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Journal of Accountancy

Share Loans Under IRS Microscope

BY ALAN BRUCE CLEMENTS

June 1, 2008

TAX PRACTICE

In a recently released Coordinated Issue Paper (LMSB-04-1207-077), the IRS underscored how its examinations will home in on a once-favored strategy for monetizing stock gains while deferring capital gains taxes. In doing so, the Service reiterated its legal basis for why a variable prepaid forward contract (VPFC) that includes a share lending agreement (SLA) results in a currently taxable sale.

Technical Advice Memo 200604033 drew widespread consternation when issued in January 2006 because of the popularity of VPFCs as, it was believed, a viable strategy to obtain cash from a highly appreciated stock position without triggering gain. Taxpayers had taken this position based on a 2003 revenue ruling holding that VPFCs under certain circumstances were not sales.

COLLARING RISK, SKIRTING GAIN

Generally, in a VPFC, a shareholder pledges highly appreciated stock to an investment bank (counterparty) in return for an options collar. In the spread between the collar's put and call exercise prices, the shareholder enjoys protection from stock price declines while still participating in limited further appreciation. In exchange for an upfront cash payment (generally 75% to 85% of the stock's current fair market value), the shareholder agrees to deliver a variable number of shares at maturity, typically in three to five years, or alternately to settle with cash or other property. In most cases, the counterparty can hedge its position by selling, re-pledging or investing the pledged securities. Most counterparties borrow the pledged shares and sell them short. The counterparty may be given the right to transfer and to vote the pledged shares.

In the earlier revenue ruling, 2003-7 (2003-1 CB 363), the Service said VPFCs per se were not sales, actual or constructive, under either IRC § 1001 or 1259, provided specific requirements were satisfied. Most importantly, the shareholder must be under no legal restraint or requirement or under any economic compulsion to deliver the pledged shares to the counterparty and must have the right to deliver cash, property or other shares. The Service also noted that restrictions on 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 in determining whether a sale has occurred.

"UNFETTERED USE" A TOUCHSTONE

Then, in TAM 200604033, followed by Chief Counsel legal advice memorandum AM-2007-004 (January 2007) and now the coordinated issue paper, the Service said that a VPFC that includes an SLA or other similar arrangement that allows the counterparty to use the pledged shares results in a current taxable sale of the underlying shares. In TAM 200604033, the Service ruled that a loan of shares to the counterparty allowing "unfettered use" such as by a sale or re-pledging effectively shifts the "benefits and burdens" of ownership to the counterparty, resulting in a sale under common-law principles. Because the taxpayer discussed in the TAM had lost the right to vote and receive dividends on the loaned shares, the taxpayer could not retrieve the same shares from the counterparty. The taxpayer's argument that it could terminate the SLA and recover voting and dividend rights or prevent a re-borrowing of the pledged shares and substitute identical ones was unavailing, since the counterparty could accelerate the transaction to hedge its risk, forcing the taxpayer to lend the shares. Likewise, the taxpayer's argument that a securities loan was eligible for nonrecognition under IRC § 1058 was not accepted by the Service because the taxpayer had transferred its risk of loss (and most of its opportunity for gain).

PENALTIES PRESCRIBED

The coordinated issue paper identifies several variants of VPFC transactions that will be deemed unfettered use by the counterparty and provides a legal analysis of the benefits-and-burdens test in light of the factors that give rise to a sale for tax purposes under *Grodt & McKay Realty Inc. v. Commissioner* , 77 TC 1221 (1981). The paper also examines factors specific to stock transactions, including voting and dividend rights. Perhaps most importantly, although VPFCs are not as of this writing a listed transaction, the paper directs examiners to consider whether they are a reportable transaction subject to penalties under IRC § 6707A. It also directs examiners to consider whether the accuracy-related penalty under section 6662 may be applicable.

Consequently, tax advisers should review carefully with their clients the terms of any VPFCs entered into and, if necessary, consider grounds for a reasonable-cause exception or disclosure of the transaction.

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