Section 1001.—Determination of Amount of and Recognition of Gain or Loss

26 CFR 1.1001–1:Determination and recognition of gain or loss.

(Also § 1259.)

Actual and constructive sales. This ruling holds that a shareholder has neither sold stock currently under section 1001 of the Code nor caused a constructive sale of stock under section 1259 if the shareholder receives a fixed amount of cash, simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date, pledges the maximum number of shares for which delivery could be required under the agreement, retains an unrestricted legal right to substitute cash or other shares for the pledged shares, and is not otherwise economically compelled to deliver the pledged shares.

Rev. Rul. 2003–7

ISSUES

Has a shareholder either sold stock currently or caused a constructive sale of stock under § 1259 of the Internal Revenue Code if the shareholder (1) receives a fixed amount of cash, (2) simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date, (3) pledges the maximum number of shares for which delivery could be required under the agreement, (4) has the unrestricted legal right to deliver the pledged shares or to substitute cash or other shares for the pledged shares on the delivery date, and (5) is not economically compelled to deliver the pledged shares?

FACTS

An individual ("Shareholder") held shares of common stock in *Y* corporation, which is publicly traded. Shareholder's basis in the shares of *Y* corporation is less than $20 per share. On September 15, 2002 (the "Execution Date"), Shareholder entered into an arm's length agreement (the "Agreement") with Investment Bank, at which time a share of common stock in *Y* corporation had a fair market value of $20. Shareholder received $*z* of cash upon execution of the Agreement. In return, Shareholder became obligated to deliver to Investment Bank on September 15, 2005 (the "Exchange Date"), a number of shares of common stock of *Y* corporation to be determined by a formula. Under the formula, if the market price of a share of *Y* corporation common stock is less than $20 on the Exchange Date, Investment Bank will receive 100 shares of common stock. If the market price of a share is at least $20 and no more than $25 on the Exchange Date, Investment Bank will receive a number of shares having a total market value equal to $2000. If the market price of a share exceeds $25 on the Exchange Date, Investment Bank will receive 80 shares of common stock. In addition, Shareholder has the right to deliver to Investment Bank on the Exchange Date cash equal to the value of the common stock that Shareholder would otherwise be required to deliver under the formula.

In order to secure Shareholder's obligations under the Agreement, Shareholder pledged to Investment Bank on the Execution Date 100 shares (that is, the maximum number of shares that Shareholder could be required to deliver under the Agreement). Shareholder effected this pledge by transferring the shares in trust to a third-party trustee, unrelated to Investment Bank. Under the declaration of trust, Shareholder retained the right to vote the pledged shares and to receive dividends.

Under the Agreement, Shareholder had the unrestricted legal right to deliver the pledged shares, cash, or shares other than the pledged shares to satisfy its obligation under the Agreement. Shareholder is not otherwise economically compelled to deliver the pledged shares. At the time Shareholder and Investment Bank entered into the Agreement, however, Shareholder intended to deliver the pledged shares to Investment Bank on the Exchange Date in order to satisfy Shareholder's obligations under the Agreement.

LAW AND ANALYSIS

Section 1001(c) provides that, except as otherwise provided in subtitle A of the Code, the entire amount of gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized. The Code does not define a "sale or exchange." The courts have considered many factors significant in determining whether a sale or other disposition of property has occurred. The factors that are relevant, and the weight to be accorded to each factor, must be determined in light of the nature of the property involved. *See Torres v. Commissioner*, 88 T.C. 702, 721 (1987).

Several cases have addressed the transfer of securities to a brokerage firm under a subordination agreement intended to allow the brokerage firm to use the securities to meet its net capital requirements under stock exchange rules. *See*, *e.g.*, *Cruttenden v. U.S.*, 644 F.2d 1368 (9th Cir. 1981); *Lorch v. Commissioner*, 70 T.C. 674 (1978), *aff'd*, 605 F.2d 657 (2d Cir. 1979), *cert. denied*, 444 U.S. 1076 (1980); *Miami National Bank v. Commissioner*, 67 T.C. 793 (1977). In these cases, an owner of marketable securities transferred legal title and actual possession of the securities to the brokerage firm, which held the securities in a subordination account under an agreement that permitted the brokerage firm to sell the securities if necessary to meet claims of general creditors of the brokerage firm. The transferor, however, retained the right to receive dividends and the right to vote any stock. In addition, the transferor could reacquire the securities in the subordination account by substituting either cash or other securities of equivalent value.

In *Miami National Bank*, the court held that despite the right of the brokerage firm to sell stock in a subordination account to satisfy its creditors, the transferor remained the owner of the stock. As a result, the court held that the transferor's subsequent sale of the stock in the subordination account was effective to permit the purchaser to be treated as the direct owner of the stock for purposes of the consolidated return ownership test. At all times, the transferor had the right to reacquire the stock in the subordination account by substituting cash or other readily marketable securities of equivalent value. The court gave significant weight to this right in holding that the creation of the subordination account did not cause the brokerage firm to become the owner of the stock in the subordination account. The court noted that the transferor's right of substitution was not "merely an idle one" because, at all times, the transferor possessed sufficient resources to exercise the right. In fact, after the brokerage firm became insolvent, the transferor substituted cash for the stock. Thus, *Miami National Bank* and other similar cases indicate that a transfer of actual possession of stock or securities and legal title may not itself be sufficient to constitute a transfer of beneficial ownership when the transferor retains the unrestricted right and ability to reacquire the securities.

In cases addressing short sales of stock or securities, the courts have refused to recognize covering purchases as triggering a sale because, until actual delivery, the taxpayer retains the unrestricted right to dispose of the covering shares. *See, e.g., Richardson v. Commissioner*, 121 F.2d 1 (2d Cir.), *cert. denied*, 314 U.S. 684 (1941). In a typical short sale, the taxpayer borrows stock or securities to effect a short sale and is under an obligation to return identical stock or securities to the lender. In *Richardson*, the taxpayer entered into numerous sales, which were generally short sales effected with borrowed stock. In one case, the taxpayer purchased 7,100 shares of stock that were intended to be used to close out a short sale but were in fact delivered to close out a different sale. Despite the taxpayer's intent to use the purchased stock to close his earliest open short sale, and despite a showing that he followed a consistent practice of applying purchases to close out his earliest open short sale, the taxpayer was held not to have closed a short sale because the stock was not actually delivered to the stock lender. Noting that the taxpayer had not entered into any agreement or understanding with the lender of the 7,100 shares and had not otherwise placed himself in a position in which he was not entitled to treat the purchased shares as long stock and sell them for his own account, the court stated:

> [The covering shares] remained under control of the taxpayer and up to the time of actual delivery could have been sold and replaced by other purchases in the absence of prior agreement with the lender to use them to make restitution. Such a shifting intent to cover a short sale ought not to be the critical event which would determine gain or loss under a tax statute. It would leave the whole matter of fixing the event to the taxpayer's own will. We hold that the time of delivery was the time at which the covering transactions must be regarded as closed.

Richardson at 4. *Accord Klinger v. Commissioner*, No. 18315 (T.C.M. 1949). Thus, *Richardson* supports the conclusion that even if the shareholder intends to complete a sale by delivering identified stock, that intent alone does not cause a transaction to be deemed a sale, as long as the taxpayer retains the right to determine whether the identified stock will in fact be delivered.

By contrast, in *Hope v. Commissioner*, 55 T.C. 1020 (1971), *aff'd*, 471 F.2d 738 (3d Cir.), *cert. denied*, 414 U.S. 824 (1973), the Tax Court, in determining that a sale had occurred, relied on the seller's receipt of sales proceeds and the purchaser's receipt of title and possession of shares without restriction in use. In that case, the taxpayer was the owner of approximately 57% of the common stock of a company that had recently become a publicly traded company, and was having difficulty in disposing of his remaining large block of stock. The taxpayer made an arrangement with an investment bank for a sale at a price that was approximately one half of the price at which the stock was currently trading. Under the arrangement, the investment bank earned its fee by reselling 25% of the block of stock to the general public. The investment bank held the remainder of the stock subject to options to purchase the stock at the investment bank's cost and subject to proxy agreements that transferred to the optionees the right to vote the shares for the election of directors. Half of the options and proxy rights were held by the taxpayer's brother; the other half were held by two individuals who were employees of the company. Subsequent to the closing of the transaction, the taxpayer became dissatisfied with the sale price and brought a suit for rescission. The litigation was not concluded in the year of the transaction. On advice of counsel, the taxpayer held the sales proceeds in cash and marketable securities pending settlement of the litigation. On his tax return for the year of the transfer, the taxpayer disclosed the transfer but did not include in income his gain on the sale on the ground that the transfer was not a completed sale on which gain was recognized.

The court concluded that the transaction constituted a sale of the entire block:

> The facts of this case conclusively establish that on July 27, 1960, the petitioner sold 206,400 shares of . . . stock to [an investment bank] as agent for several purchasers as well as for its own account. The sale was completed on that date when title and possession of the certificates were transferred by the petitioner to [the investment bank], and the petitioner received $4,000,032 as payment in full. . . . The petitioner received the money from the sale without any restrictions on his use or disposition of those funds.

55 T.C. at 1029.

In the present case, on the Execution Date, Shareholder received a fixed payment without any restriction on its use and also transferred in trust the maximum number of shares that might be required to be delivered under the Agreement. Like the taxpayers in *Miami National Bank* and *Richardson*, but unlike the taxpayer in *Hope*, Shareholder retained the right to receive dividends and exercise voting rights with respect to the pledged shares. Also unlike *Hope*, the legal title to, and actual possession of, the shares were transferred to an unrelated trustee rather than to Investment Bank. Moreover, Shareholder was not required by the terms of the Agreement to surrender the shares to Investment Bank on the Exchange Date. Rather, Shareholder had a right, unrestricted by agreement or economic circumstances, to reacquire the shares on the Exchange Date by delivering cash or other shares. *See Miami National Bank* and *Richardson*. Accordingly, the execution of the Agreement did not cause a sale or other disposition of the shares.

A different outcome may be warranted if a shareholder is under any legal restraint or requirement or under any economic compulsion to deliver pledged shares rather than to exercise a right to deliver cash or other shares. For example, restrictions placed upon a shareholder's right to own pledged common stock after the Exchange Date, or an expectation that a shareholder will lack sufficient resources to exercise the right to deliver cash or shares other than pledged shares, would be significant factors to be weighed in determining whether a sale has occurred.

Section 1259(a)(1) provides that, if there is a constructive sale of an appreciated financial position, the taxpayer shall recognize gain as if such position were sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale. Under § 1259(b), the term "appreciated financial position" means any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value. Furthermore, for purposes of § 1259, the term "position" means an interest, including a futures or forward contract, short sale, or option.

Under § 1259(c)(1)(C), a taxpayer is treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person) enters into a futures or forward contract to deliver the same or substantially identical property. The term "forward contract" is defined under § 1259(d)(1) as a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price. The legislative history indicates that a forward contract that provides for the delivery of an amount of stock that is subject to "significant variation" under the terms of the contract is not within the statutory definition of a forward contract. S. Rep. No. 33, 105th Cong., 1st Sess. 125–26 (1997), 1997–4 (Vol. 2) C.B. 1067, 1205–06.

Under these facts, the Agreement does not cause a constructive sale of the shares under § 1259(c)(1)(C). According to the Agreement, delivery of a number of shares, which may vary between 80 and 100 shares, depends on the fair market value of the stock on the Exchange Date. Because this variation in the number of shares that may be delivered under the Agreement is a significant variation, the Agreement is not a contract to deliver a substantially fixed amount of property for purposes of § 1259(d)(1). As a result, the Agreement does not meet the definition of a forward contract under § 1259(d)(1) and does not cause a constructive sale under § 1259(c)(1)(C).

HOLDING

Shareholder has neither sold stock currently nor caused a constructive sale of stock if Shareholder receives a fixed amount of cash, simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date, pledges the maximum number of shares for which delivery could be required under the agreement, retains an unrestricted legal right to substitute cash or other shares for the pledged shares, and is not economically compelled to deliver the pledged shares.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Christina Morrison and Mary Truchly of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Ms. Morrison at (202) 622–3950 or Ms. Truchly at (202) 622–3960 (not toll-free calls).