DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM:

SUBJECT:

This Field Service Advice responds to your memorandum dated ↕May 3, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Taxpayer =

FC1 =
US1 =
component =
product =
date 1 =
date 2 =
date 3 =
year 1 =
year 2 =
Country A =
x =
y =
z =

a =
b =
c =
d =
e =
f =
g =
h =
i =
j =
k =
l =
m =
n =

ISSUE:

Whether either the open transaction or relation back doctrine applies to the sale of US1 stock by FC1 so the gain realized by FC1 from the sale of the stock of US1 is not foreign personal holding company income under I.R.C. § 954(a)(1).

CONCLUSION:

Neither the open transaction doctrine nor the relation back doctrine apply to FC1's sale of US1 stock. Therefore, the gain from the sale of the stock is foreign personal holding company income under I.R.C. § 954(a)(1).

FACTS:

FC1 is a wholly owned, second tier, Country A subsidiary of Taxpayer, a domestic corporation. On date 1, FC1 sold it entire component manufacturing operation, including all work in progress, existing work force, and a royalty-free, non-exclusive license to all necessary component an process technologies to US1, an unrelated domestic corporation. In year 1, US1 purchased the component plant owned by FC1.

Terms of the sale of FC1's component business unit were set out in an Asset Purchase Agreement (“Agreement”) between Taxpayer, FC1, and US1. The Agreement stated that it was “made and entered into on date 1." The sale closed on date 2.

Pursuant to the Agreement, FC1 agreed to sell its component business unit to US1 as a going concern. After the sale, FC1 continued to manufacture product in Country A. FC1 continued to use the component manufactured by US1 to produce

product. US1 was free, however, to offer the component to customers other than Taxpayer or its affiliated (including FC1) and, its business has greatly expanded to customers other then Taxpayer and its affiliates.

The Agreement created a two year covenant for FC1 not to compete with US1 in the manufacture of component in Country A or to solicit former FC1 employees of the component business unit in Country A. Also pursuant to the Agreement, Taxpayer and FC1 committed to purchase fixed quantities (in excess of $a), of product from US1's Country A facility for a period of at least six months from the date of sale, provided US1's component continued to satisfy current specifications.

Purchase Price.

The purchase price for the component business unit was calculated based on a formula in the Agreement. The initial purchase price was set at $b, but was subject to adjustment based on the results of an outside valuation of inventory and fixed assets as of the closing date. If the combined value of inventory and fixed assets was found to be greater or less than $c, the final purchase price would be adjusted. The inventory and fixed assets were appraised at only $d and the initial purchase price was reduced to $e. Other than the appraisal adjustment, there was no provision in the Agreement for any subsequent adjustment to the purchase price.

Payment.

US1 paid for the purchase by the issuance of its own common stock. US1 stated that FC1 did not have an option to receive cash for the FC1 component business unit.

The Agreement was executed on date 1. At the time, US1 was preparing an initial public offering ("IPO") of its common stock for a date in year 1. US1 proposed to issue either preferred or restricted common stock to FC1 in payment of the $e adjusted purchase price. FC1 opted for the restricted common stock.

On date 3, US1 transferred x shares of the newly issued US1 common stock to FC1. The number of shares was determined as specified in the Agreement by dividing the adjusted purchase price of the component business unit by the initial offering price of the US1 common stock, $y/share. However, on date 3, shares of US1 common stock issued in the IPO were trading for approximately $z/share.

The Agreement contained a "lock-up" provision which restricted the sale by FC1 of the US1 common stock for up to 12 months. The restriction was structured so that one-third of the shares could not be sold until six months after the IPO; another one-third, three months later; and the final one-third an additional three months after that (or one year from the IPO).

Pursuant to the prospectus relating to the year 1 public offering of US1's common stock, FC1's restriction/lock-up on the resale of US1 stock could be waived upon the written consent of certain U.S. and International underwriters. However, the restrictions were not waived. Following the above schedule nearly to the day, all of FC1 shares in US1 were sold seven, nine, and twelve months after the sale of the component business unit to US1. All of the US1 shares received by FC1 as consideration for the sale were sold by the end of year 2. Although the US1 stock price was subject to various fluctuations, during the period from the IPO to the dates of sale, the price was on a consistent upward trend to a peak at the end of year 2.

Calculating the Gains on the Sales.

On its financial books, FC1 recorded the sale in year 1 of the component business unit as a separate transaction from the subsequent sales in year 2 of the US1 stock. Gain from the sale of the component business unit was calculated by using a discounted value for the US1 stock received in the transaction as the gross proceeds of sale. Gain from the sales of US1 stock were calculated by using the same discounted value of the stock as the cost basis. The discount, which was attributable to the lock-up provision, was determined by an unrelated, investment banking firm.

Gain on Sale of Component Business Unit.

Upon receipt of the US1 stock, FC1 debited its Marketable Securities account by the amount of $f, (which was equal to the $z per share market price of US1 stock as of date 3, times the x shares received). FC1 then discounted this amount by n percent and credited an "asset evaluation allowance" account with the amount of $g ($f x n%). The discount was made to take into account the "lock-up" provisions (as described above). The discounted value or book "cost" of the US1 shares was calculated to be $h, ($f - $g) which FC1 credited to a "P&L misc expense" account.

For financial reporting, FC1 calculated the gain realized on the sale of the component business unit to be $j. It derived this number by subtracting the book value of its component assets from the discounted value of the US1 stock ($h -$i = $j).

For income tax reporting, a statement attached to FC1's year 1 Form 5471, filed by Taxpayer as an attachment to Taxpayer's year 1 income tax return, reported a "Gain on Sale of Product" in the amount of $j. FC1 reported a gain in year 2 of $k as an addition to its current earnings and profits for the sale of the product business unit. None of the gain was reported as subpart F income.

Gain on Sale of US1 Stock.

In year 2, FC1 received gross proceeds from the sale of US1 stock totaling $l. FC1 subtracted $h, which it treated as its cost basis, from the gross proceeds of sale and reported a book gain from the sale of stock in the amount of $m. This gain was

characterized by FC1 as "other income on the sale of investments." A statement attached to FC1's year 1 Form 5471, filed by Taxpayer as an attachment to Taxpayer's year 2 income tax return, reported a "Gain on Sale of Investments" in the amount of $m. None of that gain was treated as subpart F income.

Taxpayer argues that the gain on sale of the component business unit was not included in its U.S. taxable income because the proceeds belonged to FC1, which was a controlled foreign corporation ("CFC"). Generally, gain derived from the sale by a CFC of its active business assets is not included in subpart F income. Treas. Reg. section 1.954-2(e)(1) and (3). If the component business unit was an active business asset of FC1 on the date of its sale, the gain on the sale by FC1 should not be included in Taxpayer's income.

Taxpayer and FC1 are treating the sale of the component business unit and the subsequent sales of the US1 stock as a single integrated transaction involving the sale of FC1's business assets in order to exclude all of the gains from subpart F income under Treas. Reg. section 1.954-2(e)(1) and (3). Taxpayer argues that the “lock-up” provision of the Agreement with respect to the sale of the US1 stock was part of the sale of the component business unit. Therefore, the sale of FC1's component business unit and the subsequent sale of the US1 stock, were all part of the sale of FC1's active trade or business. Consequently, the gain on the sale of FC1's component business unit consisted of two parts: 1) the gain represented by the difference between the value of the US1 stock when acquired by FC1 and the book value of the component business unit, and; 2) the gain represented by the difference between the subsequent sales price of the US1 stock and the value of the US1 stock when acquired by FC1. Taxpayer alleges that both of these gains are excluded as gain resulting from the disposition of intangible property, goodwill and the going concern value of assets used or held in the trade or business of FC1, Taxpayer's CFC, pursuant to Treas. Reg. section 1.954-2(e)(3)(iv).

Specifically, Taxpayer argues that the sale of the component business unit and the disposition of the US1 shares were not separate transactions but were, in fact, one transaction under both the "open transaction" doctrine established in Burnet v. Logan, 283 U.S. 404 (1931), and the "relation-back" doctrine of Arrowsmith v. Commissioner 344 U.S. 6 (1952).

The field's position is that the sale of the component business unit for US1 stock, and the subsequent sale of the US1 stock, represent two separate transactions for tax purposes. Consequently the gain from the sale of the component business assets is excluded from subpart F income. However, the gain from the subsequent sale of the US1 stock is a separate transaction and such gain constitutes subpart F income to Taxpayer. We agree with the Field.

LAW AND ANALYSIS

Subpart F

Section 951 of the Code generally requires a United States shareholder of a CFC to include in income the shareholder's pro rata share of the CFC's subpart F income. Section 952 defines subpart F income as including foreign base company income as determined under § 954. Section 952(a)(2). Under I.R.C. § 954(a)(1), foreign base company income includes foreign personal holding company income.

Foreign personal holding company income is defined, in part, under I.R.C. § 954(c)(1)(B)(i) as including income from the sale of property which gives rise to dividend, royalty or interest income. Gain from the sale of stock by a CFC generally results in foreign personal holding company income because stock is property that gives rise to dividend income.

Section 954(c)(1)(B)(iii) provides that foreign personal holding company income includes the excess of gains over losses from the sale or exchange of property which does not give rise to any income.

Treas. Reg. § 1.954-2(e)(3)(ii) provides that property that does not give rise to income does not include tangible property (other than real property) used or held for use in the CFC's trade or business that is of a character that would be subject to the allowance for depreciation under I.R.C. § 167 and 168 and the regulations under those sections (including tangible property described in Treas. Reg. § 1.167(a)-2).

Treas. Reg. § 1.954-2(e)(3)(iv) provides another exception from property that does not give rise to income for gain from the disposition of intangible property, goodwill, and going concern value, to the extent used or held for use in the CFC's trade or business.

Treas. Reg. § 1.954-2 applies to taxable years of a CFC that begin after November 6, 1995, however a taxpayer may elect to apply the regulations retroactively to any taxable year beginning on or after January 1, 1987, so long as the time for filing a return or claim for refund has not expired. Treas. Reg. § 1.954-0(a)(1). For purposes of this FSA it is assumed that Taxpayer has elected to apply the regulations retroactively.

Open Transaction

Section 1001 generally provides that gain from the sale or disposition of property is the excess of the amount realized over the adjusted basis of the property sold or disposed of. Treas. Reg. § 1.1001-1(a) and Rev. Rul. 58-402, 1958-2 C.B. 15, provide that a property's fair market value is a question of fact and that only in rare and extraordinary circumstances will property be considered to have no fair market value.

Under the open transaction doctrine, as affirmed by the Supreme Court in Burnet v. Logan, 283 U.S. 404 (1932), a seller may treat a transaction as open when the value of property received cannot be determined and, consequently, cannot be included in the amount realized. In Logan, a taxpayer received as payment for stock, cash and an interest in a contract providing for the right to receive income from iron ore production of a mine. The iron ore contract "did not require production of either maximum or minimum tonnage or any definite payments." Id. at 409. The Supreme Court concluded that the gain related to the iron ore contract could not currently be taxed since:

> the promise of future money payments [under the iron ore contract was] wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. . . . She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture. Id. at 413.

Since Logan, courts have extended the application of the open transaction doctrine to various transactions in which a taxpayer receives property that has no ascertainable fair market value at the time of receipt, thus requiring the transaction to be held open in order to determine the ultimate tax consequences. The application of the open transaction doctrine has been considered with respect to such items as stock, contracts, notes, contingency payments and claims.

In applying the open transaction doctrine to stock received by a taxpayer in a transaction, courts have focused on whether the stock received has an ascertainable fair market value by examining the business of the company and any restrictions on the sale of the stock. Not long after Logan, the Supreme Court considered in Helvering v. Tex-Penn Oil Co., 300 U.S. 481 (1937), whether a transaction should remain open because stock taxpayers received in a transaction did not have an ascertainable value at the time of receipt. In Tex-Penn Oil, shareholders of certain oil companies received in exchange for their stock, no-par-value stock of a new corporation formed for the purpose of acquiring and operating oil producing properties and certain oil leases. At the time of receipt, the shareholders orally agreed to refrain from selling or disposing of the stock for a period of 90 to 180 days and honored that agreement. The Supreme Court upheld the Third Circuit Court of Appeals and stated that:

> the judgments must be affirmed on the ground that in the peculiar circumstances of this case, the shares of Transcontinental stock, regard being had to their highly speculative quality and to the terms of a restrictive agreement making a sale thereof impossible, did not have a fair market value, capable of being ascertained with reasonable certainty, when they were acquired by the taxpayers. Id. at 499.

Although the Supreme Court did not specify what the "peculiar circumstances" of the case were, the Third Circuit Court of Appeals explained in more detail why the stock did not have an ascertainable fair market value:

> Transcontinental was a new company organized for the express purpose of developing new oil properties on a large scale. This was a very hazardous, speculative, and uncertain undertaking. The twelve wells which had been drilled were falling off and becoming definitely dry and profitless. The entire field which it was to develop was known to be "spotty." This development proved to be an absolute failure, a great financial loss, and entirely worthless. Another thing increasing the hazards in this case and rendering more uncertain any guess as to the value of the stock [when received by taxpayers] was the existence of a restrictive agreement wherein it was agreed that the taxpayers would not sell or dispose of the stock [for 90 to 180 days]. The determination of the value of the stock on [the date of receipt] was a mere speculative guess and a three or six months restriction on its sale makes the guess wilder and more speculative. Tex-Penn Oil Co. v. Commissioner, 83 F.2d 518, 523 (3d Cir. 1936).

Thus, both the Supreme Court and the Third Circuit Court of Appeals determined that the stock received by taxpayers could not be valued at the time of receipt by considering the "hazardous," "speculative" nature of the business of the company and the existence of a restrictive agreement.

Similarly, in United States v. State Street Trust, 124 F.2d 948 (1st Cir. 1942) the court considered the highly speculative nature of a company along with restrictions on the sale of stock to determine that such stock did not have an ascertainable fair market value at the time received by the taxpayers. In State Street Trust, the taxpayer received in exchange for stock, stock of a public utility holding company subject to a one year restriction on taxpayer's ability to sell the stock. Id. at 949. At the time of receipt, the stock was trading on the New York Stock Exchange. The court described the public utility holding company as:

> a comparatively new enterprise; that it was one of the top entities in a highly pyramided public utility holding company system; that [the stock] was subject to violent fluctuations; that the stock was junior to 83 or 84 percent of the stock of the entire holding company system; that the margin of earnings covering [this stock] was very thin; and that the stock could not be sold for a year. Id. at 951.

Considering these factors, the court affirmed the district courts holding that the stock of the public utility company held by taxpayer "was so speculative that, coupled with the restrictive agreement, it had no fair market value" despite the fact that it was traded on the New York Stock Exchange. Id. at 951.

However, where the stock received has sales restrictions but is stock of a company that is not a speculative or uncertain undertaking, courts have held that the

stock is capable of being valued and thus, the transaction in which such stock is received need not be held open. In Heiner v. Gwinner, 114 F.2d 723 (3d Cir. 1940), the court held that stock received by a taxpayer subject to a one-year restriction on its sale had an ascertainable value and, thus, the transaction was a closed one because the stock was neither speculative nor hazardous in character. In Gwinner the taxpayer received stock in a steel foundry company in exchange for stock he owned in another company. The stock was subject to a one-year restriction on its sale. The taxpayer argued that the restriction on the sale of the stock deprived it of fair market value under Tex-Penn Oil. Gwinner at 725. The court disagreed, holding that "there is no evidence in the present case that the stock was speculative or hazardous in character. We do not think the Tex-Penn case requires us to hold that a mere restriction against sale for one year, without more, as a matter of law deprives stock of all market value." Id. See also, North American Phillips Company Inc. v. Commissioner 21 T.C.M. (CCH) 1497 (1962) (holding that stock had an ascertainable value where the company was not a hazardous, speculative and uncertain undertaking, was not a new company nor was there any indication that its management was inexperienced, where there was no high degree of uncertainty as to its future; and where its sales and earnings were continually increasing and it had a backlog of orders.)

Thus, a restriction on the sale of stock alone, does not require that the transaction be held open. As the Fifth Circuit Court of Appeals noted, "where there is no absolute prohibition against a sale, a restriction may reduce but does not destroy fair market value." Mailloux v. Commissioner 320 F.2d 60, 62 (5th Cir. 1963) citing, Trinity Corporation v. Commissioner, 127 F.2d 604 (5th Cir. 1942); Kirby v. Commissioner, 102 F.2d 651 (5th Cir. 1939); ARC Realty Co. v. Commissioner, 295 F.2d 98 (8th Cir. 1961). In Trinity where stock had been pledged to secure performance of a contractual obligation, the court stated:

> However, the sale of the stock was not forbidden by the agreement; the sole effect of the restriction imposed was that a purchaser would take subject to the terms of the agreement. Such a restriction may reduce, but does not destroy the fair market value. Trinity at 605.

In fact, courts have often allowed proof of fair market value of stock despite the fact that there was a restriction on its free transfer. Fesler v. Commissioner, 38 F.2d 155 (7th Cir. 1930); Newman v. Commissioner, 40 F.2d 225 (10th Cir. 1930); Wright v. Commissioner, 50 F.2d 727 (4th Cir. 1931).

Taxpayer argues that there are many similarities between the stock in Tex-Penn Oil, the stock in State Street Trust and the US1 stock received by FC1. Taxpayer states that the US1 stock is similar to the stock in Tex-Penn Oil and State Street Trust because in each instance, the valuation issue was over stock received as consideration for a sale of assets; the stock was subject to restrictions; the stock was publicly traded; the value of the shares fluctuated widely; the stock was of "new companies;" and the activities of the companies constituted "highly speculative and uncertain undertakings."

However, what Taxpayer fails to point out are the many dissimilarities between the stock in Tex-Penn Oil and the stock in State Street Trust and the US1 stock. While the companies in Tex-Penn Oil and State Street Trust were newly formed companies, the US1 stock, although not publicly traded until the IPO, was of an established company with a history of earnings and profits. In addition, the company in Tex-Penn Oil was engaged in wildcat oil production "a very hazardous, speculative, and uncertain undertaking," and the company in State Street Trust was one of the top entities in a highly pyramided public utility holding company system, while US1 was engaged in an established, profitable, enterprise with a substantial six month purchase commitment by FC1. Finally, although the stock price was subject to various fluctuations during the period that FC1 was restricted from selling the stock, the stock price was on a clear upward trend. The price of the stock when transferred had already increased from the IPO price.

The activities of US1 are not hazardous nor speculative within the meaning of Tex-Penn Oil or State Street Trust and the restrictions did not prevent the stock from being valued. Indeed, Taxpayer valued the stock, taking into account the restrictions at the time of the sale. Consequently, the US1 stock in the hands of FC1 is not a "peculiar circumstance" that the Third Circuit Court of Appeals and the Supreme Court in Tex-Penn Oil, and the First Circuit in State Street Trust determined required a transaction to be held open.

The open transaction doctrine has also been applied to transactions not involving stock where property received in a transaction is impossible to value requiring the transaction to be held open in order to determine the ultimate tax consequences. In Dimond v. United States (In re Steen), 509 F.2d 1398 (9th Cir. 1975), the court applied the open transaction doctrine to a contingent contract obligation. The taxpayer entered into a stock purchase agreement to sell stock for a specified price with a portion to be paid in cash and the remainder in installments. Id. at 1401. The taxpayer entered a second contractual agreement whereby the purchaser agreed to reimburse the taxpayer and the other shareholders for potential state tax liabilities. Id. Several years later, the state Supreme Court resolved the tax issue resulting in a reimbursement payment to the taxpayer pursuant to the second agreement. The Commissioner argued that the transaction was closed and that the payment received pursuant to the second agreement was, therefore, ordinary income. The court held that the contingency payment had no ascertainable fair market value because it depended entirely on a favorable judicial decision on a novel question of state law, and therefore the case "appears to present one of those rare and extraordinary situations" where the transaction is not a closed one for tax purposes. Id. at 1403.

Similarly, in Likens-Foster Honolulu Corp. v. Commissioner, 840 F.2d 642 (9th Cir. 1988), the court applied the open transaction doctrine to the liquidation of a corporation where, at the time of liquidation, the corporation was engaged in litigation over condemnation proceeds and thus could not compute the total gain on the liquidation. In this case, the taxpayer argued that the transaction was closed and that

an award of additional condemnation proceeds pursuant to a jury verdict three years after the liquidation was a separate transaction. The court disagreed, stating:

> Taxpayer presents no evidence suggesting that the amount of just compensation, if any, which the jury might have awarded to [the corporation] in the condemnation proceedings was ascertainable prior to the tender of the jury's verdict. To the contrary, the record contains strong evidence that Taxpayer considered the value of the claims unascertainable at the time of the distribution." Id. at 650.

Thus, in Likens-Foster as in Dimond, the court determined that the gain on the original transaction was impossible to determine requiring the transaction to be held open where the gain on the transaction depended upon an uncertain judicial determination in the future.

The result in Dimond was consistent with the holding in Westover v. Smith, 173 F.2d 90 (9th Cir. 1949) in which the court held that an obligation received and collected subsequent to the original sale transaction had no ascertainable fair market value and, thus, required the transaction to be held open until collection of the obligation. In Westover, the taxpayer sold the assets of a corporation in exchange for cash and a royalty contract. Id. at 91. After liquidating the surviving corporation the taxpayer reported the gain on the liquidation, including the assignment of the contract which had "very substantial value" but, "owing to future business contingencies," no ascertainable fair market value. Id. Taxpayer later received payments under the contract and treated them as amounts received in the liquidation distribution, taxed as capital gain. The court upheld the taxpayers characterization of the payments stating:

> Although there was no ascertainable fair market value at the time of liquidation, we find nothing in the statute requiring the market value to be measured immediately. In such a situation the only practicable and accurate method of measuring the contract's value is through the application of money to such valuation as it is received. Id. at 92.

The court viewed the contract as part of the liquidation proceeds and, because it could not be valued at the time of liquidation allowing the taxpayer to determine the total gain on liquidation, treated payments under the contract as liquidation proceeds as well.

In contrast, when a taxpayer determines the value of an item in a sales transaction courts have declined to apply the open transaction doctrine. The Ninth Circuit Court of Appeals declined to apply the open transaction doctrine to a taxpayer's receipt of a real estate contract where the fair market value of the contract was stipulated by the taxpayer at the time of receipt. Tombari v. Commissioner, 299 F.2d 889 (9th Cir. 1962). In Tombari, taxpayers sold their business in exchange for cash and a real estate contract. Id. at 890. The taxpayers argued that the contract could not be

valued because the amount to be collected was not known at the time of receipt. However, the taxpayers stipulated as part of the sales agreement that the contract had a value that constituted a portion of the sales price. The court held that because the fair market value was stipulated for the contract, the original transaction was able to be closed promptly. Id. at 893. Subsequent collection under the contract "was as it is ordinarily, a separate and distinct transaction which `is required to stand on its own feet.'" Tombari at 893, quoting Osenbach v. Commissioner, 198 F.2d 235 (4th Cir. 1952).[1]

Likewise, where taxpayers realize gain on a transaction and the only question is the amount of gain, courts have declined to apply the open transaction doctrine. In Tribune Publishing Co. v. United States, 836 F.2d 1176 (9th Cir. 1988), the Ninth Circuit Court of Appeals held that the open transaction doctrine did not apply to an obligation received in a transaction even though the value of the obligation was uncertain at the time of receipt. In that case, a taxpayer received as part of a settlement agreement, cash, stock and future discounts on newsprint. There was uncertainty as to the total amount of the settlement because a part of the settlement was contingent on the amount of discounting taxpayer would receive over an eight-year period. Id. at 1179-1180. The taxpayer realized gain on the transaction irrespective of the value of the future discounts because the cash and stock received exceeded the taxpayers basis in the property exchanged. Id. The court stated "[w]e must disagree with [taxpayer] because we read Logan to apply only if there is uncertainty as to whether the taxpayer will realize a profit from the transaction at issue; here it appears that [taxpayer] realized a profit. Id.[2]

In the present case, the US1 stock received by Taxpayer had an ascertainable fair market value at the time Taxpayer received the stock and, consequently, the subsequent sale of the stock is a separate and distinct transaction that stands on its own. The sale of FC1's business is not an open transaction under Logan, Tex-Penn Oil, or State Street Trust. As in Tombari and Clodfelter, Taxpayer and US1 agreed to the purchase price prior to the transfer of stock and in no way was the purchase price contingent upon gain or loss ultimately realized by Taxpayer on the sale of the stock. Like the taxpayers in Tribune Publishing Co. and Estate of Bird, Taxpayer realized gain on the transaction irrespective of the value of the US1 stock. There is no need to apply

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[1]See also Clodfelter v. Commissioner, 426 f.2d 1391 (9th Cir. 1970) holding that where taxpayers sold a hotel and received payment including an installment obligation to be paid out of the operating profits of the hotel, the obligation had a fair market value at the time of receipt because the parties stipulated a value as part of the purchase price.

[2]See also Estate of Bird v. United States, 534 F.2d 1214, 1219 (6th Cir. 1976) citing Logan for the proposition that "the purpose of the open transaction doctrine is to relieve a taxpayer from having to report income which may never be received."

the open transaction doctrine to determine whether Taxpayer will ultimately realize any gain as in Logan. In addition, Taxpayer valued the stock, taking into account the restrictions, at the time of receipt, contradicting the argument that the stock did not have an ascertainable fair market value at that time.

Relation Back Doctrine

Generally, the relation back doctrine, affirmed by the Supreme Court in Arrowsmith v. Commissioner, 344 U.S. 6 (1952), represents the principle that a subsequent event that is so integrally related to a prior event that they are in effect part and parcel of the same transaction should be treated as having the same character as the prior event. The doctrine is premised on the idea that the tax consequences should be the same as if the subsequent event had occurred at the time of the sale, and is most often employed to distinguish between capital and ordinary treatment and to prevent taxpayers from receiving a double benefit.

In Arrowsmith, two individual shareholders decided to liquidate their corporation. The shareholders reported the resulting gain as capital gain. Four years later, a judgment was rendered against the liquidated corporation. As transferees, the two shareholders paid the judgment, and took an ordinary business loss. The Commissioner determined that the loss was part of the corporate liquidation and classified the loss as a capital loss. The Supreme Court agreed with the Commissioner stating that "their liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceeding." Id. at 8. The Court considered the judgement as simply the last event in the liquidation transaction begun four years earlier in order to classify the nature of the payment for tax purposes and not as a violation of the principle of separate units of annual accounting for tax purposes. Id. The stockholders were, in effect, required to return a portion of the assets received by them in the liquidation and the Court held that since the original distribution of assets was a capital transaction, the return of assets resulted in a capital loss. The stockholders would have received a double benefit by paying tax on only one-half of the gain portion of the distribution due to the distributions characterization as capital gain while deducting the full amount paid for the judgement even though the full amount had not been subject to tax when received.

A similar result was reached in United States v. Skelly Oil Co., 394 U.S. 678 (1969). The Skelly Oil Co. had raised its gas prices under a minimum field gas price order, which was subsequently vacated. As a result, Skelly settled a number of claims for refunds filed by its customers. Two of the refunds were claimed in full as deductions. The Commissioner objected, arguing that the receipts from the gas sales had been reduced for tax purposes by the 27 ½ percent depletion allowance earlier. The Court agreed, holding that the deduction for the refunds had to be reduced by the amount of the percentage depletion deductions allowed in prior taxable periods, stating:

> The Code should not be interpreted to allow [taxpayer] the practical equivalent of a double deduction, absent a clear declaration of intent by Congress. Accordingly, to avoid that result in this case, the deduction allowable in the year of repayment must be reduced by the percentage depletion allowance which [taxpayer] claimed and the Commissioner allowed in the years of receipt. Id. at 684.

The Supreme Court in Skelly Oil based its determination that the annual accounting system did not bar examination of prior events on the Arrowsmith doctrine and focused on the inequity of a taxpayer receiving a double benefit, explaining:

> The rationale for the Arrowsmith rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income. Skelly Oil, at 685.

As in Arrowsmith, the Supreme Court in Skelly Oil was primarily focused on the inequity of a taxpayer receiving a double benefit.

The Tax Court applied the Arrowsmith doctrine in Harold Wener v. Commissioner, 24 T.C. 529 (1955), aff'd, 242 F.2d 938 (9th Cir. 1957). In Wener, the taxpayers were partners in a partnership. They conveyed their partnership interests to the other partners, receiving a cash downpayment and an agreement with the remaining partners for the remainder of the purchase price to be paid in three installments. In the year following the sale the taxpayers negotiated a settlement of the remaining installment obligations and received cash in satisfaction of the remaining installments. The amount they received was less than the amount remaining under the installment agreement, and the taxpayers treated the difference as an ordinary loss. The Commissioner treated the agreements as "part and parcel of one transaction" and contended that the losses were capital. Id. at 532. The Court rejected taxpayer's argument that the sale and the agreement were two separate transactions and found that:

> prior to the dates the remainder of the purchase price was to become due, there was a renegotiation, adjustment, or revamping of the sale itself both as to price and the terms of payment. . . . [T]here was . . . a renegotiation and revision of the unexecuted provisions of the sales contract itself and the substitution of new provisions therefore. Id. at 532 - 533.

The Tax Court has also expanded the Arrowsmith doctrine to include subsequent gain related to an earlier transaction. In Lowe v. Commissioner, 44 T.C. 363, 374 (1966), the taxpayer sold stock to an unrelated third party in return for $22,500 and a note secured by the stock. When the purchaser defaulted on the note, the taxpayer reacquired the stock. The Commissioner argued that the $22,500 received by the taxpayer was ordinary income. The court held that gain on the reacquisition of stock

was actually an "adjustment," "renegotiation," and "revision" of the original selling price of the stock, and therefore, a capital gain. Id. at 374.

Finally, Arrowsmith has consistently been applied to the treatment of payments under indemnity agreements, in the context of both tax-free and taxable exchanges. See, e.g., Turco v. Commissioner, 52 T.C. 631 (1969); Estate of Shannonhouse v. Commissioner, 21 T.C. 422 (1953); Pierce v. Commissioner, 14 T.C.M. (CCH) 964 (1955); Rev. Rul. 83-73, 1983-1 C.B. 84. These cases are consistent with Wener and Lowe in that the indemnity agreements were entered into at the same time as and as part of the original transaction. Consequently, the subsequent transaction pursuant to the indemnity agreement is necessarily an adjustment, renegotiation, and revision of the terms and/or effect of the original transaction.

However, where a subsequent transaction is not so integrally related to the original transaction such that the two transactions should not be considered part and parcel of the same transaction in order to prevent a double benefit, as in Arrowsmith and Skelly Oil, and where there is no subsequent adjustment or revision of the terms or effect of the original transaction, as in Wener, Lowe, and the indemnity agreement cases, courts have declined to apply Arrowsmith to treat the character of subsequent unforseen gain or increases in annual receipts from income-producing property as determined by a previous transaction.

In the present case, the subsequent sale of the US1 stock is not so integrally related to the sale of FC1's business unit, and thus, does not require that the two transactions be considered part and parcel of the same transaction. Taxpayer claims that the sale of US1 stock was contemplated at the time of sale of FC1's business unit because of the "lock-up" provisions in the Agreement. Although Taxpayer may have "contemplated" the sale of the stock, there is nothing in the Agreement to suggest that the sale of the stock is integrally related to the sale of FC1's business unit. Nor is there anything unique about the receipt of property in a sale or exchange. The Agreement specified a firm sales price unrelated to any subsequent gain or loss on the sale of the US1 stock and the "lock-up" provision is common with respect to large blocks of stock issued at or around the time of an IPO in order to prevent disruption of the market. There was nothing in the Agreement requiring taxpayer to sell the stock after the specified period and no provision adjusting the sales price based on subsequent gain or loss with respect to the US1 stock. The US1 stock was an investment in the hands of Taxpayer and was treated as such by Taxpayer and FC1. The mere fact that this investment produced a windfall gain in a later year does not make the sale of the US1 stock integrally related to the sale of FC1's business unit, nor does it result in an adjustment, renegotiation, or revision of the Agreement.

Under Taxpayer's relation back theory, it would not have mattered if Taxpayer had held the US1 stock for an indefinite period of time after the restriction period had ended while the stock appreciated in order to reap the benefits of appreciation because Taxpayer would relate the subsequent sale to the original transaction. Such a result,

converting an investment asset received in a sale or exchange to the equivalent of cash received from that sale or exchange, is not supported by the Code or case law. The relation back theory of Arrowsmith does not apply to determine the tax consequences of Taxpayers sale of the US1 stock in year 2.

If you have any questions, please call Robert Laudeman on (202) 622-3840.

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