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

OFFICE OF
CHIEF COUNSEL

March 16, 2000

Number: **200025053** CC:DOM:CORP:4
Release Date: 6/23/2000
UIL: 165.11-00, 302.03-00, 1059.01-00 TAM-107545-99

MEMORANDUM FOR

FROM: Assistant Chief Counsel (Corporate)
by Branch Chief, CC:DOM:CORP:4

SUBJECT: Technical Advice Memorandum (TAM-107545-99)

Taxpayer =

Target =

Acquiring =

Acquisition =

Convertible Preferred =

Convertible Debentures =

In a technical advice memorandum ("TAM") issued by the Assistant Chief Counsel (Corporate), the National Office concluded that for preferred stock to be "structured to avoid the other provisions of [§ 1059] and to enable corporate shareholders to reduce tax through a combination of dividends received deductions and loss on the disposition of the stock" under § 1059(f)(2)(C), the issuer of the stock must have had a purpose or motive of achieving the tax result described in that provision. At the time the TAM was issued, the facts in the request for technical advice and supplemental documents did not allow a conclusion that the Convertible Preferred was described in § 1059(f)(2)(C). In the TAM, the National Office stated it was not prepared to conclude that the capital loss claimed by Taxpayer upon the disposition of the Convertible Debentures is not bona fide under § 165 in the absence of further factual development pertinent to the issue. This memorandum has additional comments concerning case development, hazards, and other considerations.

§ 1059(f)(2)(C)

As stated in the TAM, for § 1059(f)(2)(C) to apply, the issuing corporation must have had a purpose or motive of helping the shareholders achieve a result of avoiding the other provisions of § 1059 and reducing tax as described in § 1059(f)(2)(C). Additional facts that would tend to support a finding that the Convertible Preferred was "structured to avoid" might include evidence that the stock was distributed or marketed particularly to corporate shareholders or evidence that the terms of the stock were directed by Acquiring's tax advisors with a view to giving its shareholders a combination of a dividends received deduction and a basis shift, setting up an artificial loss. On the other hand, evidence that the Convertible Preferred was issued to many noncorporate shareholders, or issued to all shareholders of all types who exchanged Target stock for Acquiring stock in the Acquisition, would tend to point away from a finding that the stock was described in § 1059(f)(2)(C).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

An inference of the intent of Acquiring in structuring the Convertible Preferred may be derived from the typ e of Target shareholders that received the Convertible Preferred in the Acquisition. If the shareholders of Target that received Convertible Preferred were solely or predominantly corporations, we could argue that Acquiring had a purpose or motive of helping its shareholders avoid § 1059 because it tailored the Convertible Preferred for shareholders who would benefit from the combination of the dividends received deduction, a shift of basis under § 302, and a capital loss. On the other hand, if Convertible Preferred was distributed proportionally to all Target shareholders, including a fair number of individuals, the taxpayer has a strong argument that nontax reasons may have influenced Acquiring in issuing convertible preferred stock with a right for it to redeem it for convertible debentures. Possible nontax reasons for issuing Convertible Preferred include: (a) the large amount of debt incurred by Acquiring to finance the Acquisition, which may have led to a decision to delay Acquiring incurring additional debt by delaying the time that Acquiring could redeem the Convertible Preferred for additional debt; (b) the fact that convertible preferred stock can pay a lower dividend rate than nonconvertible preferred stock; and (c) a concern that using common stock as consideration in the Acquisition could reduce the common stock's value.

The taxpayer's representatives say records filed with the Securities and Exchange Commission near the time of the Acquisition indicate that, at that time, portions of the Convertible Preferred were held by institutional investors (primarily mutual funds) and depository trust accounts. Less than a majority of the Convertible Preferred was held directly by corporations. The extent to which the mutual funds and depository trust accounts represent stock holdings taxable to individuals, not corporations, is unclear. [redacted]

Finally, we have read a tax law journal article which states that the tax incentive to issue stock similar to the Convertible Preferred is to postpone an interest deduction for the issuing corporation until after tax losses have expired, after which the corporation would convert the convertible preferred stock to convertible debt. Willens, Corporate Finance Vehicles, 7 Journal of Taxation of Investments 68, 70-71 (1989) (section of article discussing convertible exchangeable preferred stock). This tax motive is not a motive addressed by § 1059(f)(2)(C) and should not be used as grounds for asserting that § 1059(f)(2)(C) applies to the Convertible Preferred.

§ 165

Section 165(a) permits the deduction of any loss sustained during the taxable year and not compensated by insurance or otherwise. Under §1.165-1(b), however, only a bona fide loss is allowable, and substance and not mere form shall govern in determining a deductible loss.

The Service recently issued Notice 99-59, 1999-52 I.R.B. 761, which describes certain types of transactions being marketed to taxpayers for the purpose of generating tax losses. In the transactions described, taxpayers use a series of contrived steps to claim tax losses for capital outlays that they have in fact recovered. The notice was issued to alert taxpayers and their representatives that the purported losses arising from such transactions are not properly allowable for federal income tax purposes.

Applying the sham transaction doctrine and citing the § 165 regulations, the court in ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), disallowed a loss. In that case, a partnership purchased Citicorp notes for approximately $175 million and in 24 days sold them for variable rate LIBOR notes worth approximately $35 million and approximately $140 million in cash. Because of the installment sale regulations governing contingent payment arrangements, the partnership recovered only one-sixth of its basis in the Citicorp notes (approximately $30 million) in the year of the sale and reported gain of approximately $110 million ($140 million cash received less the $30 million). Much of this was allocated to a tax-neutral party. The remaining basis in the Citicorp notes was transferred to the LIBOR notes. Their subsequent disposition resulted in losses that were allocated in large part to taxable partners.

In disallowing the losses, the court applied the sham transaction doctrine. It found that the ownership and disposition of the Citicorp notes lacked any significant economic consequences to the taxpayer beyond the creation of tax benefits and that the acquisition and disposition of the Citicorp notes, moreover, lacked any business purpose. The court also cited the § 165 regulations: “Tax losses such as these, which are purely an artifact of tax accounting methods and which do not correspond to any actual economic losses, do not constitute the type of ‘bona fide’ losses that are deductible under the Internal Revenue Code and regulations.” 157 F.3d at 252.

Other cases suggest a more narrow interpretation of the requirement that a loss be bona fide. See Cottage Savings Ass’n v. Commissioner, 499 U.S. 554 (1991). Cottage Savings addressed the deductibility of losses realized on the exchange of home mortgages. The Supreme Court, after holding that the exchanged mortgages were “materially different” and that therefore their exchange was a realization event under Code § 1001, concluded further that the § 165 requirement that a loss be bona fide did not prevent deduction of the losses: “Because there is no contention that the transactions in this case were not conducted at arm’s length, or that Cottage Savings retained *de facto* ownership of the participation interests it traded to the four reciprocating S&L’s, *Higgins* is inapposite.” 499 U.S. at 568. The case cited by the Supreme Court – Higgins v. Smith, 308 U.S. 473 (1940) -- concerned a sale of securities to a controlled corporation under circumstances indicating that the taxpayer retained beneficial ownership of the securities. One could argue that the Supreme Court opinion suggests a narrow inquiry under § 165 – whether a disposition occurs in an arm’s-length transaction -- rather than a broader economic substance inquiry, the type engaged in by the court in ACM Partnership.

The court of appeals in Cottage Savings had engaged in such an inquiry in holding that the losses were not bona fide. The court of appeals concluded that the losses on the mortgage exchanges were not allowable because they did not appreciably affect the taxpayer's economic position: "To secure a deduction, the statute requires that an actual loss be sustained. An actual loss is not sustained unless when the entire transaction is concluded the taxpayer is poorer to the extent of the loss claimed; in other words, he has that much less than before." Cottage Savings Ass'n v. Commissioner, 890 F.2d 848, 853 (6^{th} Cir. 1989).

ACM Partnership, however, is not inconsistent with the Supreme Court opinion in Cottage Savings. In fact, the Supreme Court recently denied a writ of certiorari in ACM Partnership. 119 S. Ct. 1251 (March 22, 1999). While Cottage Savings addressed whether the taxpayer could deduct economic losses actually sustained over a long period of time as interest rates caused mortgages to decline in value, ACM Partnership involved the issue of whether to respect the taxpayer's purchase and sale within 24 days of Citicorp notes under an arrangement designed to create accounting gains and losses that could be separately allocated by a partnership to tax neutral and taxable parties, respectively. The Supreme Court's opinion in Cottage Savings indicates that the government did not advance a broader economic substance argument in support of disallowing the losses in that case, perhaps because it was clear that actual economic losses had been sustained, and the only issue was whether the losses had been realized.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

In this case, Taxpayer's loss could be disallowed under the reasoning of ACM Partnership and Notice 99-59 if Taxpayer's acquisition of Convertible Preferred *and* exchange of Convertible Preferred for Convertible Debentures appears to have lacked any economic substance. Though the similarities between the Convertible Preferred and the Convertible Debentures (the same percentage dividend/interest rate, identical liquidation/principal amounts, identical conversion to common stock rights, and very similar voting rights) call into question the economic consequence of the exchange of Convertible Preferred for Convertible Debentures, Target shareholders (including Taxpayer) initially acquired Convertible Preferred as part of an acquisition by one public company of another. It would be difficult to argue, as required by ACM Partnership, that the initial acquisition of Convertible Preferred by Target shareholders was a sham.

In ACM Partnership, the partnership purchased and sold Citicorp notes in order to create artificial gains and losses under the installment method rules applicable to contingent payment arrangements. Similarly, in transactions described in Notice 99-59, taxpayers initially invest in the partnership interest that gives rise to the purported losses for the purpose of generating those losses. Here, Taxpayer acquired and then redeemed Convertible Preferred (for Convertible Debentures carrying virtually identical rights) under terms that allow creation of taxfree basis and reporting a loss. [redacted]

The facts in support of applying ACM Partnership do not appear to have been fully developed. [redacted]

Other

Finally, there is an issue not addressed in the TAM that may be present in the case. The tax result the taxpayer claims from the exchange of Convertible Preferred for Convertible Debentures and the subsequent sale of the Convertible Debentures depends on the redemption of the Convertible Preferred being treated as a dividend. If the redemption were part of a plan by Taxpayer to completely terminate its interest in Acquiring, the redemption would be treated as a sale or exchange under sections 302(a) and (b)(3), not a dividend. See Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954) (allowing the consequences of a taxpayer's sale of some stock followed by the corporation's redemption of her remaining shares to be considered together when the taxpayer's intent at the time of the sale was to completely terminate her interest in the corporation), Rev. Rul. 77-226, 1977-2 C.B. 90 (to the same effect), Rev. Rul. 75-447, 1975-2 C.B. 113 (sequence of the steps irrelevant if both steps are clearly part of an overall plan).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We are aware that Taxpayer disposed of its remaining interest in Acquiring approximately eight months after the redemption of the Convertible Preferred, [redacted]

[redacted]