Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: December 03, 2004

to: Mr. Paul DeNard
Industry Director, Financial Services (LM:F)
290 Broadway, 12th Floor
New York, NY 10007

from: ROBERT M. BROWN
Associate Chief Counsel (Income Tax & Accounting)

subject:

LEGEND

Date 1 =

Company =

State X =

We are sending you this memorandum pursuant to section 7.07(2) of Rev. Proc. 2004-1, 2004-1 I.R.B. 1, 26. Company withdrew a letter ruling request (PLR-156706-03) after CC:ITA had tentatively concluded that members of Company would not realize gain or loss under § 1001 of the Internal Revenue Code on the exchange of Trading Rights for Class B Interests in the First Merger. Consequently, under our tentative view members of Company could not claim a loss under § 165 if their bases in the transferable Trading Rights exceeded the fair market value of the non-transferable Class B interests.

Company's representative informed us that the transaction that was the subject of the letter ruling request closed on Date 1 in substantially the same form as described in the ruling request. We refer this matter to you for any action you believe is appropriate

ISSUES

1. Will members of Company will realize gain or loss under § 1001 on the exchange of Trading Rights for Class B Interests in the First Merger?

2. Will members of Company realize gain or loss under § 1001 on the exchange of their Class B Interests for Trading Permits on the Reorganized Company?

CONCLUSIONS

1. Members of Company will not realize gain or loss on the conversion of a member's Trading Rights into Class B interests in the First Merger.

2. Members of Company will not realize gain or loss on the issuance of Trading Permits in replacement of a member's Class B interests surrendered in the Second Merger.

FACTS

Prior to the transactions discussed in this memo, Company was a State X not-for-profit, non-stock membership organization that operated a securities company. A seat on Company carried both equity and nonequity rights. The equity rights were ownership rights in Company regarding liquidation and governance rights, but not dividend rights. The nonequity rights were trading rights (Trading Rights) on Company. Trading Rights could be leased separately or together with voting rights.[1] In addition, seats on Company could be bought or sold subject to regulation and approval of Company through Company's internal market. The market for seats on Company tended to be illiquid. The purchase or sale of a seat on Company conveyed both the equity and nonequity rights. Neither could be bought or sold separately from the other.

Company proposed to demutualize and form a holding company in a two-step process. First, Company would recapitalize through the merger of a newly formed subsidiary with and into Company, with Company surviving (First Merger). Equity rights would be converted to Class A interests and Trading Rights would be converted to Class B interests. Under the amended articles, Class A interests will be fully transferable separate from Class B interests. Class B interests may not be leased or otherwise transferred.

Second, Holdings would be organized as a State X for-profit stock corporation. Holdings would organize a wholly owned subsidiary (Mergerco). Immediately after the First Merger, Mergerco would merge with and into Company, with Company surviving (Second Merger). Each holder of a Class A interest would receive Holdings stock in

[1] In addition, electronic trading privileges are available on an annual basis without holding a seat on Company. These traders are treated as members for SEC reporting purposes and are permitted to describe themselves as members under Company's rules. However, these electronic traders do not have equity rights in Company. This memorandum does not address the trading rights of traders who do not hold a seat on Company.

exchange for the holder's Class A interest. Class B interests would be extinguished but holders of Class B interests would continue to hold trading rights in Company in the form of Trading Permits issued by Company. Trading Permits are renewable annually and additional permits may be issued by Company at its discretion. Trading Permits, like Class B interests, may not be leased or otherwise transferred. Company represents that an unlimited number of Trading Permits maybe be issued by Company after the Second Merger. Company represents that there does not appear to be any technological limitation on the number of persons who can trade on the electronic trading platform.

Company requested rulings under § 368(a)(1)(E) and § 351 with regard to the equity rights from the Associate Chief Counsel (Corporate). In addition, Company requested the rulings set forth under ISSUES from the Associate Chief Counsel (Income Tax & Accounting).

LAW AND ANALYSIS

Company requested rulings regarding the federal income tax consequences of the First Merger and Second Merger regarding the equity and nonequity interests. Because, for purposes of applying the provisions of Subchapter C to the First Merger, the Service views the equity and nonequity interests as separately held, the federal income tax consequences of the mergers may be analyzed separately with regard to the equity and nonequity interests.

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. Under § 1001(c), except as otherwise provided in subtitle A, the entire amount of gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides that the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or loss sustained.

Section 1.1001-1(c)(1) provides that a loss is not ordinarily sustained prior to the sale or other disposition of the property for the reason that until such sale or other disposition occurs there remains the possibility that the taxpayer may recover or recoup some of

the adjusted basis of the property. Until some identifiable event fixes the actual sustaining of a loss and the amount thereof, it is not taken into account.

In *Cottage Savings v. Commissioner*, 499 U.S. 554 (1991), the Supreme Court held that a financial institution that exchanged its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans in an arms-length commercial transaction resulted in gain or loss recognition under § 1001 because the exchanged assets were materially different under § 1.001-1(a). The Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective "possessors enjoy legal entitlements that are different in kind or extent." *Cottage Savings* at 564-65. The Court held that because the mortgage loans were made to different obligors and secured by different homes, they embodied distinct legal entitlements, and therefore, the taxpayer realized losses when it exchanged interests in the loans.

In *Beatty v. Commissioner*, 46 T.C. 835 (1966), the taxpayers purchased an Arizona retail liquor license. These licenses were statutorily limited in number, renewable annually, and could be sold or leased with the approval of the Arizona Department of Liquor Licenses and Control. In 1961, Arizona law was amended to provide that liquor licenses could no longer be sold or leased, with an exception that licenses could be sold only in a bulk sale of assets of the business. The law also greatly expanded the number and type of licenses available. Petitioners claimed a § 165 loss in 1961, based on the purported worthlessness of the transfer rights of their liquor license. The court found that the bundle of rights represented by the liquor license could not be separated for purposes of determining whether one or more of them had become worthless. Rather, the liquor license as a whole had to become worthless before a closed and completed transaction could be found for purposes of § 165. Although the petitioners asserted the worthlessness of the transfer rights and not that there was a sale or disposition of the license, the court clearly considered the modified license to be the same asset before and after the legislative changes.

In *Wood v. Commissioner*, T.C.M. 1985-517, *aff'd without published opinion*, 823 F.2d 1553 (9th Cir. 1987), the taxpayer owned a San Francisco taxicab permit that could be sold or leased. In 1978, Proposition K was passed, which required all taxicab permit holders to exchange their old permits for new permits that could no longer be sold, but could still be leased. In denying a loss under § 165, the Tax Court determined that there had been no closed or completed transaction. The court noted that Proposition K changed the taxpayer's cab permit "in only one respect— he could not thereafter sell or assign it." In so holding, the court referred to *Reporter Publishing Co., Inc. v. Commissioner,* 201 F.2d 743, 744 (10th Cir. 1944), in which the Court of Appeals stated:

> A taxpayer is not chargeable with a capital gain resulting from an enhanced value of a capital asset while it is still being used in the business; neither may he take a deduction from gross income because of the diminution in value of such an asset while it is still part of the business and is being used in the business.

Although the discussion in *Wood* centered on worthlessness, the opinion indicates that the loss of the right to sell the license accompanied by an actual physical Company of permits did not induce the court to treat a taxicab permit held before enactment of Proposition K as a different asset from the taxicab permit received after enactment of Proposition K.

Rev. Rul. 90-109, 1990-2 C.B. 191, holds that the exercise of an option in an insurance policy to change the insured is a sale or other disposition under § 1001. The revenue ruling states that a change in contractual terms effected through an option provided in the original contract is treated as an exchange under § 1001 if there is a sufficiently fundamental or material change that the substance of the original contract is altered through the exercise of the option. In Rev. Rul. 90-109, the exercise of the option resulted in a change in the fundamental substance of the original contract because the essence of a life insurance contract is the life that is insured under the contract.

An exchange of property is a taxable event under § 1001 only if the exchange results in the receipt of property that is "materially different" from the property transferred. Under § 165 a loss must be evidenced by “closed and completed transactions.” *See* § 1.165-1(b). “The most common way of satisfying the ‘closed and completed transaction’ requirement is by a realization event under § 1001 -- a ‘sale or other disposition of property.’” *See* Martin J. McMahon & Lawrence Zelenak, *Federal Income Taxation of Individuals,* ¶ 16.03 (2d ed.) RIA (2004), 2002 WL 1454936 (W.G. & L.). In *Beatty* and *Wood*, the courts holdings that the transactions therein did not result in “closed and completed transactions” under § 165 indicates that the transactions were not exchanges of old licenses for new and materially different licenses under § 1001, even though in both cases some rights under the licenses were eliminated or curtailed, and in *Wood* there was an actual exchange of licenses. In these cases, the rights eliminated or curtailed did not result in a sufficiently fundamental or material change that altered the substance of the original licenses, unlike the fundamental pre-authorized change to the life insurance contract in Rev. Rul. 90-109 or the receipt of a mortgage from one homeowner in exchange for a mortgage from another homeowner in *Cottage Savings*.

In the transactions in Company’s ruling request, the rights of members to sell and lease their Trading Rights would be altered, as were the rights of the taxpayers in *Beatty* and *Wood* to sell and lease their licenses. Further, like the transferability and leasing of the license rights in *Beatty* and *Wood*, the transferability and leasing rights in the Trading Rights are not property severable from the Trading Rights, even if the transferability and leasing rights could be separately valued. The Trading Rights continue to have value and utility to those possessing them. Therefore, because there is no closed and completed transaction, there is no exchange under § 1001. In addition, this result is not changed because the number of Trading Permits is expected to increase substantially, as did the number of liquor licenses in *Beatty*.

Therefore, we informed Company that we had tentatively concluded that—

1. Members of Company would not realize gain or loss on the conversion of a member's Trading Rights into Class B interests in the First Merger.

2. Members of Company would not realize gain or loss on the issuance of Trading Permits in replacement of a member's Class B interests surrendered in the Second Merger.

This Chief Counsel Advice may not be used or cited as precedent. Please call (202) 622-4920 if you have any questions.