

Of Ponzi Schemes and Nonrecourse Loans: *A.L. Calloway*

By Matthew A. Stevens

Matthew Stevens analyzes the tax consequences of an individual investor who fell victim to a scam.

I. Introduction

Most tax court cases are pretty straightforward. It's usually pretty obvious who should win, and it's also usually obvious why the outcome is the way it is. Other cases involve close legal issues, and it is not clear whether the taxpayer or the IRS should prevail. Every once in a while, though, the outcome of a case is obvious, but the path to that outcome is the subject of heated dispute. With an obtuse majority opinion that nevertheless attracted 11 votes, and two crisply worded opinions concurring only in the result, *A.L. Calloway*¹ is such a case.

II. Facts

Background

Many tax-advantaged transactions start with a glitch in the Internal Revenue Code ("the Code"). Either two disparate provisions are combined into a single transaction, with results unforeseen by Congress or the IRS (e.g., *ACM Partnership*),² or a single noneconomic rule (often one that benefitted the IRS in a different context) is turned against the IRS by a taxpayer (e.g., *Stobie Creek Investment, LLC*).³ The transaction in *A.L. Calloway*, however, while no doubt marketed as a tax-advantaged transaction, started as a scam on the taxpayer. Calloway was a career IBM employee who, by the early 2000s, held IBM stock worth about \$100,000, with a basis of about \$22,000. (I'll use round numbers throughout this article to make the concepts easier to follow.) Then, as now, an investor with a multi-million dollar appreciated position in a single stock could raise cash and protect itself from

risk of loss on the stock (at the cost of giving up much of the potential for gain) by executing a variable prepaid forward contract, such as in *Anschutz Co.*⁴ Once the contract had been executed, the taxpayer would no longer be at risk for any decline in the value of the stock, and, structured properly, the taxpayer could defer any gain at least until the stock was delivered to close out the variable prepaid forward contract,⁵ and perhaps even longer. However, a variable prepaid forward contract required a considerable amount of documentation. Additionally, the counterparty to such contract would need to hedge the variable prepaid forward contract, and such hedging tended to be unprofitable for the counterparty if the contract involved only \$100,000. As a result, few if any counterparties would have been willing to enter into a variable prepaid forward contract with Calloway over his \$100,000 position in IBM stock.

The Transaction

A small financial concern known as Derivium Capital ("Derivium") offered to help Calloway by lending him money on a nonrecourse basis against his IBM stock. Specifically, Derivium offered to lend Calloway 90 percent of the purchase price at an interest rate of about 10 percent for a three-year term (actually 10.5 percent, but I'm using round numbers). Neither interest nor principal would be required or permitted to be paid before maturity. The IBM stock would be pledged as collateral for the loan, which was nonrecourse to Calloway. The pledge agreement gave Derivium the right to sell the stock at any time, but Derivium represented orally that it had a secret way to hedge its position in IBM stock, and would not sell the stock, absent a default by Calloway. Calloway would receive credit against the amount accrued as interest for the

Matthew A. Stevens is a Partner in the Washington, D.C. office of Alston & Bird LLP.

amount of dividends paid with respect to the stock. At the end of three years, Calloway would have one of three choices. First, he could pay the interest and repay the principal on the loan and reclaim the stock. Second, he could renew the loan for another term of three years, (which would require paying a fee of 4.5 percent of the principal and interest then due, if 90 percent of the collateral value at that time did not equal or exceed the payoff amount). Third, he could forfeit the IBM stock and be forgiven the principal and interest under the loan.

The Scam

As mentioned above, the transaction was a scam on Calloway. Derivium had no secret hedging strategy. Rather, it simply sold the IBM stock into the market the day after it received the pledged stock from Calloway. Thus, Derivium effectively bought Calloway's stock for 90 percent of its fair market value, and immediately sold it for its full fair market value, thus generating a profit equal to 10 percent of such value. Because the interest rate on the nonrecourse loan was fairly high, even when reduced by the dividends on the IBM stock (which I assume throughout this article to be one percent), it was fairly unlikely that Calloway (or any other given investor who entered into a similar transaction with Derivium) would show up at the end of the three years and demand his stock back. However, if an investor did show up with the cash necessary to pay off the interest and principal on the loan, that would necessarily imply that the value of the stock would be even greater than such amount; otherwise, the taxpayer would simply walk away from the stock. Thus, for each investor who showed up to demand his stock back, Derivium would have to come up with cash out of pocket equal to the difference between the value of the stock and the cash provided by the taxpayer. This obviously would not be a sustainable business model in the event of a broad, sustained rise in stock prices.⁶

Financial Analysis

Putting aside any forebodings that Calloway might have had about Derivium's ability to return the shares if called for, did this transaction make financial sense for Calloway on an after-tax basis? It did not appear to, if the only advantage of the transaction were tax deferral. While the Tax Court stated that Calloway decided it was cheaper to take out a nonrecourse loan against his IBM stock for 90 percent of its value than it would have been to sell the stock for its full fair market value

of \$100,000 and pay the resulting capital gains tax at a rate of 20 percent, financial analysis shows otherwise. If the form of the transaction were respected for tax purposes, Calloway would be faced at the end of the term of the loan with either abandoning the stock (and recognizing the gain at that time) or repaying the amount of the principal plus interest. Abandoning the stock and recognizing the gain would mean the taxpayer would retain the \$90,000 loan proceeds but would be required to pay the tax on the gain. At a three-year interest rate of five percent (compounded semi-annually), the value of the deferral of tax liability for three years would have been \$2,148. This is substantially less than the \$10,000 Calloway took as a haircut to the fair market value of his stock.

Of course, unlike simply selling the stock in the market, the Derivium transaction also gave the taxpayer an option to repurchase the stock at the end of such three-year period. Given an interest rate of 10 percent, compounded semi-annually, the effective repurchase price of the stock at the end of the three year period was \$120,609. Assuming a risk-free rate of return of five percent, a dividend rate of one percent and a volatility of 15 percent for IBM stock, a Black-Scholes calculator available over the Internet⁷ gives this call option a value of \$7,212. This option value, combined with the value of the deferral from the previous paragraph (\$2,148), equals more than 90 percent of the haircut Calloway took on his stock as compared with a current sale. Indeed, if Calloway thought the volatility of the IBM stock were 20 percent instead of 15 percent, the implied call option value would have been \$10,551, which would mean the transaction would be more desirable economically than a current sale at market. Thus, whatever the taxpayer may have thought was the main benefit of the transaction, the option value (again disregarding the *a priori* possibility that Derivium could not make good on its obligation to redeliver the stock if required to do so) substantially outweighed the tax deferral value.⁸

Taxpayer's Treatment of the Transaction

Understandably, given the form of the transaction, Calloway treated it as a nonrecourse loan and so did not report any gain when the loan was made in 2001. Less understandably, he did not report the dividends on the stock as income, although he regularly received fanciful brokerage statements from Derivium, reporting the crediting of dividends against the interest due on his loan. In 2004, the IBM stock was worth less than the sum of

the principal and accrued interest due under the loan (less the IBM dividends). So the taxpayer surrendered the IBM stock (or, more accurately, surrendered the right to get the IBM stock back) and was forgiven the amount of the loan balance. (One can almost hear Derivium's owner give a sigh of relief at this point.) Nonetheless, although Calloway did not claim ownership of the IBM shares and had no right whatsoever to get the shares back, still he did not report any gain from the sale of those shares. One wonders what would have to happen to those particular shares in order for Calloway to admit that he needed to recognize gain.

III. Tax Court Opinions

Majority Decision

The Tax Court, in a court-reviewed decision, held that Calloway was required to recognize gain in 2001, when the non-recourse loan was made and the IBM stock sold into the market. The majority held "the key was to determine whether the benefits and burdens of ownership of the IBM stock passed from petitioner to Derivium." The Tax Court listed a number of factors used in making such determination, which factors it derived from the *Arevalo*⁹ case. The listed factors were (i) whether legal title passes; (ii) how the parties treat the transaction; (iii) whether an equity interest in the property is acquired; (iv) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (v) whether the right of possession is vested in the purchaser; (vi) which party pays the property taxes; (vii) which party bears the risk of loss or damage to the property; and (viii) which party receives the profits from the operation and sale of the property. In applying these factors, the Tax Court majority opinion did not distinguish between the purported loan of funds secured by the stock and the immediate sale of the stock by Derivium, but treated the two as a single transaction. In this section, I will describe and comment briefly on each of these factors.¹⁰

Passage of Title

The Court concluded that title to the IBM stock had passed when the stock was pledged to Derivium; Judge Holmes in his concurring opinion points out that this "passage of legal title" test cannot be applied sensibly here, given that legal title to the IBM stock at issue in Calloway was likely held by the Depository Trust Company.

Thus, this factor, which the court treated as a factor supporting the government, should have been treated as neutral.

Parties' Treatment of the Transaction

The majority's analysis of this factor consists largely of a recitation of the facts that the taxpayer never reported any of the dividends he purportedly received on the IBM stock, and never reported the stock as having been sold, either at the time the loan was extended or at the time the taxpayer abandoned his IBM stock. While failing to report the dividends as income and failing to report the abandonment of the stock as a taxable disposition was indeed sloppy on the part of the taxpayer, the taxpayer also did not report a taxable disposition at the time the loan was entered into. This fact would appear to support the conclusion that the taxpayer was generally inattentive in tax matters, not that the taxpayer did not intend a loan to exist.

Equity Inherent in the Stock

Traditionally, when courts have analyzed the question of whether a taxpayer had an equity interest in the property, they meant to inquire whether there was an excess of the fair market value of the property over the amount of nonrecourse indebtedness securing that property. By this standard, Calloway did have an equity interest in the property, because the principal amount of the nonrecourse loan was only 90 percent of the value of the stock on the date of the sale. Given that Calloway could not prepay the loan, a more sophisticated approach would have been to have computed the probability, based on a normal or log normal probability distribution, that the IBM stock would actually have a value three years hence that exceeded the sum of the accrued interest plus the principal, less the dividends paid. But the court didn't do this sort of analysis. The majority, as pointed out by Judge Holmes, seemed to focus more on Calloway's attenuated legal connection to the IBM stock rather than his economic interest in it. Thus, this factor likely did support the government's position, but for very different reasons than the Tax Court stated.

Obligation to Deliver and Pay

The majority pointed out that the loan agreement obligated Calloway to deliver the stock to Derivium (but ignored that such delivery was cast as a pledge) and obligated Derivium to pay 90 percent of the proceeds to Calloway (but ignored that such payment

was cast in the form of a loan). Under the majority's reasoning, any loan against pledged stock, even one with full recourse to the taxpayer, would possess this factor, which seems odd.

Whether the Right of Possession Passed

The majority also stated that "possession" of the stock had passed to Derivium from Calloway as a result of the pledge of the stock, in the sense that Derivium, and not Calloway, had the power to make another party the owner of the stock for tax purposes. The majority could have mentioned, but did not, that the taxpayer also gave up the voting rights when it gave up possession of the stock. This factor clearly favored the government.

Payment of Property Taxes

Clearly irrelevant, and the majority admitted as much.

Risk of Loss or Damage

Here, the Court held that the taxpayer did not bear the risk of loss or damage after it received the proceeds of the loan. This is accurate. Once the loan had been funded, the taxpayer was indifferent to the value of the IBM stock unless it was above the \$120,609 balance of the loan. This factor clearly favored the IRS.

Profits from the Property

"At best, the master agreement gave petitioner an option to repurchase IBM stock at the end of the three years; however, this option depended on Derivium's ability to acquire" such stock. Curiously, the Court made no mention of dividends, which one would have thought would have weighed in the taxpayer's favor, since the dividends would be credited against the loan balance, and payment of the dividends would make it more likely that the taxpayer would choose to pay off the principal and interest amount on the loan. To be sure, because the interest rate on the loan was steep, and the dividends were fairly small, it does not seem likely that the crediting of the dividends against Calloway's loan balance would have substantially affected the probability that the taxpayer would choose to repay the loan and reclaim the stock. Nonetheless, the payment of the dividends by IBM did lower the loan balance compared with what it would otherwise have been, and, therefore, this factor should be considered to weigh, at least modestly, in the taxpayer's favor. (Of course, as I point out above, it would have been much easier for Calloway to have

persuaded the Tax Court to treat the dividends as an indicator of possession if he had actually reported them on his income tax returns.)

One might have thought that, having concluded that the transaction was a sale, the majority's analysis would be finished. The majority continued, however, with an analysis of whether the transaction met the definition of a loan. Among other citations to various formulations of the test for debt, the majority held that, "[f]or disbursements to constitute true loans there must have been, at the time the funds were transferred, an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure repayment." As support for this proposition, the majority cited *S.W. Haag*,¹¹ which dealt with a recourse loan. As hereinafter discussed, this statement can be reconciled with the law in this area only if the "conditionality" of the obligation of the taxpayer to repay the loan is determined without regard to the lender's ability to obtain access to the borrower's other assets. It seems odd to say that the borrower has an unconditional obligation to repay the loan, where the borrower can choose not to repay.

The majority continued with its discussion of why the transaction did not qualify as a loan by stating that:

Petitioner would have no personal liability to pay principal or interest to Derivium, and it would have made no sense to do so unless the value of the stock had substantially appreciated. Petitioner transferred ownership of the stock to Derivium,¹² who received all rights and privileges of ownership and was free to sell the stock. Derivium did immediately sell the stock and immediately passed 90 percent of the proceeds to petitioner.

Thus, the majority continued, "[t]he only right petitioner retained regarding shares of IBM stock was an option, exercisable 3 years later, in 2004, to require Derivium to acquire 990 shares of IBM stock and deliver them to him in 2004. Petitioner's right to exercise this option in 2004 was wholly contractual because he had already transferred all of the incidents of ownership to Derivium, which had immediately sold the [shares]."

Having concluded that the taxpayer was no longer the owner of the IBM stock, the majority had then to deal with the taxpayer's contention that the transaction was a nontaxable securities lending arrangement

analogous to the situation described in Rev. Rul. 57-451.¹³ There, the taxpayer transferred shares to his broker (by endorsing the physical certificates over to the broker who then had new physical certificates reissued in his name). The IRS concluded that the transaction qualified as one described in Code Sec. 1036 (*i.e.*, an exchange of common stock for other common stock of the same issuer), and therefore did not require the recognition of gain or loss. In *Calloway*, the majority distinguished Rev. Rul. 57-451 on the grounds that the shares in that ruling (and in *G.D. Prevost*,¹⁴ one of the seminal Supreme Court cases in the area of stock lending) had to be returned to the taxpayer “on demand.” In *Calloway*, the taxpayer could not demand the return of the shares, nor could Derivium have forced the taxpayer to repay the loan and take the shares back, for a period of three years. Thus, the majority distinguished Rev. Rul. 57-451.

The taxpayer also contended that Code Sec. 1058 provided for nontaxability of the gain on his disposition of the stock. That section, enacted in 1978, provides for nonrecognition of gain on securities pursuant to an agreement that provides for the return of identical securities. One of the requirements of Code Sec. 1058, however, is that the agreement pursuant to which the securities were transferred must not reduce the risk of loss or the opportunity for gain in the securities transferred.¹⁵ In *H. Samuelli*,¹⁶ the taxpayer had lent out a Treasury strip for a period of about 15 months, and only had the right to get it back on three days during that period. The Tax Court decided that that limited right to terminate the securities loan was not sufficient to enable the taxpayer to enjoy the opportunity for gain of the Treasury strip, and that the taxpayer therefore flunked the test of Code Sec. 1058(b)(3). On the Code Sec. 1058 issue, the facts for the nonapplicability of that Code section are stronger for the government in *Calloway* than were the facts in *Samuelli*, because the taxpayer in *Samuelli* had three specific days within a 15-month period on which he could seek the return of his stock; the taxpayer in *Calloway* was locked out of his shares for three years. The court in *Calloway* therefore ruled for the government on this point as well.

Accuracy-Related Penalty Under Code Sec. 6662(a)

The Court held that Calloway was liable for a 20-percent substantial understatement penalty under Code Sec. 6662(a). The imposition of this penalty seemed largely grounded on the fact that the taxpayer

did not respect his own form (*i.e.*, did not report having received the dividends during the three-year term of the loan, and did not report any amount realized in 2004 when the taxpayer allowed foreclosure on the IBM stock). By contrast, in the case of *C. Shao*,¹⁷ which was decided a few weeks after *Calloway* and which involved an almost identical transaction, the taxpayer reported the transaction in accordance with its form, and, while the taxpayer still had to report gain upon the initial pledge of stock, no penalties were imposed.

Judge Halpern’s Concurring Opinion

Judge Halpern succinctly expressed what might be called the starkly modern view of tax ownership. He states:

It is enough for me that petitioner gave Derivium the right and authority to sell the IBM common stock in question for its own account, which Derivium in fact did. The nonrecourse nature of petitioner’s obligation to repay Derivium, and almost every other factor considered by the majority to determine who bore the benefits and burdens of ownership, is beside the point.

Having decided, based on these factors, that the taxpayer disposed of the stock in 2001 (the year the loan was made and the stock was sold), he then quickly disposes of the potential application of Code Sec. 1058 in a footnote. Judge Halpern takes only a bit longer to dispose of the taxpayer’s contention that Rev. Rul. 57-451 saves him from recognizing gain (albeit with a somewhat puzzling coda on how that revenue ruling was distinguishable because it arose in the context of incentive stock options).

Judge Holmes’ Concurring Opinion

Judge Holmes takes a more complicated view. He believes that the nonrecourse loan was actually what it appeared to be, but that the sale of the stock (which occurred only a single day later) triggered gain. He claims it was a mistake for the majority to view what was really two transactions as a single transaction. Specifically, he asserts that because Calloway did not know of the sale of his IBM stock, and apparently believed that Derivium had not sold the stock, the loan transaction and the sale transaction were not interdependent, and should be analyzed separately. Having established this analytical framework, Judge

Holmes then takes the majority to task for having used a set of factors that derive from a case inquiring into whether a transaction is a sale or a sham, not whether the transaction is a sale or a loan. He points out that between 60 percent and 80 percent of publicly traded stock is actually held by DTC, and that many sale transactions do not involve a transfer of title at all.

Judge Holmes further points out that the 10-percent overcollateralization in this case would be consistent with courts' traditional views that if a taxpayer had an equity interest in the property on day one, the nonrecourse loan would be respected as such. Judge Holmes then proceeds into a spirited (but not entirely persuasive) defense of the position that the loan phase of the transaction should be respected according to its form. However, just when the reader is beginning to wonder if he is reading a dissenting opinion rather than a concurring one, Judge Holmes reaches the analysis of the sale of the stock by Derivium. He cites a regulation under Code Sec. 1001, dealing with the consequence of the sales by lenders of property securing nonrecourse loans. Under this regulation, once such property has been sold, the taxpayer is no longer liable for the loan and must recognize gain or loss (subject, in the case of loss, to the wash-sale rules).

Judge Holmes' logic suffers from an apparent internal contradiction. He concludes that it was unfair to combine the loan to the taxpayer and the subsequent sale by Derivium into a single transaction (which is what the majority did), because the taxpayer did not know, or have any reason to know, of the subsequent sale. Having concluded this, Judge Holmes immediately concludes that, under the regulations under Code Sec. 1001, the sale of the collateral securing a nonrecourse loan results in the deemed satisfaction of the indebtedness, even if the taxpayer does not know of such subsequent sale. Why does the taxpayer's lack of knowledge save the taxpayer from having the loan combined with the subsequent sale for purposes of determining whether the loan was really a sale, but does not save the taxpayer from recognizing gain on the sale itself? Presumably, Judge Holmes would distinguish the two parts of the analysis by arguing that the common law approach used to analyze whether a nonrecourse loan exists requires examining the intent, with the intent of the taxpayer being given more weight than the intent of his counterparty when the two differ, whereas Reg. §1.1001-2(a)(4)(i) is a mechanical rule that simply requires looking to

see whether the collateral securing the nonrecourse loan has been sold.

IV. Analysis of *Calloway*

In this analysis, I will discuss two major issues arising from the case. First, was the case correctly decided, and, if so, did any of the three opinions use the correct reasoning to reach the taxpayer-adverse conclusion? Second, what are the implications of the majority opinion for nonrecourse loans over publicly traded securities?

Was *Calloway* Correctly Decided and Reasoned?

On the tax ownership point, the decision of the majority is clearly correct. However, the reasoning used by the majority, as pointed out by Judge Holmes, is considerably more complicated, and less helpful to tax advisors and future courts, than necessary. The most straightforward approach to the tax ownership issue would have been to have pointed out that the IBM stock pledged by the taxpayer was immediately sold in the market to another investor who had no reason not to regard himself as the owner for tax purposes of such shares. Because it is logically impossible for the same shares to be owned for tax purposes by two different shareholders,¹⁸ and because the subsequent purchaser must be regarded as the owner of the shares for tax purposes, it must be the case that the IBM shares ceased to be owned for tax purposes by Calloway when Derivium sold them into the market.¹⁹ Because the shares were no longer owned by Calloway, and because he received cash that he is not under any unconditional obligation to return, he must have disposed of them in return for such cash.²⁰

This result is clear as a matter of tax logic, but it raises serious questions of fairness and administrability. From a fairness perspective, it can certainly be argued that it is unfair to the taxpayer that the timing of his recognition of gain must depend on when his counterparty decides to sell the pledged shares into the market (assuming one does not adopt Judge Halpern's approach). Under this view, the taxpayer's tax liability should turn entirely on his own actions, and not those of a counterparty with its own agenda (in this case, the agenda included committing fraud on the taxpayer). While not without some appeal, this argument should not prevail. Calloway had the absolute right to control the timing of the recognition of gain before he entered into the nonrecourse

loan transaction. While he did not know he would be defrauded, he must have known that it was likely that he would have to recognize gain when the balance of the nonrecourse loan came due in 2004, and that there was at least some possibility that Derivium would sell the IBM stock into the market in the meantime. It therefore does not appear to be a substantial injustice to require the taxpayer to recognize gain when and if the lender sells the stock.²¹

Additionally, there is precedent for attributing the actions of another party to a transaction to a taxpayer for purposes of determining the tax treatment of that taxpayer's transaction. In *ASA Investerings*, which was one of the Merrill Lynch installment sale cases, the D.C. Circuit based its decision in that case in part on the conclusion that there was no valid partnership formed, which conclusion in turn was based partially on the fact that the taxpayer's partner in the putative partnership, ABN, hedged out the risk on the partnership's primary assets. Thus, the court took into consideration the actions of one purported partner in a partnership, ABN, in concluding that the taxpayer, another purported partner, had not in fact entered into a partnership at all. To be sure, the facts of *ASA Investerings* are distinguishable from those of *Calloway*. Allied-Signal, the taxpayer in *ASA Investerings*, was a large and sophisticated taxpayer that had deliberately entered into what the court appeared to view as a convoluted scheme to generate a large noneconomic capital loss. By contrast, *Calloway* was (apparently) a relatively unsophisticated individual taxpayer who was attempting merely to defer the recognition of gain, a goal that the tax system commonly perceives as less objectionable than the manufacture of capital losses. Moreover, ABN did not actively deceive Allied-Signal, as Derivium did *Calloway*. However, given that *Calloway* did place the power to dispose of the shares into the hands of Derivium, the two transactions are not so dissimilar as to prevent the conduct of Derivium from being taken into account from the standpoint of fundamental fairness.

Somewhat more troubling than any potential lack of unfairness to *Calloway* is the question of administrability. How is a taxpayer in the position of *Calloway* supposed to know when to recognize gain if his lender sells the stock without telling him about it? If the transaction is viewed as a secured loan, it appears that Derivium had a legal obligation to report the sale to *Calloway*.²² Not surprisingly, Derivium failed to do so. However, there does not appear to be any reason not to apply the otherwise applicable

substantive tax rules merely because this particular lender failed to disclose the fraud he committed on the borrower. Thus, notwithstanding these concerns about fairness and administrability, the general rule that no share of stock can have two owners requires Derivium's sale of the IBM stock to be treated as triggering gain to *Calloway*. Given that, the taxpayer could have avoided recognizing gain on the shares only by treating the transaction as a securities loan under either Code Sec. 1058 or the pre-Code Sec. 1058 authorities.²³

The foregoing analysis is broadly consistent with the view taken by Judge Holmes, but Reg. §1.1001-2(a)(4)(i), on which Judge Holmes relies, applies only in the case of a nonrecourse loan. As Judge Halpern points out, even in the case of stock securing a recourse loan, such stock can have only a single owner, and if a purchaser in the market is properly claiming to be the owner of the IBM shares, *Calloway* therefore could not be the owner of such shares, even if *Calloway* were still on the hook for the principal and interest amount on the loan.

The analysis of whether the disposition of the IBM stock should have been ruled nontaxable under Code Sec. 1058 is fairly straightforward. In order to be within the scope of Code Sec. 1058, securities must be transferred pursuant to an agreement that "provide[s] for the return to the transferor of securities identical to the securities transferred."²⁴ Moreover, this agreement must not "reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred."²⁵ Here, there are good arguments that neither of these tests would be satisfied. Because the pledge of the IBM stock and the nonrecourse loan were part of the same "agreement," and because such agreement clearly reduced the risk of loss on the stock, it would appear that the test of Code Sec. 1058(b)(3) would not be satisfied. Additionally, the IRS has a decent argument that the "agreement" does not require the return of identical securities to the taxpayer, not because Derivium may not be solvent at the maturity of the loan, but because Derivium is obligated to perform only if the taxpayer pays off the interest and principal, which the taxpayer is not obligated to do. Thus, it appears that the majority decision that Code Sec. 1058 does not apply is likely correct.

This argument is not entirely satisfying from a policy perspective, because it proves too much. Under this reasoning, any pledge of stock (sufficient to transfer tax ownership), coupled with a nonrecourse loan (even

a greatly overcollateralized one), would result in the recognition of any gain on the underlying shares.²⁶ This, however, is a necessary consequence of a literal application of the language of Code Sec. 1058: Any reduction in economic risk removes a transaction from the protection of Code Sec. 1058.²⁷ It is not clear whether Congress intentionally adopted this standard when it enacted Code Sec. 1058. It can perhaps be justified, however, from a policy perspective on the ground that a taxpayer who (i) owns appreciated stock, (ii) has entered into a transaction that resulted in an unrelated third party becoming the owner of that stock for tax purposes generally, and (iii) in all likelihood, received a substantial amount of cash with respect to that stock (e.g., the posting of cash collateral for a securities loan) could reasonably be required to maintain complete economic exposure to the stock in order to avoid the current recognition of gain.

As compared with the determination of whether Code Sec. 1058 applies, the determination whether Rev. Rul. 57-451 applies is more difficult. The ruling does not contain any specific requirement that no risk reduction be present, so there is no regulatory analogue to Code Sec. 1058(b)(3). However, the ruling did conclude that:

... the delivery of endorsed certificates of stock by the optionee to a broker, the latter being authorized to "lend" the certificates to his customers in the ordinary course of trade or business and having such certificates cancelled and new ones reissued in his own name, and the satisfaction by the broker of the resulting obligation to replace such certificates, will not constitute a "disposition" if the broker satisfies such obligation with certificates representing shares of stock of such kind and amount as to bring the then-completed exchange within the scope of section 1036 of the Code.

It was thus critical to the ruling that the broker have an obligation to replace the certificates with identical ones. While not entirely free from doubt, it seems reasonable to interpret the phrase "obligation to replace such certificates" as an unconditional obligation. Otherwise, one would presumably be required to wait and see whether the broker actually did replace the certificates with identical ones (because if they were replaced with other property, or with nothing, Code Sec. 1036 clearly would not apply). Yet a wait-and-see approach would be inconsistent with the existence of the annual accounting requirement,

under which one generally needs to know whether to recognize gain on a transaction on the last day of the year, even if the securities lending transaction has not yet been closed at that time. As discussed above, Derivium's obligation to deliver stock if and only if Calloway chose to pay the principal and interest on the loan, which Calloway in turn had no legal obligation to do and which he very well might decline to do without penalty, does not constitute an unconditional obligation. The principles of Rev. Rul. 57-451 therefore should not prevent Calloway from recognizing gain on the nonrecourse loan.

In distinguishing Rev. Rul. 57-451, the majority arguably erred in relying so heavily on the "on demand" requirement purportedly contained in the Revenue Ruling. The "on demand" concept did not appear in the facts of the ruling, but rather appears in a more general analysis of stock lending transactions in the legal analysis section. Moreover, the mere fact that an investor cannot get his shares back on demand does not mean that he has reduced his economic risk of loss or opportunity for gain on them (*i.e.*, as long as he is eventually forced to take back and pay for the borrowed shares, he has suffered as much loss or received as much gain with respect thereto as if he had never transferred them). On the other hand, it could also be argued that the "opportunity for gain" referred to in Code Sec. 1058 refers not merely to the taxpayer's economic exposure to the stock (which could, after all, be duplicated through an equity derivative such as a total return swap or a forward contract that clearly would not suffice to make the taxpayer the owner of the referenced equity), but to the taxpayer's ability to exercise the power of a beneficial owner by transferring ownership to shares that are substantially identical to those lent out. If a taxpayer cannot convey ownership to the stock as quickly as if he had not lent such stock, the argument would go, he should be required to recognize gain with respect to such stock. This concept, however, is inconsistent with the wash-sale rule, under which a mere contractual right to repurchase the shares after a fixed period of time will prevent the recognition of a loss under Code Sec. 1091. Thus, concerns of symmetry tend to support the looser interpretation of the "opportunity for gain" requirement of Code Sec. 1058.²⁸

The Future of Nonrecourse Loans on Publicly Traded Stock

Notwithstanding the demise of Derivium, other companies are offering nonrecourse loans against publicly traded stock. A Google search using the

terms “nonrecourse loan securities” reveals many companies advertising nonrecourse loans against publicly traded stock, albeit with a loan-to-value ratio of 80 percent or less, rather than the 90 percent offered by Derivium.²⁹ Additionally, a loan that is formally a recourse loan could be analyzed as a nonrecourse loan for tax purposes if the borrower is an LLC or other entity that is treated as a disregarded entity for U.S. federal income tax purposes. To what extent would these transactions be treated as sales under the majority opinion in *Calloway*?

As Judge Holmes points out, the majority opinion uses language that, if taken literally, would abolish nonrecourse loans for tax purposes. At one point, the majority states that “For disbursements to constitute true loans there must have been, at the time the funds were transferred, an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure repayment.” This statement is simply inconsistent with the existence of a nonrecourse loan. Moreover, as Judge Holmes also correctly points out, it is not possible to square this statement with the court decisions that have generally been willing to respect the form of the transaction if the value of the collateral is greater than the amount of the loan.³⁰ Judge Holmes aptly summarizes his concern on this point as follows:

The majority’s holding—what I fear it could be boiled down to—is that this transaction was a sale because the advance of money was nonrecourse and Derivium had the authority to sell after taking possession of the stock. Given modern conditions in which a lender’s authority to sell stock is routine and even necessary, the real effect of the holding would be to treat all nonrecourse lending against stock collateral as sales. The majority does not appear to realize how startling that would be.

Based on the following analysis, however, I conclude that these concerns, while not meritless, are overblown, and that *Calloway* is distinguishable from many other cases that are likely to emerge.

The majority’s statements on nonrecourse loans must be viewed in the context of the high loan-to-value ratio of the nonrecourse loan in *Calloway*, judged against the background of traditional debt-equity principles. Where an instrument takes the form of debt, as the nonrecourse

loan in *Calloway* unquestionably did, one of the standards courts use to determine whether it should be treated as debt is whether the lender has a “reasonable expectation of repayment.”³¹ While the majority does not use this phrase, it does note that the price of the IBM stock would have to have increased substantially in order for the taxpayer to pay off the loan. While not quantified by the majority, on the simplified facts I have been using, the stock price would have to have had a 6.34-percent internal rate of return, compounded semi-annually, in order for Calloway to have demanded the return of the shares at the maturity of the loan. A 6.34-percent rate of return, over a three-year period, does not appear to be within the realm of “reasonably expected” to occur. That is, one would not necessarily be surprised if it did occur, but intuitively it is not so likely to occur as to be considered “expected” by a reasonable person.³² Looking only at the principal of the loan, if the price of the IBM stock had dropped by only 10 percent over the three-year period, Derivium would not have been able to recover a return of all of its principal (and, of course, would not receive any interest on that principal). While obviously a closer question, it does not appear that it would be reasonable to expect the stock not to fall 10 percent in three years. To the extent that the majority based its decision on the conclusion that repayment was not reasonably expected, then, such a holding would be within the analysis that tax law traditionally would have applied.

Suppose, though, that Derivium actually had been able to hedge its holding of Calloway’s IBM stock, and therefore did not sell it.³³ Would the answer under the “reasonably expected” test have been the same? This version of the transaction avoids the conclusion that another taxpayer owns the IBM stock, and therefore provides a much more sympathetic case for concluding that the taxpayer owns it. It is an undesirable result from a tax policy perspective, however, because the taxpayer (*i.e.*, Calloway) would be able to deduct as interest what is in economic effect a put premium. Moreover, Derivium is looking to the taxpayer to recover its principal plus interest only if the value of the stock exceeds \$120,609; if the value is less than that, Derivium will either exercise its put option (if the value is less than \$101,238) or will sell the stock to the holder of its call (if the value is more than \$101,238). Accordingly, even if Derivium did not sell the stock, it is difficult to conclude that Derivium “reasonably expected to be repaid” by Calloway.

By contrast, consider how the “reasonably expected” analysis would apply had the economics been closer

to those of a traditional nonrecourse loan. Suppose that instead of lending \$90,000 against of the IBM stock, Derivium had lent \$50,000 against the IBM stock. (Assume that the interest rate is only five percent, to reflect the lower risk premium demanded by the dealer.) In that case, the hypothetical taxpayer could be expected to pay off the principal amount and the interest and reclaim the shares if the price of such shares was anywhere in excess of \$67,000. That is, the share price would have to decline by at least 33 percent over the three-year term of the loan in order for Derivium not to receive full payment of the principal amount plus interest. In contrast to the situation above, it does seem reasonable to expect the share price of IBM not to fall by more than this amount over a three-year period. Thus, assuming the lender does not sell the stock into the market, but continues to hold it, it appears that a nonrecourse loan of IBM stock for a term of three years should satisfy the traditional criteria by which nonrecourse loans are evaluated, even if the lender's security interest is perfected by a transfer of possession.³⁴

As further indication that the nonrecourse loan yet lives, shortly before this article went to press, the IRS released Advice Memorandum 2010-005 ("the AM"). While the AM, like *Calloway*, involved a contention by one of the parties that a transaction was

a nonrecourse loan, the positions of the parties were reversed. The taxpayer in the AM was a partnership that entered into a transaction with a bank styled as an option over a basket of securities, the composition of which could be changed by an investment advisor (who was also the general partner of the taxpayer-partnership). The option had an initial premium equal to 10 percent of the value of the basket, a knock-out feature that permitted the bank to cancel the option when the value of the basket fell to 90 percent of the original value, and an accreting strike price.

The IRS ruled that, while in form the taxpayer had an option rather than actually owning the basket, the degree of control that the taxpayer had over the property in the basket, coupled with the shifting of all of the risk of loss from the bank to the taxpayer, justified treating the taxpayer as the owner of the property subject to the option. The AM does not reach a formal conclusion as to whether the taxpayer borrowed funds on a nonrecourse basis from the bank, although this conclusion is strongly implied. Moreover, the AM cited *Calloway* (although not the troublesome "unconditional obligation" language quoted above). Thus, the AM stands for the proposition that, at least in the judgment of the IRS, the nonrecourse loan survived the majority decision in *Calloway*.³⁵

ENDNOTES

¹ *A.L. Calloway*, 135 TC No. 3, Dec. 58,264 (2010).

² *ACM Partnership*, CA-3, 98-2 USTC ¶ 50,790, 157 F3d 231.

³ *Stobie Creek Investment, LLC*, CA-FC, 2010-1 USTC ¶ 50,455, 608 F3d 1366.

⁴ *Anschutz Co.*, 135 TC No. 5, Dec. 58,275 (2010).

⁵ See Rev. Rul. 2003-7, 2003-1 CB 363.

⁶ While the Tax Court does not discuss Derivium's larger business strategy, it appears that Derivium was gambling that not too many stocks would increase in value by too much, and that new borrowers would appear to (unwittingly) provide funds for Derivium to use to repurchase the shares pledged by earlier investors if such repurchases became necessary. In any event, Derivium's business strategy apparently did not work; it filed for bankruptcy in September 2005.

⁷ Available online at www.numa.com/cgi-bin/numa/calc_op.pl.

⁸ For simplicity, this analysis ignores the additional right of *Calloway* to extend the term of the transaction. It is difficult to know how to account for this in comparing the pre-tax economics of the transaction to the after-tax economics. On the one hand, deferral of the loan would (assuming the IRS respected the form of the transaction), further put off the

day of gain recognition. On the other hand, the strike price would be increasing at a substantial rate over the renewal term, and there would be no guarantee that, even if it was worth paying back the loan at the end of the first term, it would still be worth it at the end of the second term. And, of course, any fee would be an additional expense.

⁹ *Arevalo*, 124 TC 244, Dec. 56,026 (2005).

¹⁰ Many of these criticisms were also made by Judge Holmes in his concurring opinion.

¹¹ *S.W. Haag*, 88 TC 604, 615-616, Dec. 43,766 (1987).

¹² This phrasing seems somewhat conclusory on the part of the majority; if the taxpayer actually transferred ownership of the stock, would not that end the analysis, rather than simply constituting a part thereof?

¹³ Rev. Rul. 57-451, 1957-2 CB 295.

¹⁴ *G.D. Prevost*, S Ct, 1 USTC ¶ 153, 269 US 443, 46 S Ct 152.

¹⁵ Code Sec. 1058(b)(3).

¹⁶ *H. Samuelli*, 132 TC No. 4, Dec. 57,759 (2009).

¹⁷ *C. Shao*, 100 TCM 182, Dec. 58,315(M), TC Memo. 2010-189.

¹⁸ Of course, Congress in its infinite wisdom could create a regime in which the same asset has multiple tax owners, but thus far, it has not done so and does not seem on the

verge of doing so.

¹⁹ This approach avoids going as far as Judge Halpern did in his concurring opinion. I would not say that merely transferring the IBM shares to Derivium with the right to sell them constituted a transfer of ownership because it was not necessary to go so far to decide the case in front of the court.

²⁰ The majority does not discuss, perhaps because the IRS did not raise the issue, whether *Calloway* should be treated as having received as consideration for the sale of the IBM stock an option to purchase the same shares of stock upon the maturity of the loan. (The IRS did raise, but did not prevail upon, this issue in *Anschutz*, 135 TC —, No. 5, Dec. 58,275 (2010).) It is not surprising that the IRS did not raise the issue in *Calloway*, nor that they did not prevail upon it in *Anschutz*. To say, on the one hand, that the taxpayer is subject to tax on his gain because he alienated the shares to a sufficient degree, but, on the other hand, the taxpayer will be treated as having received as a separate property right the potential for appreciation in the very shares that he had just alienated seems to stretch the formality inherent in the realization doctrine past the point of sanity. This is particularly true given that, at least in *Calloway*, it would have resulted in the

ENDNOTES

- taxpayer's having additional capital gain in 2001 and a (possibly unusable) capital loss in 2004.
- ²¹ Careful taxpayers can often protect themselves from adverse counterparty action, for example by having pledged property held by an independent collateral agent.
- ²² See Code Sec. 6050J (generally requiring a lender to file a information return and provide a statement to the borrower when the lender forecloses on property that secures the borrower's indebtedness). For such purpose, if someone other than the lender acquires property securing a loan in a "foreclosure, execution, or similar sale" the lender must report the transaction. Temporary Reg. §1.6050J-1T (Q&A 15).
- ²³ Judge Halpern avoids these difficult policy issues entirely by concluding that Calloway disposed of the shares when he transferred them to Derivium with the right to re-hypothecate them, which avoids any unfairness or administrative difficulty resulting from an approach that makes Calloway's tax treatment dependent on whether and when the shares are in fact sold. That is, Calloway could not complain that it was unfair to him that such sale would affect the timing of his recognition of gain (because it would not affect such timing) or that he had no way of knowing when such a sale had occurred (because he would not need to know).
- ²⁴ Code Sec. 1058(b)(1).
- ²⁵ Code Sec. 1058(b)(3).
- ²⁶ It would not, however, result in the recognition of loss, due to Code Sec. 1091.
- ²⁷ Compare this standard with the substantial diminution of risk of loss required in order to have a straddle, Code Sec. 1092(c)(2)(A), or the "reasonably expected to approximate, directly or inversely, changes in the fair market value of the property" standard under Reg. §1.246-5(b)(1)(ii) that applies to determine whether property is substantially similar or related property with respect to stock.
- ²⁸ Under this theory, *Samueli* would have been wrongly decided.
- ²⁹ One such Web site, touting the economics of its product without regard to the tax consequences, asks, "In fact, the borrower has the right to walk away from the loan, can you really call this debt?" In light of *Calloway*, the IRS may well have an answer for them.
- ³⁰ See, e.g., *F. Odend'hal*, CA-4, 84-2 USTC ¶9963, 748 F.2d 908, 912, *aff'g*, 80 TC 588, Dec. 39,992 (1983). Even more bizarre is the majority's conclusion that the parties to the loan did not adhere to their form because the taxpayer did not pay off the nonrecourse loan. Not only is this characteristic of every nonrecourse loan transaction in which the collateral is worth less than the loan balance when the loan balance must be paid, but if this were the rule, it would suffer from the additional administrative difficulty that one would not know whether a particular non-recourse loan would be respected until after it was paid off or foreclosed on. Thus, a borrower who was making periodic interest payments might not know whether such payments were deductible until some years after they were made, when the principal amount of the loan was either paid off or forgiven.
- ³¹ See, e.g., *Gilbert*, CA-2, 57-2 USTC ¶9929, 248 F.2d 399; *Liflans Corp.*, CtClS, 68-1 USTC ¶9223, 390 F.2d 965, 182 CtClS 825; *Harkins Bowling, Inc. v. Knox*, DC-MN, 58-2 USTC ¶9791; *C. M. Gooch Lumber Sales Co.*, 49 TC 649, Dec. 28,883 (1968); *Litton Business Systems, Inc.*, 61 TC 367, Dec. 32,263 (1973).
- ³² A more precise way to express the same concept would involve choosing a probability distribution to represent the outcome of stock prices (e.g., a normal or log-normal probability distribution), and then using a financial modeling program to determine the likelihood that the share price would be at or below the selected threshold. Courts have not taken this course, at least in part because no one knows what the correct probability distribution is, or what courts should require as a threshold likelihood of repayment.
- ³³ In order to have accomplished such a hedge, Derivium could have determined the amount of cash it wanted to receive at maturity. This amount would presumably have been \$101,238, which is the \$90,000 Derivium originally lent, increased by the assumed safe interest rate of five percent, reduced by the one percent assumed dividend rate. In order to assure itself of receiving this \$101,238, Derivium could, in theory, have taken the following steps. First, it could have bought a put struck at \$101,238, which would have assured it that it would receive at least this amount, even if the IBM stock had been worth less. This put would have cost approximately \$5,489. Second, Derivium would presumably wish to monetize its remaining exposure to the IBM stock. Because Derivium would profit further if, at the maturity of the loan, the value of the IBM stock exceeded \$101,238 but was less than the \$120,609 principal and interest on the loan (in which case Calloway would abandon the stock to Derivium), Derivium could sell a call struck at \$101,238. However, this call would leave Derivium exposed if the IBM stock price exceeded \$120,609 at the maturity of the loan (and Calloway took the stock back). So it would need to buy a call struck at \$120,609 to protect itself. The sold call struck at \$101,238 would have been worth \$15,079 on the date the loan was made, while the bought call at \$120,609 would have been worth \$7,212. Thus, to place itself in the position of a lender with no exposure to IBM stock, Derivium would have had to pay \$5,489 for the put plus \$7,212 for the bought call, for a total of \$12,701, while receiving \$15,079 on the sold call. This works out to a profit of \$2,378. This is, of course, much less than the \$10,000 that Derivium was assumed to make from the transaction as it was actually documented, which illustrates why Derivium simply sold the stock and hoped Calloway would not attempt to reclaim it in three years. (This analysis is grossly over simplified; it ignores the renewal feature of the loan, and assumes that Derivium actually could have transacted options at their indicated Black-Scholes values.)
- ³⁴ Apart from these two grounds for distinguishing *Calloway*, we also note that, in a common law system, the impact of one trial court decision, which does not explicitly purport to overrule any other case, simply will not be given that much weight as a general matter. Thus, even if the majority were actually attempting to make new law in this area, the case is unlikely to have much of an impact.
- ³⁵ William R. Pomierski, *Current Federal Tax Developments*, 9 J. TAX'N FIN'L PRODUCTS 2 (2010).

This article is reprinted with the publisher's permission from the JOURNAL OF TAXATION OF FINANCIAL PRODUCTS, a quarterly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher's permission is prohibited. To subscribe to the JOURNAL OF TAXATION OF FINANCIAL PRODUCTS or other CCH Journals please call 800-449-8114 or visit www.CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH.