

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

Number: **20145102F**

Release Date: 12/19/2014

CC:LB&I:F:MAN:2:SDTillem

POSTF-108547-14

date: July 23, 2014

to: Sterling Topol, Senior Financial Products Issue Specialist  
Large Business & International

from: Steven D. Tillem  
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subject:

Costless Collar Transaction

Tax Years:

UIL: 1259.00-00

**The advice rendered in this memorandum is conditioned on the accuracy of the facts presented to us. If the facts are different than the facts set forth below, you should immediately advise us. In addition, you should not cite this memorandum as precedent.**

This memorandum responds to your request on whether  
(" " or "Taxpayer") is required to recognize gain from the  
delivery of borrowed shares in satisfaction of its Financial Contracts.

**Issues**

1. Should the entire amount of cash paid to the Taxpayer on the Financial Contracts be recognized and included in the calculation of taxable gain under section 1001 of the Internal Revenue Code (the "Code") when the contracts are settled?
2. Alternatively, should the entire amount of cash paid to the Taxpayer on the Financial Contracts be recognized and included in the calculation of taxable gain under section 1259.

3. Whether a change from open transaction treatment to realization treatment constitutes a change in method of accounting under section 446 of the Code?
4. If the foregoing constitutes a change in method of accounting under section 446, whether a section 481(a) adjustment should be recognized in connection with such change, and whether the section 481(a) adjustment may reflect amounts attributable to closed taxable years?

### **Conclusions**

1. The Taxpayer closed its Financial Contracts by delivering borrowed shares on specified settlement dates and therefore, the entire amount of cash paid to the Taxpayer on the Financial Contracts should be recognized and included in the calculation of taxable gain under section 1001.
2. Alternatively, the entire amount of cash paid to the Taxpayer on the Financial Contracts should be recognized in the calculation of taxable gain under section 1259.
3. A change from open transaction treatment to realization treatment constitutes a change in method of accounting under section 446.
4. A section 481(a) adjustment should be recognized in connection with a change in method of accounting and will reflect amounts attributable to all relevant years prior to the year of change, whether open or closed.

### **Facts**

#### **Costless Collar Transaction**

Prior to \_\_\_\_\_, \_\_\_\_\_ (“\_\_\_\_\_”) invested in a start-up venture specializing in telecommunication technologies,

On \_\_\_\_\_, \_\_\_\_\_ was acquired by \_\_\_\_\_ (“\_\_\_\_\_”) and \_\_\_\_\_ investment in \_\_\_\_\_ was converted into approximately \_\_\_\_\_ million shares of common stock. In \_\_\_\_\_, \_\_\_\_\_ common stock split two for one resulting in \_\_\_\_\_ owning approximately \_\_\_\_\_ million shares of \_\_\_\_\_ common stock.

\_\_\_\_\_ entered into two transactions with \_\_\_\_\_ (“\_\_\_\_\_”) (“Financial Arrangement 1”, “Financial Arrangement 2” and collectively, the “Financial Contracts”) on \_\_\_\_\_, pursuant to which \_\_\_\_\_, under certain circumstances, agreed to deliver approximately \_\_\_\_\_ million unencumbered \_\_\_\_\_ shares to \_\_\_\_\_ on specified dates in \_\_\_\_\_ in exchange for a specified amount of cash. The Financial Contracts were governed by a single master stock purchase agreement dated \_\_\_\_\_ between \_\_\_\_\_ and \_\_\_\_\_. 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 \_\_\_\_\_ and \_\_\_\_\_ on \_\_\_\_\_ and \_\_\_\_\_.

\_\_\_\_\_ obligation to transfer \_\_\_\_\_ shares pursuant to the Financial Contracts and the amount of cash to be paid to \_\_\_\_\_ for such shares was determined by reference to the closing price of \_\_\_\_\_ shares (the Settlement Price) on specified maturity dates. \_\_\_\_\_ was obligated to deliver to \_\_\_\_\_ a specified number of shares 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, \_\_\_\_\_ 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, \_\_\_\_\_ 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.

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

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

To secure the obligations of \_\_\_\_\_ under Financial Arrangement 1, \_\_\_\_\_ pledged approximately \_\_\_\_\_ million \_\_\_\_\_ shares to \_\_\_\_\_ (the \_\_\_\_\_ million Existing Shares). To secure the obligations of \_\_\_\_\_ under Financial Arrangement 2, \_\_\_\_\_ pledged approximately \_\_\_\_\_ of \_\_\_\_\_ shares to \_\_\_\_\_ (the \_\_\_\_\_ Existing Shares and collectively with the \_\_\_\_\_ million Existing Shares, the "Existing Shares"). Throughout the term of the Financial Contracts, \_\_\_\_\_ retained voting rights and the right to receive any normal quarterly dividends on the Existing Shares. In addition, \_\_\_\_\_ did not have the right to sell, lend, pledge, rehypothecate, assign or invest in its business any of the Existing Shares unless \_\_\_\_\_ was in default under the Financial Contracts. \_\_\_\_\_ was not in default at any time during the term of the Financial Contracts and \_\_\_\_\_ did not transfer or rehypothecate any of the Existing Shares. So long as \_\_\_\_\_ was not in default on its obligations in connection with the Financial Contracts, \_\_\_\_\_ had the right

to obtain the release of the Existing Shares by substituting cash or other securities. The Existing Shares were held by \_\_\_\_\_ in book entry form.

As of \_\_\_\_\_, \_\_\_\_\_ transferred all of its Existing Shares and assigned all of its rights and obligations in connection with the Financial Contracts to \_\_\_\_\_ (EIN: \_\_\_\_\_) (“\_\_\_\_\_”). \_\_\_\_\_ is a wholly-owned subsidiary of \_\_\_\_\_, \_\_\_\_\_ is the common parent of an affiliated group of which \_\_\_\_\_ and \_\_\_\_\_ are members.

On \_\_\_\_\_, \_\_\_\_\_ transferred \_\_\_\_\_ shares of \_\_\_\_\_ stock to a \_\_\_\_\_ (“\_\_\_\_\_”) securities account. On \_\_\_\_\_, \_\_\_\_\_ entered a Master Securities Loan Agreement (“Securities Loan Agreement”) with \_\_\_\_\_. Pursuant to the Securities Loan Agreement, \_\_\_\_\_ lent \_\_\_\_\_ million \_\_\_\_\_ shares equaling the aggregate number of shares that \_\_\_\_\_ had agreed to transfer to \_\_\_\_\_ under the Financial Contracts (“Borrowed Shares”). The Borrowed Shares were represented by two separate confirmations. Upon termination of the Securities Loan Agreement, \_\_\_\_\_ is obligated to return a number of \_\_\_\_\_ shares equal to the number of Borrowed Shares. \_\_\_\_\_ has the unrestricted legal right to deliver any \_\_\_\_\_ shares to satisfy its repayment obligation under the Securities Loan Agreement. \_\_\_\_\_ (“\_\_\_\_\_”) bought \_\_\_\_\_ in \_\_\_\_\_ and assumed the rights and obligations under the Securities Loan Agreement as the successor to \_\_\_\_\_.

From \_\_\_\_\_ through \_\_\_\_\_, \_\_\_\_\_ satisfied its obligations to \_\_\_\_\_ under the Financial Contracts by delivering \_\_\_\_\_ million of the Borrowed Shares to \_\_\_\_\_. All of the Borrowed Shares transferred to \_\_\_\_\_ were in the form of physical share certificates. The Settlement Price of \_\_\_\_\_ shares on the specified maturity dates ranged from \$ \_\_\_\_\_ to \$ \_\_\_\_\_ per share. Since the Settlement Price of the \_\_\_\_\_ shares on the settlement dates was less than the relevant Downside Protection Threshold Price, \_\_\_\_\_ was entitled to and did receive an amount equal to the Downside Protection Threshold Price per share transferred.

\_\_\_\_\_ received in total \$ \_\_\_\_\_ from \_\_\_\_\_ in return for delivering the Borrowed Shares in satisfaction of the Financial Contracts.

### Private Letter Rulings

\_\_\_\_\_ requested a private letter ruling regarding how to treat the gain from the delivery of the borrowed shares in satisfaction of the Financial Contracts. On \_\_\_\_\_, the Office of Associate Chief Counsel, Financial Institutions & Products (“FIP”) issued private letter ruling number 200440005 concluding that: (1) the delivery of borrowed shares in satisfaction of the Financial Contracts will not cause \_\_\_\_\_ 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 \_\_\_\_\_ basis in the Existing Shares. A copy of private letter ruling number 200440005 is attached hereto.

On \_\_\_\_\_, FIP issued private letter ruling number 201109017 withdrawing the rulings in private letter ruling 200440005. Private letter ruling number 201109017 stated that the revocation of the rulings applied without retroactive effect with respect to the particular transactions described in private letter ruling 200440005. A copy of private letter ruling number 201109017 is attached hereto.

### Book and Tax Reporting

For book purposes \_\_\_\_\_ reported income of \$ \_\_\_\_\_ from trading of shares and the related hedge contracts with \_\_\_\_\_ by the end of \_\_\_\_\_.<sup>1</sup> For tax purposes \_\_\_\_\_ reported a long term capital gain of \$ \_\_\_\_\_ on its \_\_\_\_\_ U.S. Corporate Income Tax Return (Form 1120). \_\_\_\_\_ claims it calculated the long term capital gain of \$ \_\_\_\_\_ based on the fair market value of \_\_\_\_\_ stock shares on the settlement dates in \_\_\_\_\_ and \_\_\_\_\_ of \_\_\_\_\_ less a basis in \_\_\_\_\_ stock of \$ \_\_\_\_\_ pursuant to section 1259(c)(1)(A).

\_\_\_\_\_ stated that it will not recognize the gain from the Financial Contracts with \_\_\_\_\_ of \$ \_\_\_\_\_ (amount received from \_\_\_\_\_ of \$ \_\_\_\_\_ less the amount recognized as a long term capital gain in taxable year \_\_\_\_\_ of \$ \_\_\_\_\_) until it delivers the approximately \_\_\_\_\_ million shares of \_\_\_\_\_ to replace the Borrowed Shares pursuant to the terms of the Securities Loan Agreement.

### Tax Strategy

\_\_\_\_\_ provided the IRS with a copy of a powerpoint presentation made to its Board of Directors at a meeting on \_\_\_\_\_, which discusses a proposed tax strategy concerning the Financial Contracts with \_\_\_\_\_ (referred to as the "collar"). The powerpoint proposes borrowing \_\_\_\_\_ stock to close out the collar and states in

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<sup>1</sup> For book purposes \_\_\_\_\_ recognized unrealized gain of \$ \_\_\_\_\_ from the conversion of stock into \_\_\_\_\_ stock in \_\_\_\_\_. Other amounts of unrealized gain for book purposes were recognized by \_\_\_\_\_ from its \_\_\_\_\_ stock holdings and related collar agreements of \$ \_\_\_\_\_ and \$ \_\_\_\_\_ in \_\_\_\_\_ and \_\_\_\_\_, respectively, pursuant to Statement of Financial Accounting Standard No. 133. Realized gain was recognized by \_\_\_\_\_ for book purposes in \_\_\_\_\_ of \$ \_\_\_\_\_ from the delivery of the Borrowed Shares of \_\_\_\_\_ stock to \_\_\_\_\_ pursuant to the Financial Contracts. The total amount of gain recognized from trading in \_\_\_\_\_ for book purposes from \_\_\_\_\_ through \_\_\_\_\_ was \$ \_\_\_\_\_. No further gains or losses relating to Financial Contracts were reported for book purposes by \_\_\_\_\_ after \_\_\_\_\_.

pertinent that:

- Tax on the collar gain would be due when we close out the borrowed position.
- The lower the market price in , the lower the amount of taxes paid and the higher the deferral opportunity.

Subsequent to this presentation, entered into the Securities Loan Agreement with on , whereby borrowed the shares used in satisfaction of the Financial Contracts. In accordance with the presentation, has taken the tax position that the tax on gain from the Financial Contracts of \$ is not due until closes the borrowed position.

. and

. acquired on . , a wholly owned subsidiary of and an affiliate of acquired . on .

Unreported Dividends

received dividends in the amounts of \$ and \$ from in and , respectively. stated that it did not report the dividends as income on its and tax returns for the following reason:

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Open Exam Years

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<sup>2</sup> Reference is to the Securities Loan Agreement.

. is currently under audit for calendar years , and .

## Law and Analysis

### Issue 1

#### A. Recognition Under Section 1001

Gross income includes gain derived from dealings in property. Section 61(a)(3). Gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in section 1011 for determining gain, and the loss is the excess of the adjusted basis provided in section 1011 for determining loss over the amount realized. Section 1001(a). The entire amount of the gain or loss must be recognized, except as otherwise provided. Section 1001(c). Except as otherwise provided in subtitle A of the Code, a taxpayer must recognize the gain or loss realized from the conversion of property into cash. Section 1.1001-1(a). Thus, a taxpayer that has converted a derivative such as the Financial Contracts into cash must recognize gain or loss unless another provision of subtitle A of the Code provides otherwise.

This straightforward section 1001 analysis of transactions that close out or convert derivatives into cash is reflected in numerous other provisions of the Internal Revenue Code and the regulations. Those provisions all operate on the predicate that derivative closeout or termination arrangements result in section 1001 dispositions upon which gain or loss is recognized. Indeed, it is a fundamental tenet of the tax law that derivative contracts become taxable upon their termination or settlement, no matter how effected. See, e.g., sections 1256(c) (contracts marked-to-market), 1234 (options to buy or sell), 1234A (gains or losses from certain terminations), and 446 and section 1.446-3 (notional principal contracts). These provisions follow directly from the operation of section 1001, which treats the conversion of any form of property into cash as a realization event. See section 1.1001-1(a)(1).

When a right or obligation with respect to property is closed, whether by settlement, termination, cancellation, delivery, or offset, the only relevant question is how the event is to be characterized, not whether such closing is a taxable event. Section 1234A(1) provides, with limited exceptions, that gain or loss attributable to the termination of a right or obligation with respect to property that is a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset. Congress intended that section 1234A apply to a termination that is “economically equivalent to a sale or exchange of the contract.” See S. REP. NO. 97-144 (PL 97-34) at 170. See also Wolff v. Commissioner, 148 F.3d 186, 188 (termination subject to section 1234A).

In this transaction, upon settlement of the Financial Contracts, was required to deliver an amount of shares equivalent to all of the pledged shares and in return was entitled to receive from the Settlement Price as specified in the

Financial Contracts. In lieu of delivering the pledged shares, closed its Financial Contracts as of the settlement dates by delivering borrowed shares, and in return simultaneously received the full Settlement Price in cash as required under the Financial Contracts. closing of the Financial Contracts irrefutably converted contracts (which themselves are property) into cash under section 1.1001-1(a). This disposition required to do a final accounting of the results of that transaction. argues that short sale authorities permit it to indefinitely keep the Financial Contracts open. The application of short sale authorities to the closing of the Financial Contracts is inappropriate and unsupported.

Generally, courts define a short sale of securities as a sale of securities that the short seller does not own. Provost v. U.S., 269 U.S. 443, 450 (1926); Richardson v. United States, 121 F.2d 1, 4 (2nd Cir. 1941); Bingham v. Commissioner, 27 B.T.A. 186, 189 (1932). The securities sold short are generally borrowed from a securities lender, and the short seller has the obligation to replace the borrowed securities. The short seller recognizes gain or loss on the transaction based on the difference between the amount realized from selling the borrowed shares (typically for fair market value) and the cost basis in the shares delivered back to the securities lender to close out the short sale. The proceeds of the short sale typically are pledged as collateral to the stock lender. See Provost, 269 U.S. at 451 (“If [the short seller] borrows [the shares], he deposits with the lending broker their full market price; and until the loan is returned, this deposit is maintained, by means of daily payments back and forth between the borrower and the lender, at the varying level of the market value of the shares loaned.”) The net effect is that the traditional short seller does not receive use of the cash proceeds until the stock loan is repaid.

Profit or loss in a normal on-market short sale is not accounted for until the replacement shares are delivered to close out the short sale. The statutory and regulatory support for open transaction treatment follows directly from early case law, as illustrated by the court in Bingham. Adopting realization principles, the court commented, “A short sale imports a subsequent covering purchase. It leaves open the accounts of both the customer and broker. No profit or loss exists until by the covering purchase the obligation of the short sale is discharged.” Bingham, 27 B.T.A. at 189. Consequently, the court determined that the offsetting obligation created upon entering a short sale precluded immediately taxing the short sale proceeds because the transaction had yet to be completed. The court also confirmed that short sales should be governed by the same realization principles as are applied to straight sales, such that gain or loss is determined by the difference between the amount realized and the applicable cost basis.

By delivering the Borrowed Shares to satisfy its obligations under the Financial Contracts, claims that it executed a short sale taxable under section 1259 as a constructive sale (and thus, as noted above, recognized gain equal to the difference between the fair market value of the stock and the basis), having the effect of keeping the Financial Contracts open for tax purposes only, even though the contracts



were closed out for all other purposes. It is the Service's position that, even if [redacted] could have executed a "short sale", this does not extend open transaction treatment to a settled contract that has otherwise closed. There is no authority for [redacted] position that its contracts may be held open indefinitely merely because they were closed with borrowed shares.

[redacted] seeks to ignore the closing of its economically independent Financial Contracts position and treat them as morphing (without triggering gain) into a short sale. [redacted] takes this approach even though the transactions were economically discrete and gain or loss on the Financial Contracts was determinable. To the extent [redacted] incurred an "offsetting obligation" when it borrowed shares, that new liability was only equal to the fair market value of the stock at the time of the short sale.

[redacted] never incurred an offsetting obligation for the full amount it was entitled to receive under the contracts. This may provide a reason (putting aside section 1259 for the moment) to avoid immediate recognition on the sale of the borrowed shares, but it can have no effect on the gain resulting from closing the Financial Contracts.

[redacted] economically captured the full cash-settled value of its contracts far beyond the obligation it incurred on the short sale. [redacted] rights and obligations with respect to its contracts are very different from those relating to its short sale. At the time the contracts were executed, the settlement formula under the Financial Contracts ensured that [redacted] had no risk of loss below the floor price and would share in any appreciation in the shares between the floor price and the upside price.

When the contracts were settled, [redacted] had locked in its gain in the shares at the Downside Protection Threshold Settlement Price per share even though the current fair market value of the shares ranged between \$ [redacted] and \$ [redacted] per share. The Taxpayer was able to deliver shares worth between \$ [redacted] and \$ [redacted] per share in satisfaction of its Financial Contracts and to receive the price guaranteed under those contracts. The effect is that the Taxpayer chose to obtain shares to close its highly profitable contracts by borrowing those shares. It could have gotten much the same result by going into the market and buying those same shares or simply cash settling the contracts.

The Taxpayer closed its Financial Contracts by delivering borrowed shares on specified settlement dates and therefore, the entire amount of cash paid to the Taxpayer on the Financial Contracts should be recognized and included in the calculation of taxable gain under section 1001. To the extent [redacted] is left holding an open short sale position, [redacted] should be taxed on that particular position separately.

#### B. The Financial Contracts As Open Transactions

Under the open transaction doctrine, a taxpayer is relieved from reporting income that may never be received. This doctrine is applied rarely and only under special circumstances. See A.M. 2007-004, discussing Burnet v. Logan, 283 U.S. 404 (1931). In Burnet v. Logan, Mrs. Logan was permitted to use a cost recovery method of

accounting under which she would recognize gain over time on the sale of property for a contingent price because it was unknown at the time whether she would recognize gain or loss. See also section 1.1001-1(c)(1) (Even though property is not sold or otherwise disposed of, gain is realized if the sum of all the amounts received that are required by section 1016 and other applicable provisions of subtitle A of the Code to be applied against the basis of the property exceeds such basis.)

transaction cannot be held open under Burnet v. Logan because there is a fixed amount of gain that is determinable, and retention of the cash is not contingent on any future performance or event. In fact, the Financial Contracts are completely closed and fully executed. The gain realized by is attributable to the closing of the contracts with , and not to a stock borrowing transaction with followed by a sale of those borrowed shares. See section 1.1001-1(c)(1). It is an unquestionable accession to wealth that can be readily accounted for. There is no exception to section 1001 that allows that accession to wealth to go untaxed once realized; receipt of cash and claim of open transaction treatment for an indefinite, unlimited period of time are inherently inconsistent.

takes the position that the delivery of the borrowed shares under the Financial Contracts shows that these contracts remain open for tax purposes and thus, gain is not recognized at this time. settled its contracts with when it delivered borrowed shares and thus has no continuing obligations under the Financial Contracts to . The Taxpayer has not provided sufficient legal authority that would enable it to defer the recognition of gain on contracts that have been settled by their terms.

### C. Reliance on PLR 200440005

cannot rely on PLR 200440005 for support of its position that the Financial Contracts were not closed by delivery of borrowed shares. The rulings in PLR 200440005 failed to consider the economic substance of the transaction and that property was converted to cash for purposes of section 1001, and the rulings were withdrawn pursuant to the issuance of PLR 201109017 on November 23, 2010. A PLR is a written determination that interprets how the tax law applies to the taxpayer's specific set of facts. See section 601.201(a)(2) of the Statement of Procedural Rules. Once issued, a PLR may be revoked for a number of reasons. See section 1.01 of Rev. Proc. 2010-1, 2010 I.R.B. 1. Thus, a PLR may be revoked, for example, due to a different or clearer perception of an issue and its ramifications, or errors in law.

reliance on published guidance addressing short sales, including Rev. Rul. 2004-15, 2004-1 C.B. 515, which was cited in PLR 200440005 and Rev. Rul. 72-478, 1972-2 C.B. 487, is also misplaced primarily because the transactions described in those rulings are not similar to, but are distinguishable from, the transactions involved in this case. Specifically, the guidance in these revenue rulings is limited to standard short

sale transactions and is not applicable to the closing of a contract, which terminates all rights and obligations of the parties with respect to that contract.

Section 11.04 of Rev. Proc. 2010-1, 2010-1 C.B. 1, provides in relevant part that a letter ruling found to be in error or not in accord with the current views of the Service may be revoked or modified. If a letter ruling is revoked or modified, the revocation or modification applies to all years open under the period of limitations. PLR 200440005 was revoked effectively upon the issuance of PLR 201109017 on

acquired on , and has to date treated the transaction at issue in a manner consistent with PLR 200440005. is currently under audit for calendar years , and . Accordingly, the revocation of PLR 200440005 applies to the , and years open under the period of limitations for .

## Issue 2

The entire amount of cash paid to on the Financial Contracts should be recognized and included in the calculation of taxable gain under section 1259. Section 1259(a)(1) provides that if there is a constructive sale of an appreciated financial position, the taxpayer shall recognize gain as if such position were sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale (and any gain shall be taken into account for the taxable year which includes such date). Section 1259(d)(1) provides that the term “forward contract” means a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price. Section 1259(c)(1)(C) provides that a taxpayer shall be treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person) enters into a forward contract to deliver the same or substantially identical property.

claims it calculated the long term capital gain of \$ based on the fair market value of stock shares on the settlement dates in and of , less a basis in stock of \$ pursuant to section 1259(c)(1)(A). Fair market value is defined as “what a willing buyer would pay in cash to a willing seller.” See California Human Development Corp. v. United States, 87 Fed.Cl. 282, 299 (Fed.Cl. 2009), aff'd, 2010 WL 233-308 (Fed. Cir. 2010) (unpublished opinion) (citations omitted). There is no question here that was a “willing seller” and that was a “willing buyer” when they negotiated the terms of the Financial Contracts. This alternative argument assumes that the contracts remain open. Nevertheless, under the terms of the contracts, as of the settlement dates, the “forward”

price was fixed at the floor price for purposes of section 1259.

Once the value of the share units become fixed under section 1259, there is a constructive sale of the shares under section 1259(c)(1)(C) as well as the conceded constructive sale of the shares for purposes of section 1259(c)(1)(A). In applying either of these provisions, \_\_\_\_\_ must recognize gain based on the fair market value of its appreciated shares, which is the value that \_\_\_\_\_ is entitled to receive under its Financial Contracts, not what an unrelated, hypothetical taxpayer would receive for the constructive sale of the same shares. The value of the shares to \_\_\_\_\_ is derived from the terms of the Financial Contracts. Thus, under their deal, the fair market value of the shares is equal to the Downside Protection Threshold Settlement Price. If another party stepped into the shoes of \_\_\_\_\_ at the time of settlement, that party too would be entitled to the value of the shares as determined by the arrangements of the parties.

### Issue 3

Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. See also section 1.446-1(b)(1) of the Income Tax Regulations.

The Commissioner has broad discretion in determining whether a taxpayer's method of accounting clearly reflects income, and the Commissioner's determination must be upheld unless it is clearly unlawful. See Thor Power Tool v. Commissioner, 439 U.S. 522, 532-3 (1979); RCA Corp. v. United States, 664 F.2d 881, 886 (2nd Cir. 1981), cert. denied, 457 U.S. 1133 (1982).

Once the Commissioner has determined that the taxpayer's method of accounting does not clearly reflect income, the Commissioner has broad discretion in selecting a method of accounting that the Commissioner believes properly reflects the income of a taxpayer. The Commissioner's selection may be challenged only upon showing an abuse of discretion by the Commissioner. See Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352 (1st Cir. 1970); Stephens Marine, Inc. v. Commissioner, 430 F.2d 679, 686 (9th Cir. 1970), cert. denied, 342 U.S. 860 (1951).

An examining agent who determines that a taxpayer's method of accounting is impermissible may propose an adjustment with respect to that method only by changing the taxpayer's method of accounting. Except as provided in section 2.06 of Rev. Proc. 2002-18, 2002-1 C.B. 678 (relating to previous accounting method changes made by a taxpayer without obtaining the requisite consent under section 446(e)), an examining agent changing a taxpayer's method of accounting will select a new method of accounting by properly applying the law to the facts determined by the agent. The method selected must be a proper method of accounting and will not be a method

contrived to reflect the hazards of litigation. See sections 3.01 and 5.01 to 5.03 of Rev. Proc. 2002-18.

Section 1.446-1(e)(2)(ii)(a) provides that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item used in such overall plan. A "material item" includes "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. In determining whether timing is involved, generally the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime taxable income or merely changes the taxable year in which taxable income is reported. See section 2.01(1) of Rev. Proc. 97-27, 1997-1 C.B. 680; section 2.01(1) of Rev. Proc. 2011-14, 2011-4 I.R.S. 330; Rev. Proc. 91-31, 1991-1 C.B. 566; Primo Pants Co. v. Commissioner, 78 T.C. 705, 723 (1982); Knight Ridder v. United States, 743 F.2d 781, 798 (11th Cir. 1984); Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969).

An accounting practice that involves the timing of when an item is included in income or when it is deducted is considered a method of accounting. General Motors Corp. v. Commissioner, 112 T.C. 270, 296 (1999); Color Arts. Inc. v. Commissioner, T.C. Memo. 2003-95.

Although a method of accounting may exist under the definition in section 1.446-1(e)(2)(ii)(a) without the necessity of a pattern of consistent treatment, in most instances a method of accounting is not established for an item without such consistent treatment. See section 1.446-1(e)(2)(ii)(a). The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of section 1.446-1(e)(2)(ii)(a). If a taxpayer treats an item properly in the first return that reflects the item, however, the taxpayer has adopted a method of accounting for that item. See Rev. Rul. 90-38, 1990-1 C.B. 57.

A change in accounting method does not include correction of mathematical or posting errors, or errors in the computation of tax liability. Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, a change from treating an item as a personal expense to treating it as a business expense is not a change in method of accounting because it does not involve the proper timing of an item of income or deduction. See section 1.446-1(e)(2)(ii)(b).

If the change in accounting practice does involve timing, then it is an accounting method change, even if it also arguably involves a change in how the item of revenue or expense is characterized, such as changing from treating transactions as sales to

treating the transactions as leases. Certain cases, such as Underhill v. Commissioner, 45 T.C. 489 (1966), are sometimes read to stand for the proposition that changes involving a change in the "characterization" of an item are not accounting method changes under section 446. However, section 1.446-1(e)(2)(ii)(b) enumerates numerous adjustments that do not constitute changes in method of accounting, but contains no exception for changes that alter the characterization of an item. In fact, the regulations include corrections of erroneous characterizations among changes in methods of accounting. See Example 11 of section 1.446-1(e)(2)(iii) (inventory to depreciable asset). See also Cargill Inc. v. U.S., 91 F.Supp.2d 1293, 1297 -1298 (D.Minn, 2000) ("Like the petitioner in Witte, Cargill has not directed the Court to any provision of the Code that sets forth such a "characterization" exception. Accordingly, the Court concludes that no such exception exists.") (citing Witte v. Commissioner, 513 F.2d 391 (D.C. Cir. 1975)).

Where the correction of an error results in a change in accounting method, the requirements of section 446(e) are applicable. Huffman v. Commissioner, 126 T.C. 322, 354 (2006); First National Bank of Gainesville v. Commissioner, 88 T.C. 1069, 1085 (1987); Diebold, Inc. v. United States, 16 Cl. Ct. 193, 203-205 (1989), aff'd, 891 F.2d 1579 (Fed. Cir. 1989), cert. denied, 498 U.S. 823 (1990).

Under the foregoing principles, a consistent practice for determining when a taxpayer recognizes gross income for a type of revenue generally constitutes a method of accounting and a change from one such practice to another generally constitutes a change in method of accounting. The courts have generally held that switching the time for recognizing an item of gross income constitutes a change in method of accounting within the meaning of sections 446 and 481. In Security Associates Agency Insurance Corp. v. Commissioner, T.C. Memo. 1987-317, for example, the Tax Court held that the switch from including advance insurance sales commissions in taxable income in the taxable year received to including such commissions in the taxable year earned was a change in method of accounting. Similarly, in Johnson v. Commissioner, 108 T.C. 448 (1997), the Tax Court held that switching the time for recognizing escrowed customer payments as gross income from when the escrow agent released funds to the taxpayer to when the customer gave the sale price to the taxpayer was a change in method of accounting. See generally section 15 of the APPENDIX to Rev. Proc. 2011-14, 2011 C.B. 330.

has been consistently deferring the recognition of gain from the Financial Contracts. As proposed by Exam, will report the gain from the Financial Contracts when it settled the Financial Contracts. The change in treatment of the gain proposed by Exam results in the same amount of lifetime taxable income because the adjustments merely accelerate the reporting of taxable income to when it is earned rather than deferring recognition until the short sale is closed.

This adjustment constitutes a change in method of accounting because it involves the proper time for the inclusion of the material item in income. This change does not

permanently affect the Taxpayer's lifetime taxable income; it merely changes the taxable years in which income is reported. Therefore, because this is a change in an accounting practice that involves the timing of when an item is included in income, it constitutes a change in method of accounting.

#### Issue 4

Section 481(a) provides that in computing the taxpayer's taxable income for any taxable year (year of change), if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then there shall be taken into account those adjustments that are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer. See also section 1.448-1(a).

A change in method of accounting to which section 481(a) applies includes a change in treatment of a single material item. See section 1.481-1(a)(1); Graf Chevrolet v. Campbell, 343 F.2d 568, 570-571 (5th Cir. 1965); Knight-Ridder, 743 F.2d at 798; Peoples Bank & Trust v. Commissioner, 415 F.2d at 1344; Ryan v. Commissioner, 42 T.C. 386, 392 (1964).

Once the Commissioner has imposed a change in method of accounting, the application of section 481 (a) to such change is patent and mandatory. Primo Pants Co., 78 T.C. 705 at 720; Emert v. Commissioner, T.C.Memo. 1999-175; Hitachi Sales Corp. of America v. Commissioner, T.C. Memo. 1994-159, supp. T.C. Memo. 1995-84.

An examining agent changing a taxpayer's method of accounting will make the change in a taxable year under examination. Ordinarily the change will be made in the earliest taxable year under examination. Or, if later, the first taxable year the method is considered to be impermissible, although an examining agent may defer the year of change to a later taxable year in appropriate circumstances. An examining agent will not defer the year of change in order to reflect the hazards of litigation. Moreover, an examining agent will not defer the year of change to later than the most recent year under examination on the date of the agreement finalizing the change. See section 5.04(1) of Rev. Proc. 2002-18.

An examining agent changing a taxpayer's method of accounting ordinarily will impose a section 481(a) adjustment, subject to a computation of tax under section 481(b) (if applicable). The section 481(a) adjustment, whether positive or negative, will be taken into account entirely in the year of change. See section 1.448-1(c)(3); section 5.04(2), (3) of Rev. Proc. 2002-18. When there is a change in the method of accounting to which section 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then used, and income

for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used. See section 2.04(1) of Rev. Proc. 2002-18, 1997-1 C.B. 680; section 2.05(1) of Rev. Proc. 97-27.

An adjustment under section 481(a) can include amounts attributable to taxable years that are closed by the statute of limitations. Rankin v. Commissioner, 138 F.3d 1286, 1288 (9th Cir. 1998); Weiss v. Commissioner, 395 F.2d 500 (10th Cir. 1968); Graff Chevrolet Co. 343 F.2d 568, 571-572 (5th Cir. 1965); Huffman v. Commissioner, 126 T.C. 322, 341-2 (2006), aff'd, 518 F.2d 357, 363-4 (6th Cir. 2008); Suzy's Zoo v. Commissioner, 114 T.C. 1, 12-13 (2000), aff'd, 273 F.3d 875, 884 (9th Cir. 2001); Superior Coach of Florida v. Commissioner, 80 T.C. 895, 912 (1983); Spang Industries, Inc. v. United States, 6 Cl. Ct. 38, 46 (1984), rev'd on other grounds, 791 F.2d 906 (Fed. Cir. 1986).

As concluded above, the adjustment contemplated by Exam constitutes a change in method of accounting. Accordingly, once imposed, the computation and recognition of an appropriate adjustment under section 481 (a) becomes mandatory to eliminate any distortions (duplications or omissions of income or deductions) caused by the accounting method change. The section 481 (a) adjustment reflects relevant amounts from any taxable years preceding the year of change even if such years are closed by the statute of limitations. The adjustment will be made in the earliest taxable year under examination.

If you have any questions regarding this memorandum, please contact me at

#### Disclosure Statement

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

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