Internal Revenue Service

Number: **200440005**
Release Date: 10/1/04
Index Number: 1233.00-00

Department of the Treasury
Washington, DC 20224

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Refer Reply To:
CC:FIP:1 – PLR-103091-04
Date: June 10, 2004

RE:

Legend:

Parent =

Subsidiary =

Holding Company =

Company =

Year 1 =

X =

Y =

Z =

Bank =

Month 1 =

Month 2 =

Year 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

$a =

$b =

$c =

$d =

State A =

Broker =

Dear :

This letter responds to your submission filed on behalf of Parent and Subsidiary (the Taxpayers) requesting a ruling that (1) the delivery of borrowed shares in satisfaction of the Financial Contracts will not cause Subsidiary to recognize gain on the Financial Contracts; (2) the delivery of borrowed shares does not give rise to constructive sales of the Financial Contracts under Section 1259(c)(1)(D); and (3) the delivery of borrowed shares and the retention of the Existing shares results in gain recognition under section 1259(c)(1)(A) equal to the excess of the fair market value of the Existing Shares over Subsidiary's basis in the Existing Shares.

Facts:

Parent acquired approximately X shares of Company common stock. In Year 1, Parent entered into two transactions (collectively, the "Financial Contracts") with Bank pursuant to which Parent, under certain circumstances, agreed to deliver approximately X unencumbered Company shares to Bank on specified dates in Month 1 (Financial Arrangement 1) and Month 2 (Financial Arrangement 2) of Year 2 in exchange for a

specified amount of cash. The Financial Contracts were governed by a single master stock purchase agreement dated Date 1 between Parent and Bank. Certain terms relevant to each transaction, such as the number of shares, the delivery dates and the mechanism for determining the price per share, were established in two separate transaction confirmations signed by Parent and Bank on Date 1 and Date 2.

Each of the Financial Contracts provided for ten maturity dates on successive business days. Parent's obligation to transfer any Company shares pursuant to the Financial Contracts and the amount of cash to be paid to Parent for such shares was determined by reference to the closing price of Company shares (the Settlement Price) on the maturity dates. Parent would deliver approximately one-tenth of the total shares specified if the Settlement Price was either (i) equal to or greater than the "Threshold Appreciation Price" or (ii) less than or equal to the "Downside Protection Threshold Price". If the Settlement Price had been equal to or greater than the relevant Threshold Appreciation Price, Parent would have been entitled to receive an amount equal to the Threshold Appreciation Price per share transferred. If, as turned out to be the case, the Settlement Price was equal to or less than the relevant Downside Protection Threshold Price, Parent was entitled to (and did) receive an amount equal to the Downside Protection Threshold Price per share transferred. If the Settlement Price had been greater than the Downside Protection Threshold Price but less than the Threshold Appreciation Price, then there would have been no share transfer or cash payment.

Parent had an option to obtain an advance from Bank. Neither Parent nor any assignee exercised this option. The Financial Contracts also provided that any amounts advanced to Parent or its assignee could be refunded by Parent or its assignee prior to the settlement of the Financial Contracts. If Parent or its assignee had exercised the option to obtain an advance and if such advance had not been refunded prior to settlement, the amount payable by Bank under the Financial Contracts would have been reduced to take into account the amount of any such advance. In addition, if an advance had remained outstanding (and not refunded) and the Settlement Price had been greater than the Downside Protection Threshold Price but less than the Threshold Appreciation Price, Parent would have been required to transfer to Bank an amount of shares equal to the value of the outstanding advance.

Financial Arrangement 1 applied to a total of approximately Y shares of Company. The maturity dates specified for Financial Arrangement 1 were a period of ten consecutive business days beginning Date 3. The Downside Protection Threshold Price was approximately $a per share (which represented the price of Company shares on Date 1) and the Threshold Appreciation Price was approximately $b per share.

Financial Arrangement 2 applied to a total of approximately Z shares of Company. The maturity dates specified for Financial Arrangement 2 were a period of ten consecutive business days beginning Date 4. The Downside Protection Threshold Price was approximately $c per share (which represented the price of Company shares on Date 2) and the Threshold Appreciation Price was approximately $d per share.

To secure the obligations of Parent under Financial Arrangement 1, Parent pledged approximately Y of its Company shares to Bank (the Y Existing Shares). To secure the obligations of Parent under Financial Arrangment 2, Parent pledged approximately Z of its Company shares (the Z Existing Shares and collectively with the Y Existing Shares, the Existing Shares). Throughout the term of the Financial Contracts, Parent retained the voting rights and the right to receive any normal, quarterly dividends on the Existing Shares. In addition, Bank did not have the right to sell, lend, pledge, rehypothecate, assign or invest in its business any of the Existing Shares unless Parent was in default under the agreements. Parent was not in default at any time during the term of the Financial Contracts and Bank did not retransfer or rehypothecate any of the Existing Shares. So long as Parent was not in default on its obligations in connection with the Financial Contracts, Parent had the right to obtain the release of the Existing Shares by substituting cash or other securities. The Existing Shares were held by Bank in book entry form.

As of Date 5, Parent transferred all of the Existing Shares and assigned all of its rights and obligations in connection with the Financial Contracts to Subsidiary. Subsidiary is a newly formed wholly-owned subsidiary of Holding Company, a State A corporation, which is a wholly-owned subsidiary of Parent. Parent is the common parent of an affiliated group of which Holding Company and Subsidiary are members.

Subsidiary had the unrestricted legal right to deliver any Company common stock (as long as it was not subject to certain restrictions on transfer) to satisfy its obligations under the Financial Contracts. As explained above, since the Settlement Price was, in both Financial Arrangement 1 and Financial Arrangment 2, less than the Downside Protection Threshold Price, Subsidiary was obligated to (and did) transfer a number of Company shares to Bank. In addition, since the Settlement Price was, in each case, less than the Downside Protection Threshold Price and since neither Parent nor Subsidiary obtained an advance under the Financial Contracts, Subsidiary was entitled to (and did) receive a payment from Bank equal to the relevant Downside Protection Threshold Price per Company share transferred to Bank under the Financial Contracts.

On Date 6 (prior to Date 3), Subsidiary entered into a securities lending agreement (the Securities Loan Agreement) with Broker. Pursuant to the Securities Loan Agreement, Broker lent to Subsidiary a number of Company shares equal to the aggregate number of shares that Subsidiary had agreed to transfer to Bank under the Financial Contracts (the Borrowed Shares). The Borrowed Shares were represented by two separate confirmations. The first confirmation reflected a settlement date of Date 6 and applied to approximately Y Borrowed Shares (represented by 10 physical share certificates that were delivered to Bank on behalf of Subsidiary in settlement of Financial Arrangement 1). The second confirmation reflected a settlement date of Date 7 and applied to approximately Z Borrowed Shares (represented by 10 physical share certificates that were delivered to Bank on behalf of Subsidiary in settlement of Financial Arrangement 2). All of the Borrowed Shares transferred to Bank were in the form of physical share certificates. Upon termination of the Securities Loan Agreement, Subsidiary will be obligated to return a number of Company shares equal to the number

of Borrowed Shares. Subsidiary has the unrestricted legal right to deliver any Company shares to satisfy its repayment obligation under the Securities Loan Agreement.

Subsidiary satisfied its obligations under the Financial Contracts to deliver Company shares to Bank by delivering the appropriate number of Borrowed Shares.

Law and Analysis:

A short sale is not defined in the Code or regulations but is described in case law as the sale of borrowed stock. See, Provost et al. v. United States, 269 U.S. 443, 46 S. Ct. 152 (1926). Section 1.1233-1(a)(1) of the Income Tax Regulations provides that, for income tax purposes, a short sale is not deemed to be consummated until delivery of property to close the short sale. Pursuant to § 1.1233-1(a)(4), if the short sale is made through a broker and the broker borrows property to make a delivery, the short sale is not deemed to be consummated until the obligation of the seller created by the short sale is finally discharged by delivery of property to the broker to replace the property borrowed by the broker.

Rev. Rul. 2004-15, 2004-8 I.R.B. 515, describes a situation where a taxpayer with an existing short sale satisfies his obligation to the broker for the existing short sale by causing a second broker to transfer shares borrowed from the second broker to the first broker. The revenue ruling holds that the transfer of the borrowed shares does not close the short sale. Rev. Rul. 2004-15 indicates that the obligation of the selling taxpayer is not finally discharged by the delivery of borrowed property to the broker, and the short seller will not realize gain or loss on the short sale until it delivers shares to satisfy his obligation to the second lender. Case law supports the view that a short sale is not closed by the delivery of borrowed stock. See, H.S. Richardson v. Commissioner, 42 B.T.A. 830, 844 (1940).

Section 1259(a)(1) provides that if there is a constructive sale of an appreciated financial position (AFP), the taxpayer must recognize gain as if the position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. An AFP is defined in § 1259(b)(1) to include a position with respect to stock if there would be gain were the position sold, assigned, or otherwise terminated at its fair market value. Section 1259(c)(1)(A) treats a taxpayer as having made a constructive sale of an AFP if the taxpayer enters into a short sale of the same or substantially identical property. Likewise, section 1259(c)(1)(D) treats a taxpayer as having made a constructive sale of an AFP that is a short sale or a contract described in section 1259(c)(1)(B) or (C) if the taxpayer acquires the same or substantially identical property. Section 1259(c)(1)(C) describes a futures or forward contract. A forward contract is defined in section 1259(d)(1) as a contract to deliver a substantially fixed amount of property for a substantially fixed price.

If Subsidiary had delivered the Existing Shares or other shares that it owned to satisfy its obligations under the Financial Contracts, Subsidiary would have recognized

gain equal to the excess of the relevant Downside Protection Threshold Price under the Financial Contracts over its basis in the shares delivered. However, by delivering the Borrowed Shares to satisfy its obligations under the Financial Contracts, Subsidiary has entered into a short sale of Company shares. Although the price at which the Borrowed Shares were sold was predetermined, there is no authority indicating that a short sale cannot occur at a price other than the current market price.

As noted above, a short sale is not deemed to be consummated and gain is not recognized until the obligation of the taxpayer created by the short sale is finally discharged by delivery of property to close the short sale. See § 1.1233-1(a); Rev. Rul. 2004-15. At this time, Subsidiary has not delivered shares to Broker, so the short sale remains open and no gain has yet been recognized.

The borrowing of shares by Subsidiary from Broker does not trigger gain under section 1259(c)(1)(D). Section 1259(c)(1)(D) applies where a taxpayer holds an appreciated contract described in section 1259(c)(1)(C) and acquires the same or substantially identical property. Section 1259(c)(1)(C) applies to a forward contract which is defined in section 1259(d)(1) as a contract to deliver a substantially fixed amount of property for a substantially fixed price. Assuming the Financial Contracts are treated as a contract described in section 1259(c)(1)(C), Subsidiary would recognize gain if it acquired the same or substantially identical property. Subsidiary has not acquired any substantially identical property; it has only borrowed property. Therefore, Subsidiary does not recognize gain under section 1259(c)(1)(D).

However, entering into a short sale while holding the Existing Shares does trigger gain under section 1259(c)(1)(A). The Existing Shares are an appreciated financial position and, as stated above, the delivery of borrowed shares in satisfaction of the Financial Contracts constitutes entering into a short sale. Therefore, Subsidiary recognizes gain as if the Existing Shares were sold for their fair market value. The amount of gain recognized is equal to the excess of the fair market value of the Existing Shares over Subsidiary's basis in the Existing Shares.

Conclusion:

Based on the information submitted and representations made, we conclude that (1) the delivery of borrowed shares in satisfaction of the Financial Contracts will not cause Subsidiary to recognize gain on the Financial Contracts; (2) the delivery of borrowed shares did not give rise to constructive sales of the Financial Contracts under section 1259(c)(1)(D); and (3) the delivery of borrowed shares and the retention of the Existing Shares resulted in gain recognition under section 1259(c)(1)(A) equal to the excess of the fair market value of the Existing Shares over Subsidiary's basis in the Existing Shares.

We express no opinion regarding the tax implications of the transfer of the Existing Shares and the assignment of Parent's rights and obligations in connection with the Financial Contracts to Subsidiary.

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

____

Patrick E. White
Senior Counsel, Branch 1
Office of Associate Chief Counsel
(Financial Institutions & Products)

Enclosures:

Copy of this letter
Copy for section 6110 purposes