# Office of Chief Counsel
# Internal Revenue Service
# Memorandum

Number: **200832022**
Release Date: 8/8/2008

CC:CORP:B05:ROBurch
PRESP-133053-07

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 1032.00-00

date: April 23, 2008

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subject: PRESP-133053-07 (TP Protesting Appeal on Application of Section 1032)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Corporation A =
Acquiring =
Parent =
Counterparty =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =

| | |
|---|---|
| Date 8 | = |
| $a | = |
| $b | = |
| $c | = |
| $d | = |
| $e | = |
| $f | = |
| $g | = |
| $h | = |
| $i | = |
| $j | = |
| $k | = |
| $l | = |
| #v | = |
| #w | = |
| #x | = |
| #y | = |
| #z | = |

## ISSUE

Does a change in the underlying stock to be delivered under the terms of a forward contract originally specifying the corporation's own stock, due to a merger, render § 1032 inapplicable when the loss on the forward contract is based on the value of the corporation's own stock as of the date of the merger?

## CONCLUSION

No. The use of a conversion ratio in conjunction with the change in the underlying stock locked in the amount of loss on the forward contract. Such loss was based on the value of the corporation's own stock on the date of the merger and, accordingly, § 1032 applies to the loss.

## FACTS

On Date 1, Corporation A announced a $a share buyback program by entering into equity forward contracts with several counterparties, in which Corporation A agreed to buy back a certain number of its own shares for a set price (the forward price) on various scheduled termination dates (or settlement dates). The counterparties agreed to deliver the agreed amount of shares.

Each contract could be settled in one of three ways. First, Corporation A could deliver the forward price and the counterparty would deliver the agreed amount of shares (physical settlement). The parties could also settle the contract by one party delivering to the other party the amount of net equity in the contract, using either cash

(cash settlement) or additional Corporation A shares (share settlement). Under a cash or share settlement, Corporation A would deliver cash or additional shares to the counterparty if, on the date of settlement, the market price of Corporation A's shares were less than the forward price Corporation A agreed to pay. The counterparty would deliver cash or additional shares to Corporation A if, on the date of settlement, the market price of Corporation A's shares were more than the forward price Corporation A agreed to pay.

During the tax years ending Date 2 and Date 3, Corporation A physically settled seven of nine contracts. In these contracts, Corporation A paid the forward price and the counterparty delivered the agreed amount of shares. Corporation A relied on § 1032 to report no gain or loss on these contracts.

On Date 4, when Corporation A had two contracts remaining, Parent formed a merger subsidiary (the Acquiring corporation) into which Corporation A merged via a reorganization represented as qualifying under § 368(a)(2)(D). Under the terms of the two remaining contracts, the shares Corporation A agreed to buy back under the contract changed from Corporation A's shares, to shares of Acquiring's Parent, using a conversion ratio of #v. The use of the conversion ratio pinpointed the number of Parent shares that would equal the value of one Corporation A share on the merger date. Corporation A's value was declining up to the date of the merger. Parent's stock rose in value after the date of the merger. Just before the date of the merger, if the two contracts were settled with either cash or additional shares, Corporation A would have realized an approximate $b loss. The conversion ratio preserved this loss in the contracts going forward.

Contract 1: Prior to the merger, the terms of the first contract provided that Corporation A would pay $c per share for #w of its shares for a total payment of $d on Date 5. The application of the conversion ratio changed the number of shares to #x shares of Parent stock. The total payment of $d stayed nearly the same. The resulting price per share under this contract was $e per share.

Contract 2: Prior to the merger, the terms of the second contract provided that Corporation A would pay $f per share for #y of its shares for a total payment of $g on Date 6. The application of the conversion ratio changed the number of shares to #z shares of Parent stock. The total payment of $g stayed nearly the same. The resulting price per share under this contract was $h per share.

On Date 7, Acquiring cash settled the two remaining contracts. Acquiring owed the Counterparty $i on both contracts. The Counterparty sold, for $j, the number of Parent shares it would otherwise have been required to deliver. Acquiring paid the Counterparty the remaining $k in cash. On its tax return for the year ending Date 8, Acquiring reflected a capital loss of $k due to the contracts. Parent relies on § 1032 not applying to the forward contracts to assert that Acquiring is entitled to deduct the loss, arguing that the loss was realized with respect to stock which was not Acquiring's own stock.

## LAW AND BACKGROUND

The first sentence of § 1032 provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. This sentence was enacted in 1954. The history of § 1032 demonstrates that Congress intended that it be applied broadly. In its current form, § 1032 reflects several changes from the original provision, all of which were intended to reach the result of nonrecognition with respect to gain or loss on a corporation's various transactions in its own stock.

Prior to the enactment of § 1032, the Treasury regulations under gross income provided how a corporation should be taxed on transactions involving its shares of capital stock. These regulations were in force from 1918 to 1934 and broadly declared that there was no gain or loss from the purchase or sale of a corporation's own stock. The rule of nonrecognition was uniformly applied to cases in which the taxpayer sold or purchased its stock at a price different from the stock's fair market value at the time of the exchange. In Simmons & Hammond Manufacturing Co., 1 B.T.A. 803 (1925)[1], the taxpayer purchased its own shares for market value, sold the shares below their fair market value, and claimed a loss. The court explained that had the shares been sold at fair market value, the transaction would have constituted a "capital transaction" that would not have changed the corporation's capital accounts because the assets and liabilities would have been equally increased. When the corporation sold the shares for less than their fair market value, however, the loss was not the corporation's loss. By acquiring the shares at less than fair market value, Simmons and Hammond increased their proportionate share in a distribution of the corporate assets without contributing proportionately to the asset account. In effect they had gotten the equivalent of a distribution of surplus to the extent of their below market purchase price. While the court acknowledged that the sale of the shares below fair market value created a diminution in value for the other, remaining shareholders, it held that this was not a loss to the corporation.

In Illinois Rural Credit Association, 3 B.T.A. 1178 (1926), the taxpayer did not include in its income payments it received to purchase stock that was never issued. The corporation planned to issue its stock in exchange for a fully paid subscription price. However, when some shareholders did not pay the full subscription price, the corporation retained their money without issuing stock. The corporation did not treat the amounts received as income, and the court agreed that such amounts were not income.

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[1] The Board of Tax Appeals later overruled Simmons & Hammond in R. J. Reynolds Tobacco Co. v. Comms'r, 553 B.T.A. 949, 960 (1937). The Board of Tax Appeals was following its 1932 ruling in S.A. Woods, 57 F.2d 635 (1st Cir. 1932), cert. denied 287 U.S. 613, that triggered recognition when a corporation dealt with its own shares as it would shares of another corporation. In response to S.A. Woods and cases following that rule, Congress changed the law by enacting § 1032.

The subscribers made the payments as capital payments to provide capital for the corporation. The fact that the stock was never issued for such payments, because they were not fully paid, did not alter their capital character, which was distinguishable from income.

In 105 West 55th Street, Inc. v. Comms'r, 15 B.T.A. 210 (1929), aff'd 42 F.2d 849 (2d Cir. 1930), a subscription agreement allowed a corporation's two shareholders to purchase additional stock during a certain amount of time for a set price, and only one did so. After the corporation's stock had greatly increased in value, Hearn, the shareholder who had not purchased additional stock, sued the other to enforce his right to subscribe to the shares at the previously set price. The shareholders settled the suit by having the corporation give an amount of cash to Hearn, which amount the corporation deducted on its return. Relying on the capital transaction reasoning in Simmons, supra, the court explained that the effect of the corporation's payment to Hearn was to reduce the value of the other shareholder's shares. Because such reduction affects only the owners of the stock, there was no loss to the corporation.

Despite the decisional law that favored nonrecognition when a taxpayer engaged in transactions involving its own stock, an opposite decision was made in Commissioner v. S.A. Woods Machine Company, 57 F.2d 635 (1st Cir. 1932), cert. denied 287 U.S. 613. In S.A. Woods, the Woods Company (the respondent) sued the Yates Company for infringement of a patent and obtained a decree in its favor for damages. In connection with the settlement, the Yates Company transferred to the Woods Company 1,022 shares of the Woods Company capital stock having a value of $433,200.04. After acquiring the stock, the Woods Company retired it, thereby reducing its capital stock from 3,000 shares to 1,978 shares. The Commissioner ruled that the value of the stock was taxable income. Unlike the decisions in the prior cases, the Woods court considered whether the receipt and retirement of the shares in this case justified a different result. The court reasoned that where a corporation has legally dealt in its own stock as it might in the shares of another corporation, and in so doing has had a gain or loss, there is no reason why gain or loss should not be taken into account in computing taxable income. The court found that the transaction was the equivalent of the payment of cash to the Woods Company and the investment of the cash in its own stock. The result of the cash received would have been taxable income, and the court held that the transaction was not changed in its essential character by the fact that the Woods Company received its own stock.

The First Circuit Court of Appeals decided S.A. Woods in 1932. In 1934 the Treasury regulations were changed to give effect to the decision by implementing a facts and circumstances analysis to discern whether a corporation was engaging in only a capital transaction, or whether the corporation was intending to deal in its own shares as it might in another corporation's shares. The latter decision required recognition and the former did not. Over the next two decades, the courts continued ruling on this issue with increasing inconsistency.

Section 1032's legislative history indicates Congress understood that the developing case law and the facts and circumstances test of the regulations were creating uncertainty for taxpayers. In enacting the current first sentence of § 1032 in 1954, Congress codified the rule that was consistent with the pre-1954 case law and regulations. It eliminated the 1934 rule that required recognition in S.A. Woods-type transactions. See S. Rep. No. 1622, 83d Cong., 2d Sess (1954).

Congress amended § 1032 in 1984 and 2000 to broaden its application to transactions involving instruments that were substitutes for a taxpayer's own stock. In 1984, for example, taxpayers were engaging in transactions that allowed them to elect into and out of nonrecognition under § 1032 by using Illinois Rural Credit, supra, to avoid the result in Revenue Ruling 72-198, 1972-1 C.B. 223.[2] Revenue Ruling 72-198 addressed a situation in which Corporation X acquired all of the outstanding stock of corporation Y in exchange for the issuance of its own stock warrants. The warrants entitled the holder to purchase a certain amount of X voting stock at a certain price within a specified period of time. The Revenue Ruling noted that § 1032 provides that no gain or loss shall be recognized to a corporation upon the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. Accordingly, the Revenue Ruling held that no gain or loss is recognized to X upon the issuance of its stock warrants in exchange solely for the outstanding stock of Y. Section 1032 applies when any warrants are exercised and stock is issued, and consequently no gain or loss will be recognized to X upon such exercise and issuance. If, however, the warrants lapsed without being exercised, the Revenue Ruling applied Treas. Reg. § 1.1234-1(b), and held that X would recognize gain in an amount equal to the fair market value of the Y stock at the date of its exchange for the issuance of the warrants.

Congress understood the problem created by these seemingly inconsistent rules. The committee report included an example of how a taxpayer could make use of the ruling to whipsaw the government:

> Present law can put the Service into an unacceptable position. If a corporation issues a warrant for $2 and buys it back for $1, it is likely to argue that, notwithstanding Rev. 72-198, it recognizes no income, citing Illinois Rural Credit Association and other authorities. If the corporation's stock goes up in value and the corporation buys the warrant back for $3, it is likely to claim a loss, citing Rev. Rul. 72-198. The committee desires to end this discontinuity. Furthermore, the committee believes that the repurchase of a warrant by the issuing corporation should not produce different tax consequences to the corporation than an exercise of the warrant followed by a repurchase by the corporation of the newly issued stock.

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[2] Rev. Rul. 86-9, 1986-4 I.R.B. 6, declared Rev. Rul. 72-198 obsolete with respect to options acquired or lapsing after July 18, 1984, the effective date of section 57(a) of the Tax Reform Act of 1984.

See Staff of H. Comm. on Ways and Means, 83d Cong., Report on Deficit Reduction Act of 1984 (Comm. Print).

Based on the consistent trend by Congress to broadly apply § 1032, and the policies underlying that trend, the Service interprets § 1032 as applying to forward contracts, whether or not stock is actually transferred, where gain or loss is determined based on the value of the taxpayer's own stock.

The Service issued a private letter ruling in which it ruled that § 1032 applies in a case where no stock was sold, and where it resulted in the nonrecognition of gain. Under the facts of this ruling, the corporation had gain resulting from payments made by holders of contracts, in cash settlement of the corporation's contracts to sell its stock. See PLR 200450016. This letter ruling has been discussed by commentators. See 2005 TNT 20-30, and 2005 TNT 25-4. Note that private letter rulings are not precedent and are not cited herein for that purpose.

## DISCUSSION

The cases and rulings cited above are cited in support of the Service's view that Congress did not intend § 1032 to be elective or to be avoided by economically equivalent transactions, and that it should be applied broadly. The instant case presents facts that were not previously ruled upon by the Service or the courts. However, the overriding principle that is present in the Service's rulings and the history of § 1032 does apply to the instant case. This principle is that when taxpayers engage in transactions that result in a gain or loss that is based on the value of their own stock, § 1032 requires nonrecognition of such gain or loss.

In this case, Corporation A entered into the two forward contracts at issue using Corporation A's stock as the underlying subject of the contract. The forward price under Contract 1 was $c and the forward price under Contract 2 was $f. Between Date 1 and the merger date, Corporation A's value had fallen. While we do not know the value of Corporation A's stock on Date 1 nor the value on the merger date, the facts that we have indicate that the value of Corporation A's stock dropped and was below the forward price in both contracts on the merger date. The cash settlement of these forward contracts as of the date of the merger, based on the value of Corporation A's own stock, would have resulted in a loss to which § 1032 would have applied.

Corporation A merged into Acquiring via a transaction represented to qualify as a tax-free reorganization. The reorganization provisions in the Code treat the merged corporation (Corporation A) as continuing in a modified corporate form via the surviving corporation (Acquiring). See § 1.368-1(b). As a result of the merger, Acquiring stepped into the shoes of Corporation A with respect to the forward contracts remaining. See, e.g., § 381, the regulations thereunder, and Boris I. Bittker and James S. Eustice, Federal Income Taxation of Corporations and Shareholders, 6th ed. para. 12.22 (Warren, Gorham, and Lamont 2000).

On or around the date of the merger, the contract was changed to provide that Parent's stock would be the underlying subject of the contract. In addition to the change to Parent stock, the value of Corporation A's stock on the merger date was used to establish the number of shares of the substitute stock that would be measured against the original forward price that was set at the beginning of each contract (conversion ratio). By using the conversion ratio, the loss based on the value of Corporation A's stock (up to the merger date) was locked into the forward contracts and remained so after the underlying subject of the contracts changed to Parent's stock. After the merger, Parent stock rose in value until the contract was settled. Even with Parent's rise in value, however, the previous locked in loss (the difference between the forward price and Corporation A's value on the merger date) was so significant that the gain produced by Parent's rise in value merely reduced the amount of overall loss when the contracts were settled.

Corporation A's representatives refer to Rev. Rul. 70-305, 1970-1 C.B. 169, to support recognizing the loss on the forward contract. In Rev. Rul. 70-305, X, a wholly-owned subsidiary of P, purchased P shares on the open market. X then sold the shares to outside interests at a gain. The Ruling holds that the stock of P held by X is not treasury stock, that the sale of such stock is not a sale by the corporation of its own stock for purposes of § 1032, and that the transaction results in a gain or loss recognized by X. Corporation A's representatives assert that because Acquiring settled the forward contract using Parent's stock, the Ruling applies and the transaction falls outside § 1032, which allows the taxpayer to recognize the loss on the forward contract.

However, the Revenue Ruling does not apply to the loss in the instant case. The loss to X in the Revenue Ruling was based on the value of a different corporation's stock. In contrast, the loss to Acquiring in the instant case was based on the value of Acquiring's own stock (i.e. Acquiring's § 381 predecessor's stock) up to the point of the merger.

The loss on Corporation A stock that was embedded in the changed contract did not change or disappear just because the parties agreed to change the underlying stock to be delivered under the contract. For example, if Parent's stock had not risen in value between the merger date (when the underlying stock to be delivered changed) and the settlement date of the contracts, there would have been a loss at the end of the contracts of exactly the amount of loss that occurred up to the merger date. That loss originated from and was attributable solely to the value of the Corporation A stock. It did not lose its origin when the parties changed the underlying stock to be delivered under the forward contracts. Accordingly, taxpayer's loss on the forward contracts should have been treated as a nonrecognized loss under § 1032.

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Please call Rebecca O. Burch or me at (202) 622-7550 (not a toll-free call) if you have any further questions.

Sincerely,

_Debra L. Carlisle___________

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