers, Inc. v. Commissioner, 55 T.C. 866, 876 (1971), aff’d, 457 F.2d 1165, 1171 (5th Cir. 1972).

Background

(a) Features of a Typical Exchangeable or Convertible Debt Instrument²

An exchangeable or convertible debt instrument essentially embodies two components: a debt component represented by an obligation to pay a sum certain at a future date; and an equity-like component represented by a right (or option) to exchange the instrument into a stated number of shares of stock. This additional equity-like feature usually is factored into the pricing of the instrument by allowing the issuer to offer a lower rate of interest on the pure debt component of the instrument. The unitary value of an exchangeable debt instrument reflects both of these components. It generally should not be lower than the more valuable of the two components and should be higher given the holder's ability to select the better of the two alternative payouts.

In the typical case, the holder's right to exchange the instrument continues to exist at or near the maturity of the instrument (and any earlier call date); that is, the term of the exchange right is exactly or nearly coextensive with the term of the instrument. In this case, the holder generally would exercise its exchange right when the value of the stock underlying the instrument plus dividend payments exceeds the value of the principal amount due at maturity (or upon call) plus interest payments. Typically, the exchange ratio is set so that the stock or other property into which the instrument is exchangeable or convertible would have to appreciate significantly over the term of the instrument for the holder to find it advantageous to exercise its right to exchange or convert.

Typically, the issuer has the right to call (or redeem) the instrument at a set price (the call price) prior to its maturity. In general, an issuer would call an instrument if the instrument's market value were to exceed the call price at redemption; and in such a case, the holder would exercise its exchange right prior to redemption if the market value of the stock were to exceed the call price plus accrued but unpaid interest.

(b) Parent's Exchangeable Debt Instrument

The terms of the Instrument differ from those of a typical exchangeable or convertible debt instrument in significant respects. First, the period during which Counterparty could exercise its right to exchange the Instrument was not coextensive with the Instrument's term; the right terminated during the second year after issuance while the Instrument continued approximately another five years beyond that point. Therefore, if the exchange right went unexercised, the Instrument's unitary value would then reflect only the value of its debt-like component because the equity-like component (and the value of that component) had vanished. Moreover, the Instrument was designed so that at the end of the Exchange Period its value would be significantly less than the principal amount of the Instrument.

² Exchangeable and convertible debt instruments function similarly as an economic matter. However, convertible debt is convertible only into stock of the issuer, whereas exchangeable debt may be exchanged for other types of property and may be exercisable against parties other than the issuer. Here, the Instrument is exercisable only against the issuer, Parent, and is exchangeable solely for stock of Company.

Although it is typical for an exchangeable or convertible debt instrument to offer a lower effective yield than that offered on a pure debt instrument with similar terms absent the exchange or conversion feature, the Instrument's effective yield absent this feature was less than one third of the comparable yield at which Parent would have issued a fixed rate debt instrument with terms and conditions similar to those of the Instrument. The fair market value of the Instrument at issuance equaled the Instrument's principal amount because the equity-like component justified the value. However, the relatively low strike price for the exchange right made the equity-like component more valuable than a typical exchangeable or convertible debt instrument, and the relatively low effective yield of the Instrument made the debt-like component less valuable than a typical exchangeable or convertible debt instrument. The design of the Instrument reflected a built-in expectation that the Instrument would be exchanged for Company stock. If the exchange right went unexercised, Counterparty would hold a pure debt instrument that was expected to be substantially less valuable than its initial investment.

Lastly, the Instrument did not allow Parent to call (or redeem) the Instrument for cash prior to the Exchange Period. If the value of Company stock appreciated (or, as explained below, even depreciated), Counterparty would unilaterally exercise its exchange right during the Exchange Period and Parent had no ability to retain the Exchange Shares.

Tax Ownership Analysis

Based upon the application of the factors relevant to determining tax ownership of stock, we conclude that tax ownership of the Exchange Shares resided with Counterparty rather than Parent.

(1) Opportunity for Gain & Risk of Loss

Counterparty had all of the opportunity for gain from appreciation in value of the Exchange Shares and a substantial portion of the risk of loss of a decline in value of those shares because the Instrument was designed with the expectation that Counterparty would exchange the Instrument for Company stock.

In Rev. Rul. 83-98, 1983-2 C.B. 40, corporation X's adjustable rate convertible notes (ARCNs) were considered common stock upon issuance because, among other reasons, the ARCNs were structured so that under most likely eventualities a holder of an ARCN would exercise its right to convert the instrument into X common stock. In the ruling, X had common stock outstanding that had recently traded at approximately \$20 per share, and it issued ARCNs, each of which was offered at a price of \$1000 cash or 50 shares of X common stock. The holders had the right to elect to receive either \$600 or 50 shares of X common stock at maturity.

At maturity, the holders would convert the ARCN into X stock if the value of the stock was more than \$600. Because the X stock was worth \$1,000 when the ARCNs were issued, redemption for cash at maturity would occur only if the value of the stock dropped by more than 40 percent. Further, as long as the 50 shares of X stock were trading at more than \$600, it would be economically disadvantageous for the holder of an ARCN to permit X to redeem it for \$600.³

Like the ARCNs in Rev. Rul. 83-98, 1983-2 C.B. 40, Parent's Instrument was structured so that under most likely eventualities, Counterparty would exercise its exchange right during the limited Exchange Period and regain the Exchange Shares, rather than hold the Instrument to maturity. At issuance, the value of the Instrument reflected both the straight debt component and the exchange right, or equity-like, component. The relatively low strike price for the exchange right made the equity-like component of the Instrument more valuable than normal, and the relatively low effective yield of the Instrument made the debt-like component less valuable than normal. If the exchange right went unexercised, the value of the Instrument in Counterparty's hands would decline markedly because the value of the exchange right would disappear.

As a rational economic actor, Counterparty was unlikely to forego its right to exchange the Instrument for the Exchange Shares. The fair market value of the retained Instrument (now, consisting solely of the debt component), in most likely scenarios, would be much less than the fair market value of the Exchange Shares. Counterparty was unlikely to choose to hold the Instrument to maturity because it would receive a below-market rate of return on a long-term, potentially illiquid investment. Moreover, because the Pledge Agreement terminated if Counterparty did not exercise its exchange right, Counterparty would hold the Instrument, unsecured by any collateral.

Because of the high probability that Counterparty would exercise its exchange right, Counterparty effectively retained all of the opportunity for gain from appreciation in value and much of the risk of loss from a decline in value that was inherent in the ownership of the Exchange Shares. By way of illustration, assume that when the Instrument was issued, the Exchange Shares were valued at \$10,000,000 (Company stock was trading at \$50 per share), and the fair market value of the straight debt component of the Instrument was \$5,000,000 (equivalent to a per share value of \$25). When the window for exercise opened, if the fair market value of Company stock were to remain at \$50 per share or to appreciate to any extent, Counterparty would exercise its exchange right because the fair market value of the straight debt component would

³ See also, Rev. Rul. 82-150, 1982-2 C.B. 110. A paid \$70,000 for an option to purchase all of the stock of corporation FX that had been capitalized with \$100,000. The option was exercisable at A's discretion at any time, and the price to be paid was \$30,000. Although, in form, A acquired an option, the ruling holds that, in substance, A was the actual owner of the FX stock. The ruling implicitly reasons that where the strike price of the option, upon issuance, is significantly less than the fair market value of the stock, there is a very high probability that the holder will exercise the option and therefore, a completed sale of the stock to the holder has occurred. A provided (or would provide) all of the funds to capitalize FX and it was A's investment that would appreciate or depreciate depending upon FX's success or failure. Because A had assumed the risks of an investor in equity, the benefits and burdens of the ownership of FX stock had passed and the sale of the FX stock to A was completed when the option was granted.

be less than the fair market value of the Exchange Shares. Thus, any appreciation in the fair market value of the Company stock would inure to the benefit of Counterparty.

Now assume that during the Exchange Period, Company stock was trading at \$40 per share, for an aggregate value of \$8,000,000, and, again, the fair market value of the straight debt component of the Instrument was \$5,000,000 (equivalent to a per share value of \$25). Although the fair market value of Company stock declined, Counterparty would still exercise its exchange right because, again, the fair market value of the Exchange Shares exceeded the fair market value of the straight debt component. Only when Company stock was valued below \$25 per share would Counterparty forego its right to exercise the exchange right. Thus, both Counterparty and Parent bore some of the risk of loss of a decline in value of the Exchange Shares, but the value of Company stock would have had to have declined precipitously, in the fairly limited period from the Acquisition Date to the Exchange Period, before any risk of loss shifted to Parent.

(2) Legal Title to Exchange Shares & Right to Dispose

Although courts do not regard the simple expedient of drawing up papers as controlling for purposes of determining tax ownership of property, legal title to property and the ability to dispose of it are indicative of the parties' intentions. See Anschutz, 135 T.C. at 105-06, aff'd, 664 F.3d 313 (10th Cir. 2011); Grodt & McKay, 77 T.C. at 1237; Segall, 114 F.2d at 709. On the Acquisition Date, the Exchange Shares were pledged to Counterparty as collateral and delivered to Agent, an entity related to Counterparty. Unless there was an event of default, neither Parent nor Counterparty had the right to sell the Exchange Shares outright to a third party; nor did either party have the right to otherwise encumber the shares.

Agent held legal title to the Exchange Shares. Under the Pledge Agreement, Counterparty reserved the right to cause the Exchange Shares to be transferred into its name or the name of an assignee. In addition, until Parent's obligations under the Purchase Agreement and Instrument were satisfied, only Counterparty had the ability to reacquire legal title to the Exchange Shares by exercising its exchange right. Moreover, because the Instrument lacked typical call provisions, Parent could not retain the Exchange Shares by redeeming the Instrument for cash prior to the Exchange Period.

(3) Right to Vote

Parent was entitled to vote and provide consents with respect to the Exchange Shares that were held in the collateral account. Only upon an event of default under the various agreements did the voting and consent rights shift from Parent to Counterparty. The transfer of this benefit of ownership favors treatment as a completed stock purchase by Parent as of the Acquisition Date. However, the nature of the transaction belies the weight that should be afforded this factor.

Based upon its pre-existing stock ownership, Parent already held a majority of Company's outstanding common stock. Thus, Parent's ability to control and manage Company through the exercise of its voting rights was not enhanced by the transfer of the Exchange Shares.⁴

(4) Right to Possession

On the Acquisition Date, the Exchange Shares were pledged to Counterparty as collateral for the Instrument and delivered to Agent, an entity related to Counterparty. Counterparty retained the ability to reacquire the Exchange Shares from Agent upon its exercise of the exchange right, or upon Parent's default under the Pledge Agreement. Thus, Counterparty never relinquished its right to possession of the Exchange Shares.

(5) Right to Dividends

The Pledge Agreement provided that Parent was entitled to receive all cash dividends paid on the Exchange Shares held in the collateral account. In addition, all non-cash dividends, although received and retained by Counterparty as collateral for the Instrument, were to be held for the benefit of Parent. Further, upon the termination of the Pledge Agreement, Parent had the right to receive any remaining collateral.

Based upon the Pledge Agreement alone, it appears that all of the dividend rights with respect to the Exchange Shares actually were transferred to Parent. However, Parent's right to receive *all dividends* on the Exchange Shares was effectively limited in terms of both the absolute amount of the dividend and the type of property that may be received. As noted above, under the Purchase Agreement, Counterparty could exchange the Instrument for the Exchange Shares prior to the Exchange Period if either: (i) Company declared a dividend payable in other than cash or stock; or (ii) Company declared a quarterly cash dividend that, together with all other special dividends for any quarter in which the dividend is paid, exceeded a certain amount per share. If either event occurred, Counterparty effectively had the right to the dividends payable on the Exchange Shares because it was in its economic interest to exercise the exchange right and reclaim the shares.

Parent may argue that there was no realistic possibility that either of these events would occur because, through its pre-existing stock ownership, it already controlled whether Company would pay dividends and the amount and type of any such dividends. This, however, merely reinforces the conclusion that Parent's right to dividends with respect to the Exchange Shares was limited by the terms of the Agreements, and therefore, it was not entitled to receive *all* rights to dividends with respect to the Exchange Shares.

⁴ Note that this discussion goes only to the weight to be given this factor for purposes of the benefits and burdens analysis and does not alter the Service's position regarding the voting requirement of section 1504(a)(2)(A). See, e.g., Rev. Rul. 69-126, 1969-1 C.B. 218 (stock owned must possess at least 80% of the voting power of all classes of stock).

SUMMARY

Company did not become a member of Parent's affiliated group and may not join in the Parent group's consolidated return. Counterparty retained all of the opportunity to share in gain from an appreciation in value of the shares, and it bore a substantial part of the risk of loss from a decline in value. It is clear that Parent acquired neither possession of, nor legal title to, the Exchange Shares; nor did Parent acquire the ability to dispose of them. In addition, although Parent held both the right to certain dividends with respect to the Exchange Shares and the right to vote the Exchange Shares, Parent's rights were not absolute. We find that based upon the analysis of the relevant factors outlined above, the benefits and burdens of stock ownership did not pass to Parent, and Parent was not the tax owner of the Company stock.

OTHER CONSIDERATIONS

Some variations on the structure outlined above may include additional features that would further support a determination that the benefits and burdens of stock ownership did not pass.

For example, if Counterparty did not own a sufficient number of shares of Company stock to increase Parent's pre-existing stock ownership to the level necessary for affiliation under section 1504, Counterparty may have borrowed some or all of the Company stock used in the transaction. If Company stock is thinly traded,⁵ Counterparty's ability to go into the market to buy Company shares would be constrained; any large market purchases would substantially increase the price of the stock making the exchange prohibitively expensive. In these cases, the likelihood that Counterparty would not exercise its right to exchange the Instrument for the original Company stock in order to satisfy its external obligation to return the borrowed stock is particularly remote.

In some cases, Parent and Counterparty may have entered into cost reimbursement and/or hedging agreements to ensure that Counterparty bore little or no cost with respect to the purported sales transaction. For example, the agreements may provide that Counterparty may accelerate its right to exchange the Instrument for the Exchange Shares if it is not reimbursed for certain costs. Alternatively, acceleration of the exchange right may occur if Counterparty is unable to hedge the price and market risk with respect to the Shares. Such acceleration provisions have the effect of allowing Counterparty to unilaterally reclaim the Exchange Shares based upon its economic interest.

In addition, the agreements may restrict Counterparty's ability to sell or dispose of the Instrument by requiring Parent's consent to the disposition, or by giving Parent

⁵ In these cases, Parent's pre-existing ownership interest in Company is likely to be substantial in order to maintain control over Company's activities; therefore, the availability of shares for purchase, whether on an exchange or held privately, would be limited.

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the right of first refusal to pay the purchase price or the right to designate an alternate buyer.

We encourage you to develop these cases, and stand ready to assist you in the legal analysis. Please call Joanne M. Fay or Frances L. Kelly of the Office of the Associate Chief Counsel (Corporate) at (202) 622-7790 (not a toll-free number) if you have any further questions.

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