Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:CLE:PIT:TL-N-6073-00
MAYost

date: NOV 13 2000

to: John Niederst, Team Manager
[redacted] Audit

from: Associate Area Counsel, LM:MCT:CLE:PIT

subject: [redacted] **Stock Transactions**
[redacted] **Audit**
U.I.L. No. 307.00-00

This is in response to your memorandum dated October 11, 2000, which forwarded a proposed adjustment on Form 886A involving certain stock transactions relating to [redacted]. This memorandum is subject to 10-day post review by our National Office and, therefore, is subject to modification.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

Whether a reverse stock split closely followed by a stock rights offering with respect to the common stock of [redacted] can be disregarded for tax purposes in determining

[redacted]'s tax basis in such stock which was sold in [redacted] and [redacted].

CONCLUSION

The stock transactions at issue can not be disregarded for tax purposes in determining [redacted]'s tax basis in the common stock of [redacted] that was sold in [redacted] and [redacted].

FACTS

[redacted] and [redacted] were equal partners in [redacted], an Ohio general partnership. The tax basis of [redacted]'s partnership interest in [redacted] was $ [redacted]. In [redacted], [redacted] and [redacted] transferred their respective interests in [redacted] to a newly-formed corporation, [redacted], in exchange for all of the common stock of [redacted]. [redacted] and [redacted] each received [redacted] shares of [redacted] with a fair market value of $ [redacted] per share. In connection with the formation of [redacted], [redacted] then sold its [redacted] stock to the public, causing the formation of [redacted] to fail the continuity-of-interest requirements of I.R.C. § 351. [redacted] recognized taxable gain of $ [redacted] in [redacted] on the transfer of its [redacted] partnership interest to [redacted], based on proceeds of $ [redacted], which was the fair market value of the [redacted] shares received at § [redacted] per share, less its tax basis in its partnership interest of $ [redacted]. As a result, [redacted] took a basis of $ [redacted] in the [redacted] of [redacted] shares received in [redacted].

From [redacted] through [redacted], [redacted] continued to hold these [redacted] shares with the balance of the outstanding stock of [redacted] being publicly held. At their Annual Meeting on [redacted], however, [redacted]'s shareholders agreed to a [redacted]-for-[redacted] reverse stock split. Pursuant thereto, each certificate representing shares of common stock outstanding immediately after the reverse split was deemed to represent [redacted] the number of shares it represented immediately prior to the reverse split. The reverse stock split became effective [redacted], upon the filing of a Certificate of Amendment to the Articles of Incorporation for [redacted] with the Ohio Secretary of State. As a consequence, [redacted]'s stockholdings in [redacted] dropped to [redacted] shares. The reverse split caused no change in the $ [redacted] tax basis that [redacted] had in the [redacted] stock; however, since the number of shares held by [redacted] was reduced from [redacted] to [redacted], the basis per share increased from $ [redacted] per share to $ [redacted] per share ($ [redacted]/[redacted] shares).

The stated business purpose for the reverse split was to increase the stock price of [redacted]. [redacted] advised the Exam team that

[redacted]'s Board of Directors believed that the share price for [redacted] reduced the effective marketability of the stock because of the reluctance of many leading institutional investors to trade in low-priced stocks and because brokerage firms were reluctant to recommend low-priced stocks to their clients. Immediately prior to the reverse split, [redacted] closed at $ [redacted] per share. After the reverse split, [redacted]'s stock price increased to around $ [redacted] per share. [redacted] traded between a low of $ [redacted] and a high of $ [redacted] through mid-[redacted] of [redacted], when [redacted]s Board of Directors issued stock rights to each stockholder of record on [redacted].

The rights offering entitled each shareholder to receive [redacted] transferable rights for each share of stock owned. Each right entitled the holder to purchase [redacted] shares of [redacted] stock for $[redacted] per share. The rights expired on [redacted]. Approximately [redacted] percent of the total number of rights were exercised, resulting in the issuance of [redacted] new shares of [redacted]. [redacted] exercised all of its rights and paid $ [redacted] for [redacted] additional shares, bringing its total stockholdings in [redacted] to [redacted] shares. Net proceeds from the rights offering totaled $ [redacted], which was to be used by [redacted] to finance new [redacted] market opportunities.

For tax purposes[1], [redacted] allocated its original tax basis of $ [redacted] between its [redacted] old [redacted] shares and the stock rights received, in accord with I.R.C. § 307(a). The allocation was done based on the date of distribution ([redacted]) relative fair market values of the [redacted] stock and the stock rights.[2] Treas. Reg. § 1.307-1(a). Of [redacted]s original basis of $ [redacted], $ [redacted] was allocated to the [redacted] shares of [redacted] stock and $ [redacted] to the stock rights.

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[1] Under I.R.C. § 305(a) and (d)(1), the distribution of the rights to acquire stock is not includable in [redacted]s income.

[2] As of [redacted], the fair market values of a share of [redacted] stock (ex-rights) and a [redacted] stock right were $ [redacted] and $ [redacted], respectively. For each share of [redacted] stock held, [redacted] rights were received valued at $ [redacted] ($ [redacted] per right X [redacted] rights per share). These relative values resulted in allocation multipliers of [redacted] ($ [redacted]/$[redacted] and [redacted] ($[redacted]/$[redacted]). The multipliers are the value of a share of [redacted] stock and the value of the [redacted] rights per share divided by the sum of their values ($[redacted]). They also represent the proportions of basis of [redacted] stock (pre-rights) allocated to [redacted] stock (ex-rights) and in the aggregate to the [redacted] rights distributed per share.

The stock acquired through exercise of the rights was treated as a separate block from the old [redacted] shares previously held. The tax basis for the new stock was computed to be $ [redacted], which equals the exercise price of $ [redacted] plus the tax basis allocated to the rights ($ [redacted]. After acquiring the [redacted] shares pursuant to the rights offering, [redacted] held [redacted] old shares that were acquired in [redacted] with a claimed tax basis of $ [redacted] (or $ [redacted] per share), and [redacted] shares acquired in [redacted] with a claimed tax basis of $ [redacted] (or $ [redacted] per share).

In [redacted], [redacted] sold [redacted] shares of [redacted]. [redacted] determined the basis of the stock sold using the FIFO method and calculated a per share basis of $ [redacted]. [redacted] reported a loss on the stock sale of $ [redacted]. In [redacted], [redacted] sold the remaining [redacted] of its original [redacted] shares of [redacted] stock at an overall loss of $ [redacted], again claiming a per share basis of $ [redacted]. Later in [redacted], [redacted] sold an additional [redacted] shares of stock, which had been acquired through the exercise of the stock rights, and reported a $ [redacted] gain on these shares.

The Exam team questions the economic substance or business purpose of the reverse stock split followed closely by the issuance of the stock rights. The basis for their concern is that the subject transactions effected a "basis shift" to the old shares which allowed [redacted] to claim large losses on the subsequent sales of [redacted] shares.

LAW AND ANALYSIS

To be recognized for tax purposes, a transaction must have economic substance. Gregory v. Helvering, 293 U.S. 465 (1935); Lerman v. Commissioner, 939 F.2d 44, 53 (3rd Cir. 1991). An inquiry into whether transactions have sufficient substance to be respected for tax purposes turns on both the objective economic substance of the transactions and the subjective business motivation behind them. See Kirchman v. Commissioner, 862 F.2d 1486, 1491-92 (11th Cir. 1989). A transaction entered into solely for the purpose of tax avoidance and which is without economic, commercial or legal effect other than the expected tax benefits has no economic substance. Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 196 (1983), aff'd in part, revd. in part, and remanded, 752 F.2d 89 (4th Cir. 1985). Thus, a transaction will not be given effect for tax purposes if it has no valid corporate or business purpose other than avoiding federal taxes.

On the other hand, a transaction must be respected where it is a genuine multi-party transaction compelled or encouraged by

business realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features. Frank Lyon Co. v. United States, 435 U.S. at 583-84. It is entirely permissible for a taxpayer to plan its business affairs in a way that minimizes its taxes. See, Gregory v. Helvering, 293 U.S. at 469.

Under the facts in our case, the stock transactions at issue simply can not be cast aside for tax purposes as lacking economic substance or business purpose. Although the reverse split coupled with the rights offering accomplished a "basis shift" to the old shares owned by [redacted] (as well as the public shareholders of [redacted]), this tax benefit appears to be acceptable tax planning within the context of legitimate business activity.[3] The ultimate goal of the stock transactions was to raise up to $ [redacted] in additional capital from [redacted]'s shareholders to fund new [redacted] market opportunities. The reverse split represented the first step in the overall strategy to raise this new capital. The stock split succeeded in increasing the per share price of [redacted] stock from $[redacted] to around $ [redacted], which made the stock more attractive to institutional investors and paved the way for the rights offering at $ [redacted] per share. In all probability, without the reverse split, [redacted] would have been forced to set a lower exercise price for the stock rights.[4] And a lower exercise price would have necessitated a correspondingly larger stock rights offering to meet [redacted]'s capital target. As a result of the reverse split, [redacted] was able to successfully realize additional net funds of $ [redacted] for business investment, while limiting the size of the rights offering.

Moreover, the reverse split and rights offering had economic and business consequences to [redacted] shareholders apart from shifting tax basis between blocks of stock. The subject transactions affected the number of shares held and resulted in additional capital investments from the shareholders. To the extent a shareholder chose not to exercise the stock rights, that

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[3] As discussed in the FACTS section, the "basis shift" results from I.R.C. §§ 305 and 307.

[4] It is likely that the market would have dictated a lower exercise price, since there would have been substantially more [redacted] shares outstanding in the market at the time of the rights offering. This likelihood is supported by the market's reaction to the issuance of the stock rights. The stock price for [redacted] fell sharply, due apparently to the prospect of a large number of additional shares of [redacted] entering the market as a result of the offering.

shareholder's relative equity position in [redacted] would have been adversely impacted. In [redacted]'s case, its stock ownership in [redacted] dropped to [redacted] shares after the reverse split, then increased to [redacted] shares after exercise of the stock rights, with an additional capital investment of $ [redacted] in [redacted] stock.

In light of the above, the stock transactions at issue clearly appear to be part of a genuine financing strategy and were not contrived in pursuit of artificial tax losses. The transactions had economic substance wholly apart from their tax consequences under I.R.C. §§ 305 and 307 and, thus, should be respected for tax purposes.

If you have any questions, please feel free to call Michael A. Yost, Jr. at (412) 644-3441.

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By: _____
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