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Section 1032: Are We There Yet

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I. INTRODUCTION

This paper will discuss various issues related to Section 1032 of the Internal Revenue Code (the "Code"), which provides for nonrecognition of gain or losses by a corporation upon its receipt of money or other property in exchange for stock. The provision allows permanent, rather than deferred, nonrecognition for such exchanges. Section 1032 provides an exception to a transaction that would otherwise result in gain or loss recognition where a corporation receives money or property in exchange for the issuance of its stock. Section 1032 is a counterpart to the nonrecognition rule applicable to a transferor’s receipt of stock upon the transfer of money or property to a corporation.

There are several policy reasons behind the nonrecognition rules embodied in Sections 351 and 1032. Nonrecognition supports capital investment in newly formed business enterprises without the imposition of

2. See Glen Arlen Kohl, The Identification Theory of Basis, 40 Tax L. Rev. 623, 643 (1985). As discussed infra, compare Section 1032 with the Section 351 shareholder nonrecognition rules whereby the shareholder takes a basis in the acquired stock equal to the basis in the exchanged property, thereby maintaining any gains or losses.
3. Other provisions of the I.R.C. that provide for nonrecognition treatment in certain transactions include: (1) I.R.C. § 118 (2005) (providing that a corporation’s gross income does not include contributions to its capital other than contributions in aid of construction of any other contribution as a customer or potential customer); (2) I.R.C. § 1031 (2005) (providing that neither gain nor loss will be recognized on the exchange of property held for productive use in a trade or business or for investment); and (3) I.R.C. § 1033 (2005) (providing that under certain circumstances, any gain which is realized from an involuntary conversion will not be recognized).
5. I.R.C. § 351 (2005) (identifying the shareholder nonrecognition rule where, subject to certain requirements, the shareholder will not recognize gain or loss upon the transfer of property to a corporation).
To this end, nonrecognition "encourages the combination of assets for profit" when parties transfer property for the purpose of forming a corporation. An exchange of stock for money or other property is not viewed as creating gain attributable to the corporation or the transferor of the property. Rather, from the perspective of the transferor of the property, the exchange more accurately reflects a mere change in form of the property involved. When the value of the property is transferred in exchange for the value of the stock, recognized gain or loss should not result because, at least initially, the stock is worth approximately the net value of the property transferred. Additionally, Section 1032 seeks to avoid uncertainty in the tax law as to the type of transactions that will be subject to nonrecognition treatment, avoiding the potential for whipsaw.

Despite such policy goals, the proper scope of nonrecognition treatment must be considered in light of the anti-deferral function of the corporate income tax. Allowing nonrecognition by a corporation undercuts this anti-deferral policy. As a result, although a shareholder's gain in property transferred to a corporation in exchange for stock is maintained with the shareholder through the basis rules attendant to Section 351, the shareholder experiences the benefit of deferral until disposition of the corporation's stock.

7. The legislative history to Section 351's predecessor stated that the provision was enacted to "permit business to go forward with readjustments required by existing conditions." S. REP. NO. 67-275, at 11-12 (1921); S. REP. NO. 68-398, at 17-18 (1924) ("[C]ontribution of money or other property to a corporation in exchange for stock after corporation is also covered by Section 1032.").
8. See Dennis R. Honabach, Taxing the Corporate Liquidation – A Proposal for Consistency, 8 J. CORP. L. 1, 7 (1982).
9. See Rands, supra note 6, at 52.
10. Treas. Reg. § 1.1002-1(c) (1960) ("The underlying assumption [of § 351] is that the new property is substantially a continuation of the old investment still unliquidated . . . ."). See also Honabach, supra note 8, at 7; Portland Oil Co. v. Comm'r, 109 F.2d 479, 488 (1st Cir. 1940) (stating that the purpose of the nonrecognition rules is to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture).
13. See Scarborough, supra note 11.
15. See BLOCK, supra note 12, at 3-4.
Even worse, the recent development of certain equity derivatives\textsuperscript{16} that are not specifically addressed by Section 1032 provide the opportunity for whipsaw; nonrecognition under the provision is claimed when there is gain and a transaction that produces a loss is argued to escape application of the rule.\textsuperscript{17} It is asserted that Section 1032 is lacking with respect to equity derivatives because other instruments that have the same economic impact are subject to the provision.\textsuperscript{18} Inconsistent tax treatment of economically equivalent transactions results.\textsuperscript{19}

The tension between the policy goals cited above begs the question as to the proper scope and applicability of Section 1032 to ensure that economically equivalent transactions will be treated in a consistent manner. On one hand, should Section 1032 be narrowed so that it does not apply to the acquisition or lapse of an option, and only provides nonrecognition treatment to a corporation’s purchase or sale of its stock for market value?\textsuperscript{20} Such a modification to Section 1032 is supported by the anti-deferral function by forcing recognition of any gains (or losses) that increase (or decrease) the value of the shareholder’s interest.\textsuperscript{21}

On the other hand, should Section 1032 be expanded to provide nonrecognition treatment for any transaction (including those involving equity derivatives), to the extent that it references changes in the value of the corporation’s stock?\textsuperscript{22} It is argued that this proposal is a logical progression from the legislative, judicial, and administrative enactments related to Section 1032 and the policy of encouraging investment in a business entity.\textsuperscript{23}

As discussed in this paper, an expansion of Section 1032 is the proper route in consideration of the intent expressed by Congress, the courts, and the Internal Revenue Service (the "Service") through enactments and

\textsuperscript{16} A derivative is a contract in which two parties place a bet on a particular stock price, interest rate, or some other financial fact. \textit{See generally} JOHN C. HULL, OPTIONS, FUTURES, \& OTHER DERIVATIVES (5th ed. 2000).

\textsuperscript{17} \textit{See} Honabach, \textit{supra} note 8.

\textsuperscript{18} \textit{See id}.

\textsuperscript{19} \textit{See id}.

\textsuperscript{20} \textit{See} Alvin C. Warren, \textit{Taxation of Options on the Issuer’s Stock}, TAXES, Mar. 2004, at 47.

\textsuperscript{21} \textit{See id}.


\textsuperscript{23} \textit{See id}.
rulings related to Section 1032. In answer to the question posed in the title of this paper with regard to Section 1032, "Are we there yet?" the answer is: "not yet." Expansion of Section 1032 will reduce the current problem of taxpayers utilizing a "wait and see" attitude and, depending on the result, shielding themselves from gain recognition pursuant to Section 1032 or structuring the transaction so that it falls outside Section 1032, allowing taxpayers to recognize a loss.

With these issues in mind, Section II of this paper will provide a summary of legislative enactments and judicial and administrative rulings related to Section 1032. Thereafter, Section III will review the general scope and applicability of Section 1032 in current tax practice. Section IV will undertake an analysis of attempts to provide for a workable definition of "money or other property in exchange for stock" within the meaning of Section 1032 and the impact of the applicable rules on equity derivatives. Section V will discuss the effect of Section 1032 on employee stock option plans. Section VI will review and discuss the proper scope of Section 1032 and proposals for amending the provision to reduce the opportunity for whipsaw.

II. HISTORY OF SECTION 1032

Although Section 1032 had no statutory predecessor prior to its enactment in 1954, the provision built upon the well-accepted policy that a corporation recognized no gain or loss upon the original issuance of its shares.\textsuperscript{24} Regulations first enacted in 1918 and subsequent holdings established the rule that the initial issuance of stock by a corporation would not result in recognized gain or loss.\textsuperscript{25} Rather, the transaction was considered a capital transaction, with the proceeds of the sale treated as capital and not as ordinary income.\textsuperscript{26} Nonrecognition treatment was

\begin{itemize}
\item \textsuperscript{26} See Kohl, \textit{supra} note 2, at 643. See also 105 W. 55th Street, Inc. \textit{v. Comm'r}, 15 B.T.A. 210, 213 (1929); Union Trust Co. \textit{v. N.J. v. Comm'r}, 12 B.T.A. 688, 690 (1928).
\end{itemize}
applicable even when the sale price of the stock was more or less than the
par value of the stock.\textsuperscript{27}

Despite this long standing policy, the broad applicability of
nonrecognition treatment was denied in \textit{S.A. Woods Machine Co. v. Commissioner}.\textsuperscript{28} In that case, the question at issue was whether gain or
loss would result when the plaintiff corporation accepted shares of its own
capital stock (which were immediately retired) in settlement of a patent
infringement claim.\textsuperscript{29} Citing previous rulings, the Board of Tax Appeals
held that when the plaintiff corporation received the stock, "it owned no
property which it did not own before . . . [t]he corporation . . . was already
the owner of all the property of the corporation, and the acquirement of
these . . . shares added nothing to this ownership."\textsuperscript{30} The court therefore
held that the corporation did not realize gain from the purchase or sale of
its own stock.\textsuperscript{31}

The ruling was subsequently reversed by the First Circuit.\textsuperscript{32} In
reviewing the merits of the case, the circuit court stated that the essence of a
transaction must be examined to determine whether it constituted a
recognition event, and that such a determination "depends upon the real
nature of the transaction involved."\textsuperscript{33} The court went on to say that
nonrecognition status applied to the extent that shares were acquired or
parted with in connection with a readjustment of the capital structure.\textsuperscript{34}
However, when an issuing corporation dealt with its own stock in a manner
that was consistent with its treatment of the stock of an unrelated corporation,
gain or loss upon disposition of such stock would be recognized.\textsuperscript{35}

Citing the relevant facts, the First Circuit noted that the transaction
could be analyzed in two discrete portions: first, a payment of the debt in
cash and, second, the investment of the proceeds by the corporation in its

\textsuperscript{27} \textit{See Kohl, supra} note 2, at 643.
\textsuperscript{28} 21 B.T.A. 818 (1930).
\textsuperscript{29} \textit{See id.}
\textsuperscript{30} \textit{Id.} at 820. \textit{See also} Simmons \& Hammond Mfg. Co., 1 B.T.A. 803 (1925); Appeal of Farmers Deposit Nat`l Bank and Affiliated Banks, 5 B.T.A. 520 (1926); Appeal of H. S. Crocker Co., 5 B.T.A. 537 (1926).
\textsuperscript{31} \textit{See S.A. Woods Machine Co.}, 21 B.T.A. 818.
\textsuperscript{32} \textit{See Comm`r v. S.A. Woods Mach. Co.}, 57 F.2d 635 (1st Cir. 1932).
\textsuperscript{33} \textit{Id.} at 636.
\textsuperscript{34} \textit{See id.}
\textsuperscript{35} \textit{See id. \textit{See also} Comm`r v. Boca Ceiga Dev. Co.}, 66 F.2d 1004 (3d Cir. 1933).
own stock. The court noted that "the transaction was not changed in its essential character by the fact that, as the debtor happened also to own the stock, the money payment and the purchase of stock were bypassed, and the stock was directly transferred in payment of the debt."

The ruling led to enactment of regulations in 1934 that modified the previous position of the Service that a corporation's dealings in its stock were not taxable. The 1934 regulations adopted the facts and circumstances analysis of S.A. Woods Machine. In adopting the rule, the regulations distinguished between a corporation's receipt of money or property upon original issuance of its capital stock and a corporation dealing in its own shares as it might in the share of another corporation, i.e., dealings in its treasury stock. Generally speaking, the former were to be treated as a nonrecognition event and the latter as a taxable transaction.

Rather than clarifying the issue, the regulations created uncertainty as to the meaning attached to a "corporation dealing in its own shares as it might in the share of another corporation." Several decisions interpreted the regulations as meaning that when a corporation purchased and

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36. See S.A. Woods Machine Co., 57 F.2d at 636.
37. Id.
38. See T.D. 4430, XIII-1 C.B. 36 (1934) (applying the amendment retroactively to 1924, though the feature was later overturned. Helvering v. R. J. Reynolds Tobacco Co., 306 U.S. 110, 117 (1938)).
40. Treasury stock is "issued stock of a corporation which has been reacquired by the corporation." WEST'S TAX LAW DICTIONARY 972 (2005 ed.).
41. See T.D. 4430, XIII-1 C.B. 36 (1934). The regulations stated:
   Acquisition or Disposition by a Corporation of its Own Capital Stock – Whether the acquisition of disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock.
   But where a corporation deals in its own shares as it might in the share of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of applicable statutes.
42. See Deconstructing Code Sec. 1032, supra note 22.
subsequently sold its own shares, not as an investment or for the purpose of resale at a profit, but for some other corporate purpose, the corporation did not deal in its own shares as it dealt in the shares of another corporation, and any resulting gain or loss was not recognized. However, if the corporation acted purely with a profit motive, receipt of money or property in exchange for its stock was a taxable event.

Other courts construed the regulations to mean that regardless of the original intent of the corporation in purchasing its shares, as long as the corporation did not actually cancel and retire the shares, but eventually resold them (without issue as to whom they were sold), the corporation was treated as having sold an asset as it would be upon the sale of another corporation’s stock. Resulting gain was treated in the same manner as income from the sale of any other asset.

Section 1032 was enacted as part of the Internal Revenue Code of 1954 in an effort to alleviate the confusion as to the proper tax treatment of a

44. See Penn-Texas Corp., 308 U.S. at 578; Gen. Elec. Co., 299 F.2d at 945-46.
45. See Comm’r v. Air Reduction Co., 130 F.2d 145 (2d Cir. 1942); Aviation Capital v. Pedrick, 148 F.2d 165 (2d Cir. 1945); Allen v. Nat’l Manufacture & Stores Corp., 125 F.2d 239 (5th Cir. 1942); Helvering v. Edison Bros. Stores, 133 F.2d 575 (8th Cir. 1943); Brown Shoe Co. v. Comm’r, 133 F.2d 582 (8th Cir. 1943); U.S. v. Stein Bros. & Co., 136 F.2d 488 (8th Cir. 1943); Edwin L. Wiegand Co. v. U.S., 60 F.Supp. 464 (Ct. Cl. 1945).
46. The Sixth Circuit held that the corporation’s sale of its own stock was a taxable event. In arriving at the decision, the court pointed to the underlying facts; that the shares at issue were: (1) purchased on the open market; (2) designated on the books of the corporation as an asset; (3) carried at cost on the corporation’s balance sheet as investments in stock of domestic corporations; (4) not retired; (5) taken in the name of one of the corporation’s officers and endorsed by him; (6) participated in a stock dividend; and (7) sold through brokers without according stockholders the usual priorities accorded them on the issue of treasury stock. Dow Chem. Co. v. Kavanagh, 139 F.2d 42, 46 (6th Cir. 1943). The court also relied on the definition of taxable income (which was then provided in Section 22(a) of the Internal Revenue Code), which included “Gains, profits, and income derived from . . . sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property . . . [as well as] gains or profits and income derived from any source whatever.” The court held that the purchase and subsequent sale of the stock at issue fell clearly within the definition of “taxable income” under the Code and that “any other construction of it attempts to illegally exempt from the operation of the statute what is obviously and as a practical matter gain, profit or income.” Comm’r v. Landers Corp., 210 F.2d 188, 191 (6th Cir. 1954).
corporation’s dealings in its own stock. As noted in the legislative history, the purpose for enacting the provision was to "remove the uncertainties of present law." Under the provision, neither gain nor loss was recognized by a corporation that received money or other property in exchange for its stock, including treasury stock.

Section 1032 not only embodied the historical nonrecognition rule for a corporation’s dealings with newly issued stock, but also required such treatment for transactions involving treasury stock. Congress’ intent to provide nonrecognition treatment beyond the scope of the pre-1934 regulations was further evidenced by the regulations promulgated under Section 1032, which afforded such treatment regardless of "the nature of the transaction or the facts and circumstances involved" or whether the value of the money or property transferred was "equal to, in excess of, or less than, the par or stated value of such stock." Nonrecognition applied "even though the corporation deals in such shares as it might in the shares of another corporation."

The regulations further clarified and expanded Section 1032 to apply when a corporation transferred its shares as compensation for services performed. As noted by commentators, this interpretation was logical, given that a corporation could sell its shares for cash, receive nonrecognition treatment, and thereafter transfer the cash to the service provider as compensation. This interpretation of Section 1032 to treat such economically equivalent transactions in a consistent manner is well established.

47. As enacted under the 1954 Code, Section 1032 incorporated the following provisions: (a) Nonrecognition of Gain or Loss – No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.; (b) Basis – For basis of property acquired by a corporation in certain exchanges for its stock. Section 362; Internal Revenue Code of 1954, Pub. L. No. 592-736, § 1032, 68A Stat. 3, 303 (1954).
50. See id.
52. Id.
53. See id.
55. The revenue ruling stated that where a corporation distributed shares of its treasury stock to its employees as compensation for services rendered, the corporation did not report
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The Deficit Reduction Act of 1984 further amended and expanded the scope of Section 1032 by codifying the rule that a corporation would not recognize a gain or loss with respect to any lapse or acquisition of an option to buy or sell its stock. The legislative history noted that under the then-current version of Section 1032, there was potential for inconsistent tax positions with respect to options by virtue of contradictory positions taken by the Service and the Board of Tax Appeals. The legislative history provided an explanation of how a taxpayer could make use of the rulings to whipsaw the Service:


57. See STAFF OF H. COMM. ON WAYS AND MEANS, 83D CONG., REPORT ON DEFICIT REDUCTION ACT OF 1984 (Comm. Print 1984). The Service noted that Section 1032 applies when any warrant is exercised and stock is thus issued. In such a situation, a corporation recognizes no gain or loss. However, the Service pointed to regulations under Section 1234 as being applicable to any lapse of a warrant, and therefore (ordinary) gain will be recognized to a corporation issuing such warrants, in an amount equal to the fair market value of the stock received at the date of its exchange for the issuance of the warrants. Section 1.1234-1(b) states, in pertinent part,

any gain to the grantor of an option arising from the failure of the holder to exercise it, and any gain or loss realized by the grantor of an option as a result of a closing transaction, such as repurchasing the option from the holder, is considered ordinary income or loss.

Rev. Rul. 72-198, 1972-1 C.B. 223 (addressing a situation where a corporation acquired all of the outstanding stock of another corporation in exchange solely for the issuance of its own stock warrants). An interesting case involved subscribers to capital stock of a corporation. Subsequent to making partial payment on their subscriptions, subscribers defaulted in their obligation to remit remaining payments due under the subscription plan. Upon the failure to make the payment, the corporation declared that the subscribed stock, as well as the payments made thus far, were declared forfeited to the corporation. The Board of Tax Appeals held that the forfeited payments were not income to the corporation because the subscription payments were initially made to provide capital for the corporation. The Board dismissed the fact that payments were made in installments and stock was never issued for such payments. Ill. Rural Credit Ass'n, 3 B.T.A. 1178 (1926).
Present law can put the Service into an unacceptable position. If a corporation issues a warrant for $2 and buys it back for $1, it is likely to argue that, notwithstanding Rev. 72-198, it recognizes no income, citing *Illinois Rural Credit Association* and other authorities. If the corporation's stock goes up in value and the corporation buys the warrant back for $3, it is likely to claim a loss, citing Rev. Rul. 72-188. The committee desires to end this discontinuity. Furthermore, the committee believes that the repurchase of a warrant by the issuing corporation should not produce different tax consequences to the corporation than an exercise of the warrant followed by a repurchase by the corporation of the newly issued stock.\(^{58}\)

The 1984 Amendment continued the trend of treating economically equivalent transactions consistently; the amendment to Section 1032 ensured that the repurchase of a warrant by a corporation would result in the same tax consequences as the exercise of a warrant, followed by the issuing corporation's repurchase of the newly issued stock.\(^{59}\)

The Community Renewal Tax Relief Act of 2000 further amended and expanded Section 1032 by providing nonrecognition treatment to a corporation with respect to a securities futures contract to buy or sell its stock.\(^{60}\) The amendment was part of general modifications to the Code dealing with securities futures contracts.\(^{61}\) Pursuant to the amendments, a sale, exchange, or termination of a securities futures contract is treated as the sale or exchange of the property described in the contract, and the character of the gain or loss is the same as the character of the property described in the contract.\(^{62}\) Under the revised Section 1032, a corporation will not recognize gain or loss on transactions in securities futures contracts with respect to its own stock, to the extent that the corporation would not

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\(^{58}\) *Staff of H. Comm. on Ways and Means, 83d Cong., Report on Deficit Reduction Act of 1984* (Comm. Print 1984). Note that although the legislative history focused on warrants, the language of the 1984 amendment refers more generally to options issued by a corporation on its own stock.

\(^{59}\) *See id.*


\(^{61}\) *See id.* The 2000 Act provided that a securities futures contract is not to be treated as a Section 1256 contract, but rather "gain or loss on these contracts will be recognized under the general rules relating to the disposition of property." *Id.*

\(^{62}\) *Id.*
recognize gain or loss upon the receipt of money or other property in exchange for stock.\textsuperscript{63}

Recently, the "zero basis" regulations were promulgated under Section 1032 to address a situation where a "corporation or a partnership . . . acquires money or other property . . . in exchange, in whole or in part, for stock of [another] corporation."\textsuperscript{64} As a result, nonrecognition treatment is no longer limited to transactions involving a corporation's own stock. Subject to several requirements, a transaction falls within the scope of Section 1032 even if it does not involve the corporation's own stock.\textsuperscript{65} This represents a significant expansion of Section 1032.

The regulations employ a "cash purchase" model, treating economically equivalent transactions in a consistent manner; the acquiring corporation is treated as "purchasing" the stock of the issuing corporation for fair market value with cash contributed to the acquiring entity by the issuing corporation.\textsuperscript{66} The regulations extend nonrecognition to an option issued by a corporation to buy or sell its own stock in such transactions, subject to the same requirements as stock.\textsuperscript{67}

In 1999 and 2000, there were several legislative proposals to require a corporation to report interest income in the event that the corporation made a forward sale of its stock, but no definitive rule was adopted.\textsuperscript{68}

\begin{itemize}
\item \textsuperscript{63} I.R.C. § 1032(a) (2000). The amendment to Section 1032(a) was effective as of December 21, 2000.
\item \textsuperscript{64} T.D. 8883, 2000-1 C.B. 1151. Contemporaneous with the adoption of the zero basis regulations, the Service amended the regulations under Section 83 to clarify that the nonrecognition framework of the Section 1032 regulations when applicable - and not Section 83 - will control a corporate shareholder's transfer of its own stock to any person in consideration for services performed for another corporation. Treas. Reg. § 1.83-6(d) (as amended in 2003).
\item \textsuperscript{65} See T.D. 8883, 2000-1 C.B. 1151. The regulations apply only if: (1) the acquirer acquires stock of the issuer directly or indirectly from the issuer in a nonrecognition transaction (using basis carryover rules under Section 362(a) or 723); (2) the acquirer immediately transfers the issuer's stock; (3) the party receiving the issuer's stock does not receive a substituted basis in the stock; and (4) the issuer's stock is not exchanged for stock of the issuer. Treas. Reg. § 1.1032-3(c) (as amended in 2000).
\item \textsuperscript{66} Treas. Reg. § 1.1032-3(b) (as amended in 2000).
\item \textsuperscript{67} Treas. Reg. § 1.1032-3(d) (as amended in 2000).
\item \textsuperscript{68} See \textit{Staff of the J. Comm. on Taxation, 106th Cong., Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal}, 178-80 (Comm. Print 1999) [hereinafter \textit{Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal}]; \textit{Staff of the J. Comm. on Taxation, 106th Cong., Description of Revenue Provisions Contained in the President's Fiscal
Additionally, attempts were undertaken to clarify and further broaden the applicability of Section 1032, as well as to change the rules for forward stock purchase contracts, although no action was taken on the legislation.\textsuperscript{69}

As evidenced by the legislative, judicial and administrative history related to Section 1032, there is strong support to provide nonrecognition treatment for all economically equivalent transactions, including those involving equity derivatives. The mere fact that certain transactions were not contemplated at the time of legislative or administrative enactment does not mean that such transactions should be exempt from the Section 1032 framework.

III. SUMMARY OF CURRENT STATE OF SECTION 1032

The current application of Section 1032 can be summarized as follows. In general, a corporation will not recognize gain or loss upon its receipt of money or property in exchange for stock, including treasury stock.\textsuperscript{70} Nonrecognition applies whether or not the corporation deals in its own shares as it might in the shares of another corporation.\textsuperscript{71} Nonrecognition treatment also applies to services provided in exchange for the corporation’s stock.\textsuperscript{72} As discussed in greater detail below, a corporation will generally not recognize gain or loss on the lapse or acquisition of an option to buy or sell its stock or upon its receipt of a securities futures contract to buy or sell its own stock.\textsuperscript{73}

Section 1032 does not apply to the acquisition by a corporation of shares of its own stock, except where the corporation acquires such shares in exchange for shares of its own stock, including treasury stock.\textsuperscript{74} When a corporation does acquire shares of its own stock in exchange for shares of its own stock, the transaction may also qualify under the recapitalization rules\textsuperscript{75} and the rules governing the distribution of stock and stock rights.\textsuperscript{76}


\textsuperscript{70} Id.

\textsuperscript{71} Treas. Reg. § 1.1032-1(a) (1960).

\textsuperscript{72} Id.

\textsuperscript{73} I.R.C. § 1032(a) (2000).

\textsuperscript{74} Treas. Reg. § 1.1032-1(b) (1960).

\textsuperscript{75} Treas. Reg. § 1.1032-1(c) (1960); I.R.C. § 368(a)(1)(E) (2005).
A corporation can enter into one of four option transactions with respect to its own stock, and each of these transactions can either be physically settled or cash settled. The corporation can: (1) issue a call option; (2) issue a put option; (3) purchase a call option; or (4) purchase a put option. In general, a corporation will not recognize any gain or loss with respect to issuances, purchases, sales, or assignments of put or call options with respect to its own stock.

Upon the issuance of a call option, the option premium is generally not included in the income of the option issuer immediately upon receipt; realization of the premium income is deferred until the option is exercised or lapses. When a call option is issued by a corporation with respect to its stock, and the option is both exercised by the holder and physically settled or the option lapses without exercise, the corporation will have no gain with respect to the premium it previously received. In the case of a cash settled call option, the Service has ruled that the transaction is the economic equivalent of a physically settled call option followed by a sale of the stock by the holder back to the corporation (which is covered by Section 1032) and the transaction will receive nonrecognition treatment under Section 1032.

When a put option issued by a corporation with respect to its own stock is exercised by the holder and physically settled, the corporation will have

76. Treas. Reg. § 1.1032-1(c) (1960); I.R.C. § 305(a) (2005).
77. A physical settlement occurs when the option holder buys stock from the corporation for a strike price that is less than the stock's fair market value. David H. Shapiro, Taxation of Equity Derivatives, at 2 (BNA Tax Management Portfolio 188-1st, 2004).
78. A cash settlement occurs with respect to an option when, upon exercise, the option settles in (or could be settled in) cash or property other than the underlying property. I.R.C. § 1234(c)(2)(B) (2000). See also West's Tax Law Dictionary 972 (2005 ed.).
79. A call option "gives the buyer the right to purchase stock at a specified price known as the strike price until a specified date known as the expiration date." West's Tax Law Dictionary 114 (2005 ed.).
80. A put option gives the holder "a right to compel the seller of the option to purchase shares at a fixed price during a set time period." West's Tax Law Dictionary 115 (2005 ed.).
no gain or loss on the purchase of its own stock pursuant to the stock redemption rules. The cash settlement of a put option will receive nonrecognition treatment even through the transaction is not specifically covered by Section 1032.

In the event that a corporation purchases a call option with respect to its own stock, and the option is thereafter exercised by the corporation and physically settled, the corporation will have no gain or loss on the purchase of its own stock. If the call option lapses, the corporation is precluded from recognizing a loss for the premium it previously paid to acquire the call option as a result of Section 1032.

A put option purchased by a corporation with respect to its own stock that is exercised and physically settled will produce no recognized gain or loss to the corporation. If there is a lapse of the put option, the corporation is precluded from recognizing a loss for the premium it previously paid to acquire the option. Although the legislative history of Section 1032 did not contemplate a situation where a corporation was the holder of an option with respect to its own stock, a literal application of Section 1032 will afford nonrecognition treatment. In addition, commentators note that failure to apply Section 1032 to such options might result in whipsaw; the corporation can purchase physically settled options rather than cash settled options. Gain on cash settled options would be taxable, and if the options are in the money, the corporation will exercise the options, buying its stock below the market price or selling it above the market price, and will have no taxable gain. In the event that the options expire out of the money, the corporation will have a deductible loss.

87. Section 1032(a) specifies that nonrecognition will be afforded to “any lapse or acquisition of an option,” but not specifically to a lapse of an option to sell a corporation’s stock to the corporation. Rev. Rul. 88-31, 1988-1 C.B. 302.
89. I.R.C. § 1032(a) (2000).
90. Id.
91. Id.
93. See Exploring the Boundaries of Section 1032, supra note 81, at 553.
Section 1032 is not necessarily applicable to a situation where a corporation either: (1) buys a put or call option on its own stock and sells the option to a third party at a gain or loss; or (2) issues a put or call option on its own stock that permits the corporation to transfer its obligation to a third party, and the corporation completes the transfer in exchange for a payment by it to the third party that is greater or less than the option premium originally received by the corporation.\footnote{6} Nonrecognition is not certain because Section 1032 does not specifically apply to a corporation’s gain or loss resulting from its sale or transfer of obligations under an option.\footnote{7} However, it is argued that nonrecognition should apply in such cases because taxpayers could otherwise whipsaw the Service by recognizing losses on purchased options that have depreciated in value by selling them to third parties, while exercising purchased options that have increased in value and receiving nonrecognition treatment under Section 1032.\footnote{8}

A corporation’s purchase or sale of its own stock in connection with a physically settled forward contract\footnote{9} will not result in the recognition of gain or loss because the transaction is clearly within the scope of Section 1032; the transaction involves the transfer of stock of the corporation in

\footnote{6} I.R.C. § 1032(a) (2000).
\footnote{7} Id.
\footnote{8} Additionally, the commentators argued that the transaction could be viewed as falling within the literal scope of Section 1032. The corporation’s sale of the option purchased by the corporation, or assignment of the liability under the option issued by corporation, could be seen as a lapse of the asset or liability as to the corporation. The commentators also pointed out that the corporation’s sale or assignment could be likened to an acquisition of the option by a third party, in the case of the option purchased and sold by corporation, or an acquisition of the liabilities under the option by a third party, in the case of the option issued and assigned by corporation. Exploring the Boundaries of Section 1032, supra note 81, at 554.
\footnote{9} A forward contract is a private, bilateral, executory contract in which one party (in the “long position”) agrees to purchase and the other party (in the “short position”) agrees to sell and deliver a specific asset at a specific time for a specific price (the “forward price”). See Shapiro, supra note 77. In general, as an executory contract, a standard equity forward contract is viewed as having no tax effect (i.e., it does not generate a realization event for tax purposes) until the contract is settled. Lucas v. N. Tex. Lumber Co., 281 U.S. 11 (1930); Comm’r v. E.F. Baertschi, 412 F.2d 494 (6th Cir. 1969); Rich Lumber Co. v. U.S., 237 F.2d 424 (1st Cir. 1956); Frost Lumber Indus., Inc. v. Comm’r, 128 F.2d 693 (5th Cir. 1942); Comm’r v. Segall, 114 F.2d 706 (6th Cir. 1940). If the forward contract is physically settled, the seller recognizes gain or loss at the time it delivers the stock in an amount determined by reference to its adjusted basis in the stock and the amount received in the sale. The buyer takes a basis in the stock and realizes gain or loss upon its ultimate disposition of the shares. I.R.C. § 1001. If, instead, the forward contract is cash-settled, the recipient will recognize gain and the payor will recognize a commensurate loss at the time the payment is made. Id.
exchange for money or other property. However, in the event that the forward contract is cash settled, nonrecognition treatment is not certain because such a transaction involves the parties settling their obligations under the contract in cash; the transaction does not involve a direct exchange of stock for money or other property as required by Section 1032.

In the case of a corporation's issuance of convertible debt, upon conversion of the debt, the corporation will not realize any gain as long as the fair market value of the stock transferred to the debt holder is equal to the value of the retired debt obligation. Where such debt is converted to stock, the transaction will be viewed as the corporation having issued its stock for cash and no gain or loss will be recognized.

Section 1032 does not address the tax treatment where a corporation enters into an equity swap with respect to its own stock. This transaction may present another opportunity for whipsaw; a corporation entering into such a transaction may claim that Section 1032 nonrecognition does not apply to losses resulting from the transaction, or the corporation may argue that Section 1032 prevents it from recognizing gains resulting from such transactions. Such transactions represent yet another transaction that is not appropriately addressed by Section 1032.

The corporation's basis in the property acquired pursuant to a Section 1032 transaction is dependent on whether the transferor will receive nonrecognition treatment under Section 351. When Section 351 applies

100. I.R.C. § 1032(a) (2000).
102. A debt security may be exchanged by the owner for another security, usually at a fixed price on a specified date. See BLACK'S LAW DICTIONARY 1385 (8th ed. 2004).
105. See id. A swap may be viewed as a series of cash-settled forward contracts. In some swaps, differences in the value of the underlying property are settled up every period. For example, assume that the underlying property is $100 when the swap begins. In other swaps, by contrast, these changes in value are not taken into account until a final "nonperiodic" payment is made when the swap matures. In both types of swaps, the long pays the short a finance charge, usually every period. See David M. Schizer, Balance in the Taxation of Derivative Securities: An Agenda for Reform, 104 COLUM. L. REV. 1886, 1889 (2004).
106. See Exploring the Boundaries of Section 1032, supra note 81, at 555-56.
107. I.R.C. § 1032(b) (2000); Treas. Reg. § 1.1032-1(d) (1960); see also I.R.C. §§ 362 (2000), 1012 (2005). A party receiving stock of a corporation in exchange for mony or property experiences similar, but not identical, nonrecognition treatment under Section 351. The Code provides that nonrecognition treatment will be afforded to the contributing party if three requirements are met: (1) the contribution of property is by one or more persons; (2) the contribution is solely in exchange for stock; and (3) the contributors control the
to the transferor, the corporation's basis in the property received is the same as it would be in the hands of the transferor, increased in the amount of gain recognized by the transferor upon such transfer. The corporation will have a transferred basis in the acquired property; the corporation takes on the basis of the property as it was in the hands of the transferor. The upward adjustment of this basis amount by the amount of any gain realized by the transferor reflects the amount of gain recognized by the transferor, but not yet realized.

In the event that Section 351 does not apply to the transferor of property, the exchange will be treated as a taxable exchange to the transferor of the property and the corporation's basis in the property will be a tax cost basis, which is the property's fair market value.

The basis rules under Section 1032 are significant because if Section 351 is applicable to the transaction, the property transferred to the corporation maintains any gain experienced by the transferor. Upon the disposition of such property by the corporation, all such gain realized by the transferor, as well as any additional appreciation of the property in the hands of the corporation, will be recognized by the corporation.

As discussed above, although Section 1032 is clearly applicable to certain transactions, other transactions (e.g., transfer of put/call obligations for payment, equity swaps, etc.) are at best subject to the provision through reasonable statutory interpretation. To foster consistency within the tax system, Section 1032 should be expanded to address these transactions and all other transactions that are the economic equivalent of transactions that fall squarely within the rubric of Section 1032.
IV. DEFINING "MONEY OR OTHER PROPERTY IN EXCHANGE FOR STOCK" UNDER SECTION 1032—DEBT VERSUS EQUITY CONSIDERATIONS

Frequently, questions arise as to the meaning of "money or other property in exchange for stock" within the context of Section 1032. This issue is significant to both the issuing corporation and the transferor of property; application of Sections 1032 and 351 allow a corporation to experience a tax-exempt transaction and provides the transferor with deferral of any gain associated with the transferred property. From a policy perspective, application of Section 1032 should be contingent upon the transfer of an equity interest because the underlying purpose in providing nonrecognition treatment is to encourage capital investment in newly-formed business ventures. As discussed below, the applicable test for determining when a transaction involves "money or other property in exchange for stock" within the meaning of Section 1032 is useful in determining the proper treatment of equity derivatives.

Despite the fact that the regulations under Section 1032 provide for nonrecognition treatment "regardless of the nature of the transaction or the facts and circumstances involved," questions arise as to the meaning of "money or other property in exchange for stock" because the Code does not define the terms. In enacting Section 1032, "Congress was only concerned with the problem of taxing gains or losses on treasury stock transactions and did not consider the problems which might arise in defining the term 'stock.'"

As discussed below, the courts and the Service have established a two-prong test to address the issues raised by Congress’s reluctance to provide a definitive boundary for "money or other property in exchange for stock" as contemplated by Section 1032. The test provides for both objective and subjective analyses: examining whether there is a transfer of a proprietary or equity interest in the corporation and the transferor’s motive or intent accompanying such transfer.

116. Affiliated Gov't Employees' Distrib. Co. v. Comm'r, 322 F.2d 872, 876 (9th Cir. 1963).
118. See id. See also Affiliated Gov't Employees' Distrib. Co, 322 F.2d at 877; Rev. Rul. 81-83, 1981-1 C.B. 434.
Prior to examining the cases and rulings interpreting this aspect of Section 1032, it is helpful to examine general tax principles related to equity and debt. Although the Code does not provide a definition for the terms used in Section 1032, another provision states that stock "includes shares in an association, joint-stock company, or insurance company." The definition is not particularly useful, given that it fails to list all of the instruments that will qualify for nonrecognition under Section 1032. Courts have addressed the absence of a useful definition of "stock" by reading Congress's intent "to accept the ordinary connotations of the term [stock]" and that the purpose of the Code definition for stock was only to set forth "certain interests which might not be considered 'stock', as it is normally defined." As an additional point of reference, Section 351 does not provide a definition for stock, although it has been unhelpfully noted that that "stock" within the meaning of Section 351 has its "ordinary meaning."

Under general debt and equity principles, the determination of whether a particular instrument represents an equity interest or indebtedness will

119. I.R.C. § 7701(a) (2005). During the passage of the 1954 Code, the House version of the act included definitions for "participating stock," "nonparticipating stock," and "securities" for the purpose of clarifying the rules governing corporate reorganizations and certain other transactions. However, as noted in the Senate Finance Committee Report, the definitions were not ultimately included in the 1954 Code as a result of the belief that "any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks and securities will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments." S. Rep. No. 1622, 83d Cong., 2d Sess. 42 (1954). Additionally, a similar list was proposed in 1957 by an advisory group to a subcommittee of the House Committee on Ways and Means, but was not acted upon. In 1954 the American Law Institute embodied such a test in § x500 of its draft income tax statute. See ALI Federal Tax Project, Income Tax Problems of Corporations and Shareholders 396 (1958).

120. "Stock" is also defined, in part, as: (1) "the capital or principal fund raised by a corporation through subscribers' contributions or the sale of shares"; and (2) "a proportional part of a corporation's capital represented by the number of equal units (or shares) owned, and granting the holder the right to participate in the company's general management and to share in its net profits or earnings." BLACK'S LAW DICTIONARY 1456 (8th ed. 2004).

121. See Affiliated Gov't Employees' Distrib. Co., 322 F.2d at 876-77.

122. Carlberg v. U.S., 281 F.2d 507, 514 (8th Cir. 1960). See also Deputy v. Du Pont, 308 U.S. 488, 498 (1940); Comm'r v. Neustadt's Trust, 131 F.2d 528, 530 (2d Cir. 1942). Note that several courts have held that "stock" within the meaning of Section 315 has the same meaning as "stock" within the reorganization provisions under Section 368. See, e.g., Camp Wolters Enterps., Inc. v. Comm'r, 22 T.C. 737 (1954), acq. 1954-2 C.B. 3 and aff'd, 230 F.2d 555 (5th Cir. 1956); Lloyd-Smith v. Comm'r., 116 F.2d 642 (2d Cir. 1941); Dillard v. Comm'r, 20 T.C.M. (CCH) 137 (1961); U.S. v. Hertwig, 398 F.2d 452 (5th Cir. 1968); Dennis v. Comm'r, 57 T.C. 352 (1971), aff'd, 473 F.2d 274 (5th Cir. 1973).
have a significant tax impact on both the issuer and the holder of the instrument.123 If the instrument is determined to be debt, the issuing corporation is able to deduct interest payments.124 A similar deduction is not available for dividend payments made by the corporation.125 From the perspective of the shareholder, if the interest is determined to be a loan, shareholders are not generally subject to tax on their receipt of loan principal payments, although shareholders are subject to tax on any interest income.126 If the instrument is determined to be an equity interest, any payments made by the issuing corporation to the shareholder will be classified as dividends, which must be treated by the shareholder as income to the extent that the corporation has sufficient earnings and profits.127 There are other significant implications of classifying an instrument as debt or equity.128

The determination of whether a particular interest is properly classified as debt or equity may not be an easy task. Legislative, judicial and administrative attempts to provide workable definitions have met with limited success. On one end of the debt/equity spectrum is straight debt, which is usually defined as “an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or the lack thereof.”129 On the other end of the spectrum is “equity,” which is usually defined as


124. See I.R.C. § 163(a) (1982); see also Bauer v. Comm'r, 748 F.2d 1365 (9th Cir. 1985); Liflans Corp. v. U.S., 390 F.2d 965 (Ct. Cl. 1968).


126. Payments of principal on debt usually constitute tax-free recoveries of basis by creditors, but they produce capital gain if the payments exceed the adjusted basis of the debt. See BITTKER & EUSTICE, supra note 123, § 4.01. See also I.R.C. § 61(a) (1982 & Supp. IV 1986).


128. Other factors that will likely be impacted by the debt/equity determination include: (1) the consequences of the holder’s sale of the stock or security; (2) the character of the investor's loss upon sale or worthlessness; (3) the consequences of a shareholder guaranty of a corporate loan; (4) shareholder losses on "Section 1244 Stock"; (5) cancellation-of-indebtedness income; and (6) limitations on corporate interest deductions. See generally BITTKER & EUSTICE, supra note 123, §§ 4.01-4.12.

"unlimited claim to the residual benefits of ownership and an equally unlimited subjection to the burdens thereof." In seeking to articulate a useful boundary between debt and equity it has been noted that:

The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them.

It has also been observed that a "reasonable expectation of repayment that does not depend solely on the success of the borrower's venture" is an essential element of a debt interest. Historically, the character of a particular instrument was initially determined under case law. In determining the equity or debt character of an interest, courts took a form over substance approach, noting that that "the taxpayer's motive is not the crucial factor. . . . This is but a corollary of the undoubted proposition, the incidence of taxation depends upon the substance of a transaction." Courts analyzed whether the taxpayer had reasonable expectation of repayment, relying on such factors as: (1) the ratio of debt to equity; (2) pro rata holdings of debt and stock; (3) the use of the borrowed funds; (4) whether outside investors would have made such an advance on similar terms; and (5) conduct generally consistent with that of a creditor. These factors were utilized, analyzed and expanded by subsequent judicial decisions.

In response to the judiciary's muddying of the waters with respect to debt/equity considerations, Congress enacted Section 385 of the Code, which authorized the Department of the Treasury to promulgate regulations.

130. Id.
131. U.S. v. Title Guarantee & Trust Co., 133 F.2d 990, 993 (6th Cir. 1943).
133. Gilbert, 248 F.2d at 404 (citing Comm'r v. Court Holding Co., 324 U.S. 331, 334 (1945)).
134. See id. at 406.
135. See Fin Hay Realty Co. v. U.S., 398 F.2d 694 (3d Cir. 1968) (providing a sixteen factor test to distinguish between debt and equity); see also Estate of Mixon v. U.S., 464 F.2d 394, 402 (5th Cir. 1972) (specifying thirteen elements in determining whether an advance constitutes debt or equity); In re Lane, 742 F.2d 1311, 1314-15 (11th Cir. 1984); Stinnett's Pontiac Serv., Inc. v. Comm'r, 730 F.2d 634, 638 (11th Cir. 1984), aff'd. 44 T.C.M. (CCH) 55 (1982).
that would determine whether an interest in a corporation were treated as equity or debt.\textsuperscript{136} Eleven years after Section 385 was enacted, the applicable regulations were issued in proposed form\textsuperscript{137} and were made final a year later.\textsuperscript{138} Although the regulations did provide some guidance, several critical definitions did not provide adequate specificity.\textsuperscript{139}

Ultimately, the regulations fell victim to the ingenuity of investment bankers. The financial markets devised instruments that had enough debt characteristics to qualify as debt under the regulations, but the Treasury believed these were too much like equity to receive debt treatment.\textsuperscript{140} The regulations were ultimately withdrawn.\textsuperscript{141}

In response to the Service’s inability to promulgate appropriate regulations, Congress abandoned the broad definitional approach in favor of narrowly targeted rules enacted for the purpose of reducing abuses of the interest deduction.\textsuperscript{142} In addition, a consistency rule was added, which required that an issuer’s initial characterization of a corporate interest as stock or debt is binding upon the issuer and all holders.\textsuperscript{143} Holders are permitted to take an inconsistent position (unless the applicable regulations provide otherwise) if they disclose the inconsistency on their returns.\textsuperscript{144}

\textsuperscript{136} I.R.C. § 385 (2005). Section 385 required that the regulations provide factors which are to be taken into account in determining whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists with respect to a particular instrument.


\textsuperscript{139} For example the regulations did not adequately define the meaning of “independent creditor” and “excessive debt.” See Prop. Treas. Reg. §§ 1.385-6(b), (g); 47 Fed. Reg. 180, 182 (Jan. 5, 1982).

\textsuperscript{140} See Polito, supra note 129, at 789.

\textsuperscript{141} The effective date of the withdrawal was August 5, 1983. T.D. 7920, 1983-2 C.B. 69. Additionally, various proposed substantive amendments to those regulations were withdrawn on July 6, 1983. Id. See also T.D. 7801, 1982-1 C.B. 60 (proposed amendment withdrawn).

\textsuperscript{142} The measures included the high yield original issue discount limitations of Section 163(e)(5), the interest-stripping limitation of Section 163(j), and the granting of prospective regulatory authority in Section 385(a) to bifurcate hybrid instruments into part stock and part debt. I.R.C. §§ 163(e)(5), (j); 385(a) (2000).


\textsuperscript{144} I.R.C. § 385(c)(2) (2000).
The determination of whether a particular interest is classified as debt or equity is essential to the Section 1032 analysis; in the event the interest is determined not to be stock, the issuing corporation will recognize gain on property received in exchange for such instruments. Similar to other issues that arise under the income tax laws, a determination of whether a particular interest is equity or debt "must regard matters of substance and not mere form." As such, courts have been called upon to determine whether the features of an instrument given by a corporation in exchange for property embodied the characteristics of an equity interest, and would therefore subject the transaction to treatment under Section 1032. The cases typically dealt with situations where the instrument at issue was an interest in a membership corporation, such as a country club or similar institution.

In *Community T.V. Association of Havre v. United States*, a district court held that payments received by the plaintiff corporation from a certain class of shareholders in return for the issuance of additional stock ("Class B stock") constituted ordinary taxable income. After determining that the Class B stock was not stock within the meaning of Section 118(a), the court turned to the issue of whether the corporation's receipt of money in exchange for the shares should be afforded nonrecognition treatment under Section 1032. The court focused on the fact that the shares in question did "not possess any of the ordinary attributes of common stock, i.e., the right to pro rata dividends,

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146. Affiliated Gov't Employees' Distrib. Co. v. Comm'r, 322 F.2d 872, 877 (9th Cir. 1963).
147. The court's holding was based upon the plaintiff corporation's issuance of Class "A" and "B" stock. Plaintiff was an operator of a television cable system. Customers were required to execute a services contract, which required the payment of a connection and service charge in addition to a subscription fee, for which the customer would receive a certificate for one share of Class "B" Stock. Any breach of the agreement by the customer provided the plaintiff corporation the right to cancel the contract, which would extinguish all rights of the subscriber, including a forfeiture of all moneys paid to the plaintiff. The agreement was not assignable or transferable by the subscriber without the prior written consent of the plaintiff. The holding was based upon the court's initial determination that the payment made by the Class B stockholder did not constitute "contributions to capital" and thus could be excluded from the plaintiff's gross income pursuant to I.R.C. § 118(a). In making this determination, the court cited to the rule that payments made to a corporation in consideration of services rendered, or to be rendered, or in consideration of direct benefits to be received from the corporation, constitute taxable income. See also Teleservice Co. of Wyo. Valley v. Comm'r, 254 F.2d 105 (3d Cir. 1958); United Grocers, Ltd. v. U.S., 186 F.Supp. 724 (N.D. Calif. 1960); Warren Television Corp. v. Comm'r, 17 T.C.M. (CCH) 1053 (1958).
participation in the profits and management, and equal sharing in the ultimate distribution of assets." 150. The court delineated additional factors that evidenced the limited rights embodied in the Class B stock. 151

In concluding that the Class B stock was not "stock" within the meaning of Section 1032, the court summarized its findings as follows:

It is obvious that no one except a subscriber to the television service would be interested in acquiring any 'Class B stock'. . . . As a practical matter, the most a subscriber could hope to realize on the stock would be a possible return of his initial investment, without any dividend or profit. 152

The Ninth Circuit Court of Appeals utilized a similar analysis in Affiliated Government Employees' Distributing Company v. Commissioner. 153 The court upheld a decision of the United States Tax Court that membership fees paid to the taxpayer corporation constituted taxable income. 154 The court undertook a pragmatic review of the true relationship of the parties to the transaction, ultimately finding that neither party "could realistically have considered the fees paid to have been 'in exchange for stock.'" 155

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150. Id. at 274. See also Elko Lamoille Power Co. v. Comm'r, 50 F.2d 595, 596 (9th Cir. 1931); Comm'r v. H. P. Hood & Sons, 141 F.2d 467 (1st Cir. 1944).

151. The court noted additional factors, such as: (1) no right to dividends; (2) no voice in management (except upon request in an advisory capacity); (3) the fact that the shareholders would participate in the distribution of assets only after the Class A shareholders were paid in full; (4) the fact that Class B stock was subject to redemption at par at any time and to any other restrictions and limitations the Board of Directors (as selected from the Class A stockholders) may by majority vote prescribe; (5) that there was no limitation upon the dividends which the Class A stockholders and directors may vote for themselves; and (6) that in the event of the default under the "Connection and Service Agreement", the interest of the Class B stockholder were subject to forfeiture without reimbursement. The court concluded that the only proprietary interest of the Class B stockholders was a right to a share of the capital assets upon liquidation, after Class A stockholders had been paid in full. Cmty. T.V. Ass'n of Havre, 203 F.Supp. at 274.

152. Id.

153. 322 F.2d 872 (9th Cir. 1963).

154. The ruling of the Tax Court turned on the issue of whether the membership fees paid to the corporation could be considered exempt from taxation either as contributions to capital pursuant to Section 118, or as money received in exchange for stock under Section 1032. However, upon the case reaching the circuit court, the corporation conceded that the membership fees were not contributions to capital. The corporation continued to argue in the circuit court that the tax court erred in failing to find that the fees were paid in exchange for stock and thus exempt under I.R.C. § 1032. Id.

155. The court's ruling relied on facts, including that the taxpayer petitioner, a non-profit corporation, operated a group of department stores that were for the exclusive use of its
The court accepted the definition of "stock" proposed by the plaintiff corporation to be "the interest or right which the owner, who is called the 'shareholder' or 'stockholder' has in the management of the corporation, and in its surplus profits, and, on a dissolution in all of its assets remaining after the payments of its debts." However, the court applied a form over substance analysis, noting that adherence to that definition was not alone determinative.

Relying on several factors, the court determined that the fees were paid merely as consideration for the right to use the corporation's facilities. The court rejected the argument that the motive of the individuals was irrelevant to the determination of whether the interests constituted stock. Rather, it was proper to consider all of the facts and circumstances relevant to the memberships, including the motives and expectations of the parties. Although the Ninth Circuit refused to classify the membership interests at issue in Affiliated as stock within the meaning of Section 1032, the court noted the limited nature of the holding, stating that memberships in non-stock corporations were not per se outside of the scope of Section 1032.

In University Country Club, Inc. v. Commissioner, the U.S. Tax Court placed similar emphasis on the intent of the shareholders. The court faced the issue of whether proceeds from a stock sale were properly

members and guests. The taxpayer's stores did not sell products to the general public, but rather restricted its sales and the use of its stores to its members and their guests. The corporation's bylaws provided for several different levels of membership, depending on whether the member worked for a particular employer or were invited to join at the invitation of the Board of Directors. The rights and obligations of the different membership classes varied over time, but ultimately, an individual's membership class informed his voting rights, ability to attend annual or special membership meetings, rights upon liquidation or dissolution of the corporation and obligation to pay the membership fee. Additionally, all memberships were nontransferable and nonassessable and any membership could be revoked by a two-thirds vote of corporation's Board of Directors "for any cause deemed sufficient" without refunding any amount paid. Additionally, any member could resign his membership and receive a refund for the paid membership fee. The corporation's bylaws were subsequently modified to provide that any refund of a membership fee (for any reason) was at the sole discretion of its board of directors. Id. at 877.

156. Id.
157. Id. See also Weiss v. Stearn, 265 U.S. 242, 254 (1924).
158. Affiliated Gov't Employees' Distrib. Co., 322 F.2d at 877.
159. Id.
160. Id.
161. Id.
162. 64 T.C. 460 (1975). The analysis for determining whether the proceeds from the sale of the stock were contributions to capital is similar to the one undertaken in determining whether a particular interest will be deemed stock within the meaning of Section 1032. Id.
classified as a contribution to capital and excluded from the taxpayer corporation's gross income, or whether such receipts represented a right to use the taxpayer corporation's facilities and therefore should constitute ordinary income.\textsuperscript{163}

The court looked to the "totality of the indicia of ownership" of the interests at issue in determining whether the payments made were indeed contributions to capital.\textsuperscript{164} The opinion focused on the limited rights imparted to the holders of the shares in question, as opposed to the extensive rights associated with another class of stock.\textsuperscript{165} The court concluded that the shares at issue did not represent an ownership interest in the organization, but rather merely provided for the privilege of using the corporation's facilities, and therefore the proceeds of the sales of the stock were to be treated as ordinary income to the taxpayer.\textsuperscript{166}

In a 1981 revenue ruling, the Service analyzed whether the receipt of water lines by a water company from a developer constituted "in exchange for stock" within the meaning of Section 1032.\textsuperscript{167} The Service looked closely at the issue of "whether the transferor received a significant proprietary or equity interest in the corporation as well as the transferor's

\textsuperscript{163} The court relied on the facts that the taxpayer corporation in the case was engaged in the construction, ownership, and operation of golf courses, swimming pools and other recreational facilities. The corporation authorized both no-par Class A stock and par value Class B stock. The Class A stock was issued to only a handful of individuals while a majority of the Class B stock were to be offered and sold to the general public, with the remaining shares to be held by the corporation for subsequent sale to future owners of residential lots planned for development. \textit{Id.}

\textsuperscript{164} \textit{Id.} at 472.

\textsuperscript{165} The court noted that (1) the shareholders had virtually no voice in the management of the corporation; (2) the Class B stock could not be transferred without the approval of a majority of the holders of Class A stock but no such restriction was imposed on Class A stock; (3) upon liquidation, the interest of the Class B shareholders could be diminished as a result of the lack of preemptive rights; (4) all of the corporate minutes of the meetings of the Board of Directors in evidence were signed by the directors elected by the Class A shareholders; none were signed by the director for the Class B shareholders; and (5) although there was no distinction between the classes of stock as to dividend rights, no dividends were actually declared or paid on the Class B stock. \textit{Id.}

\textsuperscript{166} See \textit{id.}

\textsuperscript{167} The relevant facts of the revenue ruling were that the taxpayer corporation, a water supply company, issued shares of its stock to a developer in exchange for the right to extend its water lines to a subdivision owned by the developer. The stock did not pay any dividends and attached irrevocably to the lots in the subdivision. The developer received one share of stock (with no accompanying dividend rights) for each lot that was to be served by the taxpayer corporation. Rev. Rul. 81-83, 1981-1 C.B. 434.
motive or intent for the transfer of the money or other property.168 The revenue ruling noted that the analysis was to be conducted through an examination of the rights accompanying the stock received, which revealed that the developer's interest in the water company was in exchange for the provision of water service to the subdivision, rather than a significant equity interest in the corporation.169

In a 1999 private letter ruling, the Service provided what is most likely the clearest guidance to date with respect to the definition of “money or other property in exchange for stock” under Section 1032.170 The issue under review was whether initiation fees received by the taxpayer corporation from incoming members qualified as amounts received in exchange for stock under Section 1032.171

Relying on previous rulings of courts and the Service, a two-prong test was articulated to determine the proper classification of the interest at issue.172 The analysis examined: “(1) whether the transferor received a significant proprietary or equity interest in the corporation; and (2) the transferor's motive or intent accompanying the transfer of the money or other property.”173

The first prong of the test—the presence of a significant proprietary or equity interest in the hands of the transferor—examined the rights accompanying the interests received and relied on the indicia of an equity


169. The ruling explained the scant rights associated with the stock, given that dividends were not available and that appreciation of the stock was a remote possibility, and given the peculiarity of the transaction. The Service ultimately concluded that the developer's intent was to convey the water lines to the taxpayer in order to obtain future water service for the development rather than to obtain an equity interest in the taxpayer. Rev. Rul. 81-83, 1981-1 C.B. 434.

170. See I.R.S. Priv. Ltr. Rul. 199952085, (Sept. 30, 1999). The ruling cannot be used or cited as precedent by any party other than the affected taxpayer, although the ruling does provide helpful guidance in articulating the applicable test for stock under Section 1032 and is therefore worthy of a detailed review. See also I.R.C. § 6110(k)(3) (2000).


172. See id.

173. See id. See also Affiliated Gov't Employees' Distrib. Co., 322 F.2d at 877; Rev. Rul. 81-83, 1981-1 C.B. 434.
interest. The second prong of the test—the transferor's motive or intent for the transfer—invoked the analysis that determined investment motive for shareholder contributions to the capital under Section 118. Three objective factors were identified as relevant in determining the presence of investment motive: (1) whether the fee paid by the transferors was earmarked for application to a capital acquisition or expenditure; (2) whether the transferors of the payment were the equity owners of the corporation and the payment increased the corporation's equity capital; and (3) whether the members were afforded the right to receive a profit from the investment.

Applying the test to the facts of the private letter ruling, the Service held that the interests at issue constituted a significant equity interest. The Service highlighted several factors as determinative, including that the interests provided voting rights with respect to certain matters that were equal to that of the other classes of equity interests and that no class of stock received dividends, so all classes were treated equally.

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174. See Priv. Ltr. Rul. 199952085, (Sept. 30, 1999). The ruling noted that the hallmarks of an equity interest were: (1) the right to vote and the resulting ability to exercise control over the corporation; (2) the right to participate in current earnings and accumulated profits of the corporation; and (3) the right to share in net assets upon the liquidation of the corporation. Several additional factors are relevant, including whether the payment was made as an investment in the capital of the corporation, rather than in consideration of goods or services, and whether the corporation's operating expenses were funded by sources other than the payment for the interest alone, i.e., initiation fees, annual dues from the members, or other operations of the taxpayer corporation. See also Paulsen v. Comm'r, 469 U.S. 131, 138 (1985); Himmel v. Comm'r, 338 F.2d 815, 817 (2d Cir. 1964).

175. See Priv. Ltr. Rul. 199952085, (Sept. 30, 1999). The ruling should not be surprising, given that courts and the Service typically address issues arising under Sections 1032 and 118 in similar fashion.

176. See id. See also Bd. of Trade of City of Chicago and Subsidiaries v. Comm'r, 106 T.C. 369 (1996) (holding that unrestricted transferability of membership interests is evidence that payers of transfer fees had the opportunity to profit from appreciation in their investment). Notably, there is an inference against the presence of an equity interest where there are limitations or restrictions on the holder's power to sell or transfer the interest. The inference is drawn from the well-accepted maxim that the ability to sell an interest in a corporation permits an equity holder to profit from any appreciation in the investment. Affiliated Gov't Employees' Distrib. Co. v. Comm'r, 37 T.C. 909, 918 (1962), aff'd, 322 F.2d 872 (9th Cir. 1963); Oakland Hills Country Club v. Comm'r, 74 T.C. 35 (1980) (denying taxpayer's motion for summary judgment on Section 118(a) issue where transferability of stock was restricted).


178. See id. The Service's ruling relied on additional factors, including: (1) because the affected members did have a right to share in the corporation's assets on liquidation, there was an ultimate right to the corporation's assets; (2) the affected members held the right to
As discussed above, "money or other property in exchange for stock" requires a transfer of an equity interest in the corporation and intent on the part of the transferor of property to hold an equity position in the corporation. The rule is consistent with the legislative policy underlying Section 1032, i.e., to encourage investment in newly formed business enterprises.\textsuperscript{179}

The requirements are also useful in determining whether equity derivatives should be subject to Section 1032; to the extent that a derivative constitutes an equity interest in the corporation, the instrument should be subject to the nonrecognition rule. Therefore the derivative should be analyzed to determine whether the substance of the transferred interest is equity in the corporation and whether there is intent on the part of the transferor to obtain an equity stake in the corporation.

For example, a physically settled forward contract likely constitutes "money or other property in exchange for stock" within the meaning of Section 1032. Upon settlement, the transferor will own shares in the corporation and, by virtue of the exercise, the required intent can be surmised. However, in the case of a cash settled forward contract, an equity stake in the corporation is not transferred to the holder of the contract (there is, instead, a transfer of cash or property other than the underlying property contemplated in the contract). Because there was never an agreement for an actual transfer of stock, the intent requirement is not met in such a case.

V. SECTION 1032 AND COMPENSATORY STOCK OPTIONS

The growth and availability of employee stock option programs over the past several decades in the United States has been significant. A recent study reported that approximately fourteen million American workers received stock options in 2002.180 This figure is consistent with other research indicating that the number of employees obtaining stock options increased from less than one million in the early 1990s to approximately ten million by 2001.181 Research also indicates that compensatory stock options are no longer limited to the domain of top executives; ninety three percent of stock options are held by the “middle class” and “working class.”182 Considering the expenditures made by employers to fund employee stock option plans, the tax consequences are a significant issue.

Employee stock option plans generally fall into one of two categories: “statutory” options, which are governed by Sections 421, 422, 423 and 424, and “nonstatutory” options, which are governed by Section 83.183

In order to be eligible for favorable tax treatment provided to statutory option plans, the options must qualify as either an incentive stock option (“ISO”) or as an employee stock purchase plan (“ESPP”).184 Under the Code, an ISO is “an option granted to an individual for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations.”185 Although an ISO may meet the technical requirements, there is an “opt out” opportunity available; an option will not be treated as an ISO if, at the time that the option is granted,

182. See Kruse et al., supra note 180.
184. Treas. Reg. § 1.421-1(b) (2004) (defining “statutory option” as an incentive stock option, under Section 1.422-2(a), or an option granted under an employee stock purchase plan, under Regulation 1.423-2).
185. See I.R.C. § 422 (2005) for the requirements to qualify as an ISO.
the terms of the option provide that it will not be treated as an ISO.\textsuperscript{186} There are certain additional administrative requirements in order for the plan to qualify as an ISO.\textsuperscript{187}

The second type of statutory plan is an ESPP, which provides employees with the opportunity to purchase stock of the employer, usually at a discounted price.\textsuperscript{188} ESPPs are usually intended for "rank and file employees," as opposed to ISOs, which are typically provided to key employees.\textsuperscript{189} In addition to the employee participation rules generally applicable to statutory options noted above, there are specific rules specifying which employees must be allowed to participate in an ESPP.\textsuperscript{190}

If the requirements of either the ISO or ESPP are met, the transfer of stock is not a taxable event to the employee; no income is received by an employee upon exercise of the option within the required time limits and any taxation is deferred until the stock is sold.\textsuperscript{191} In the event that stock acquired under a statutory stock option plan is disposed of before expiration of the applicable holding period, a disqualifying disposition of stock occurs,\textsuperscript{192} and special tax rules apply.\textsuperscript{193} The statutory stock option regime provides great benefit to recipients of such options since the options are not usually marketable, making it difficult for recipients to pay tax at the time of receipt.\textsuperscript{194}

\begin{thebibliography}{9}
\bibitem{187} See Treas. Reg. § 1.422-2 (2004) for the additional administrative requirements.
\bibitem{188} See I.R.C. § 423(b) (2005) for the requirements of ESPPs. \textit{See also} Johanson, \textit{supra} note 183.
\bibitem{189} \textit{See} Johanson, \textit{supra} note 183.
\bibitem{190} See I.R.C.§ 423(b)(4) (2000) (providing rules regarding employee participation in ESPPs). \textit{See also} Vizcaino v. Microsoft Corp., 97 F.3d 1187 (9th Cir. 1996), (en banc), \textit{rev'd and remanded} 120 F.3d 1006 (9th Cir. 1997) (discussing the eligibility of common-law employees, temporary employees, and independent contractors, as well as employees whose employment status has been reclassified by the employer in an employer's ESPP).
\bibitem{191} I.R.C. § 421(a) (2004).
\bibitem{192} A disqualifying disposition occurs if the stock is disposed of prior to the expiration of the applicable holding period. I.R.C. § 421(b) (2004). \textit{See} Treas. Reg. § 1.424(c) (2004) (defining a "disposition" of stock).
\end{thebibliography}
From the perspective of the issuing corporation, under a statutory stock option plan, no deduction for the value of the option is allowed and only the amount paid for the option will be considered as received by the corporation. A statutory option plan does provide other, non-financial benefits, such as allowing a company "to attract and keep talent without draining cash flow by paying higher salaries." Additionally, although Section 421 places a limitation on the amount deemed to be received by the corporation to the amount paid for the option, nonrecognition treatment under Section 1032 is available. The applicability of Section 1032 to a corporation's grant of statutory stock options is well accepted by the courts, although nonrecognition is allowed only to the extent available under Section 1032. To the extent that the transaction does not meet the requirements of Section 1032, the corporation will realize gain equal to the amount paid for the option.

In the event that any requirement of a statutory stock option (other than the applicable holding period rules) is not met, the stock option is treated as a nonstatutory option under Section 83 of the Code. In general, Section 83 provides rules for the taxation of stock or other property that is transferred to an employee or independent contractor in connection with the performance of services.

Although the discussion in this paper with regard to Section 83 will be limited to the transfer of stock and stock options, Section 83 is applicable

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195. I.R.C. §§ 421(a)(2) and (3) (2004).
196. Johanson, supra note 183.
198. See Divine v. Comm'r, 500 F.2d 1041 (2d Cir. 1974). See also Luckman v. Comm'r, 418 F.2d 381, 385-86 (7th Cir. 1969).
199. I.R.C. § 421(a)(2) (2004). See Divine, 500 F.2d at 1054 (holding that because Section 1032 was not applicable to the transaction at issue, the Section 421(a)(3) limitation on amount realized by the issuing corporation was controlling).
200. I.R.C. § 83(e)(1) (2005); Treas. Reg. § 1.422-1(c) (2004). Section 83 also does not apply to the transfer of the following property: (1) a transfer to or from a qualified pension, profit-sharing, or stock bonus trust (described in I.R.C. § 401(a)); (2) a transfer under an annuity plan that is qualified under I.R.C. § 404(a)(2); (3) the transfer of an option with no readily ascertainable fair market value; (4) the transfer of property upon the exercise of an option where the option had a readily ascertainable fair market value at the date it was granted; and (5) group-term life insurance to which I.R.C. § 79 applies.
to a broad range of property. The regulations provide that the grant of an option to purchase certain property does not itself constitute a transfer of such property; although as discussed below, the grant of the option itself may be subject to Section 83.

The recipient of restricted property is required to include the fair market value of such property less the amount paid for the property (if any) in his gross income in the first taxable year in which the rights to the property are transferable or the property is no longer subject to a substantial risk of forfeiture. A recipient of restricted property will not be taxed on the value of the property until the restriction is removed. The recipient’s basis in the property is equal to the property’s fair market value at the time of exercise.

Subject to certain administrative requirements, the recipient can elect to have the excess of the fair market value over his cost for the property as of the date of transfer included in his income in the tax year of the transfer,

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202. "Property" includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future, and a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor. Treas. Reg. § 1.83-3(e) (as amended in 2005).


205. The fair market value of the property is determined without regard to any restriction other than a restriction which by its terms will never lapse. I.R.C. § 83(a)(1) (2004).

206. Under the Code, property is subject to a substantial risk of forfeiture if "such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual." In general, the existence of a substantial risk of forfeiture is dependent upon the facts and circumstances, and will be deemed to exist where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person. I.R.C. § 83(a) (2004). See also Schulman v Comm'r, 93 T.C. 623 (1989) (holding that transferability to any person other than transferor means transferability to at least one possible transferee other than the original transferor). The regulations point to relevant facts, such as the regularity of the performance of services and the time spent in performing such services, and whether the person performing services has the right to decline to perform such services without forfeiture. Treas. Reg. §1.83-3(c)(1) (as amended in 2005). See also Robinson v. Comm'r, 805 F.2d 38 (1st Cir. 1986) (resorting to "logic and common sense" to determine whether a substantial risk of forfeiture existed); Montelepre Systemed, Inc. v Comm'r, 956 F.2d 496 (5th Cir. 1992) (holding that property is subject to substantial risk of forfeiture when a corporation is required to perform substantial services under contract in order to retain its right of first refusal).


even though the property remains substantially nonvested. Once the property becomes substantially vested, compensation (ordinary) income will not be includible in gross income. Rather, the property will be treated as a capital asset.

From the perspective of an issuing corporation, a deduction may be claimed in an amount equal to the amount included in the gross income of the recipient of the property. The deduction is allowed in the tax year in which the transferee is required to include the amount in income. Section 1032’s nonrecognition treatment is as equally applicable to a corporation’s transfer of stock or stock options under Section 83 as to any other transfer of property or money in exchange for stock of the corporation.

As noted above, the receipt of services in exchange for stock will result in nonrecognition treatment for the issuing corporation and the regulations under Section 83 confirm such treatment will apply to the transferor corporation. The rule is logical in that economically

209. I.R.C. §83(b) (2004). Among other requirements, the election must be made no later than 30 days after the property is transferred. Treas. Reg. §1.83-2(b) (as amended in 2003). In order to effectuate the election, the recipient must file two copies of a written statement (incorporating certain required information) with the IRS Service Center where the taxpayer files his return; one at the time of the election and one with the tax return for the tax year in which the property was transferred. Treas. Reg. 1.83-2(e) (as amended in 2003). The recipient must provide a copy of the written statement to the person for whom the services were performed. Treas. Reg. § 1.83-2(d) (as amended in 2003).


211. See Judith E. Alden & Murray S. Akresh, Using Equity to Compensate Executives, in EXECUTIVE COMPENSATION 67, 83 (Yale D. Tauber & Donald R. Levy eds., 2002) (explaining that a Section 83(b) election leads to treatment of restricted stock as a capital asset). The significant advantages in making the election include: (1) that appreciation of the property subsequent to the date of transfer will be taxed at capital gains rates, as opposed to ordinary income rates; and (2) that the recipient retains ultimate control over the timing of a subsequent disposition and income inclusion. Two notable disadvantages of making the election are that election will trigger immediate taxation of the value transferred and any tax paid as a result of the election cannot be recovered if the stock fails to vest. See also David I. Walker, Is Equity Compensation Tax Advantaged? 84 B. U. L. REv. 695, 702-03 (2004).

212. I.R.C. § 83(h) (2004); Treas. Reg. § 1.83-6(a) (as amended in 2003). The amount of the deduction allowed is determined under either I.R.C. § 162 or I.R.C. § 212. There is no requirement on the part of the employers to deduct and withhold income tax in order to claim the deduction. See also T.D. 8599, 1995-2 C.B. 12.


216. "Except as provided in section 1032, at the time of a transfer of property in connection with the performance of services the transferor recognizes gain to the extent that
equivalent transactions are treated in a consistent manner; a corporation could have sold its stock for cash, received nonrecognition treatment under Section 1032, and thereafter distributed the proceeds to employees as compensation. Application of Section 1032 allows the corporation to attain nonrecognition treatment without the unnecessary step of a disposition of stock to a third party. The Service has supported this position with regard to a corporation's distribution of treasury stock to its employees as compensation for services, as well as to the distribution of previously authorized but unissued stock. To this end, the Service has held that "the nonrecognition of gain or loss provisions of Section 1032(a) of the Code ha[s] no effect upon a business expense deduction that is otherwise allowable under Section 162(a) of the Code."221

As noted above, the grant of a stock option may be subject to Section 83. In determining the tax treatment of a stock option, an essential issue is whether the option has a readily ascertainable fair market value at the time of the grant. If the option has a readily ascertainable value at the time of the

the transferor receives an amount that exceeds the transferor's basis in the property. In addition, at the time a deduction is allowed under section 83(h) and paragraph (a) of this section, gain or loss is recognized to the extent of the difference between (1) the sum of the amount paid plus the amount allowed as a deduction under section 83(h), and (2) the sum of the taxpayer's basis in the property plus any amount recognized pursuant to the previous sentence." Treas. Reg. § 1.83-6(b) (as amended in 2003).

217. See Utz, supra note 54.

218. See id.

219. See Rev. Rul. 62-217, 1962-2 C.B. 59. See also PLR 200449001 (ruling that Section 1032 does not prevent a corporation from taking a deduction for an otherwise deductible expense that the corporation pays with its own stock, even if the stock is transferred in a section 1032 exchange).

220. A corporation, upon the distribution of shares of its previously authorized but unissued stock to its employees as compensation for services rendered, would not recognize gain or loss by reason of the distribution of the stock under Section 1032(a), and the fair market value of the stock on the date of the distribution is deductible by the corporation. See Rev. Rul. 69-75, 1969-1 C.B. 52.


223. See id. An option will be deemed to have a readily ascertainable value if the option is actively traded on an established market. Treas. Reg. § 1.83-7(b)(1) (as amended in 2004). If an option is not actively traded on an established securities market, it will be considered to have a readily ascertainable value if certain conditions are met. Treas. Reg. §1.83-7(b)(2) (as amended in 2004). Relevant conditions include whether: (1) the option is freely transferable by the recipient; (2) the option is immediately exercisable in full by the recipient; (3) the option or the property that is subject to the option is not subject to any condition or restriction that has a significant effect upon its fair market value (this does not
grant, the recipient will recognize compensation (ordinary income) upon such grant and any future appreciation will be treated as capital gains.\textsuperscript{224} The employer will receive the benefit of an immediate deduction.\textsuperscript{225}

There is an open issue as to the proper applicability of Section 1032 nonrecognition treatment to such a transfer. On one hand, given that the employer will realize the benefit of a current deduction for the compensation payment,\textsuperscript{226} the deduction may result in a deemed disposition of the property, causing an immediate gain to the employer less any basis the employer had in the option.\textsuperscript{227} If this scenario is followed, nonrecognition treatment is unavailable because the “property” transferred by the corporation is an option on the employer's stock, rather than stock, as required by Section 1032.\textsuperscript{228}

On the other hand, if the employer is treated as the writer of a call option to the employee, the employer will not recognize any immediate gain or loss on its receipt of the option premium (the provision of the services by the employee.)\textsuperscript{229} Rather, the employer is allowed to “wait and see” in order to determine whether gain or loss will be recognized.\textsuperscript{230} In the event that the employee exercises the option, the option premium is deemed to be an additional amount realized by the corporation.\textsuperscript{231} Treatment of the transaction in this manner converts the option transaction into a sale of the stock itself and Section 1032 will shield the employer from gain recognition.\textsuperscript{232}

The possibility for inconsistent tax consequences in such transactions raises a significant concern. Taxpayers are subject to uncertain application of Section 1032 depending on whether the corporation's deduction is deemed to cause a disqualifying distribution (nonrecognition is unavailable) or the employer is treated as the writer of a call option to the employee (nonrecognition is available.) To remedy this uncertainty, a proposal has been put forward that would require the employer to deduct

\begin{itemize}
\item include liens or other conditions to secure payment of the purchase price; and
\item the fair market value of the option privilege is readily ascertainable.
\end{itemize}

\textsuperscript{224} Treas. Reg. § 1.83-7(a) (as amended in 2004).
\textsuperscript{225} I.R.C. § 83(h) (2004).
\textsuperscript{226} See id.
\textsuperscript{227} Treas. Reg. § 1.83-6(b) (as amended in 2003).
\textsuperscript{228} I.R.C. § 1032(a) (2000).
\textsuperscript{232} I.R.C. § 1032(a) (2000).
the value of the stock option in the year of issue or vesting, with no further tax consequences to the corporation.\textsuperscript{233}

If the option does not have a readily ascertainable fair market value at the time of grant, the recipient will have compensation (ordinary income) at the time of exercise.\textsuperscript{234} The employer will receive the benefit of a deduction in the year that the option is exercised or disposed of,\textsuperscript{235} and nonrecognition treatment will be provided to the corporation pursuant to Section 1032.\textsuperscript{236}

As discussed above, under regulations enacted in 2000, the scope of Section 1032 was significantly expanded to provide nonrecognition treatment to a subsidiary’s use of parent stock (or options) to pay compensation.\textsuperscript{237} Prior to enactment of the regulations, such transactions might have resulted in gain recognition for the subsidiary because they were not specifically covered by Section 1032.\textsuperscript{238}

As a result of the gap, Section 83 applied to the transaction and the employer was treated as if it had sold the property for its fair market value by virtue of using it to pay compensation.\textsuperscript{239} The employer would recognize gain or loss equal to the difference between the amount of the deduction allowed and its basis in the property, plus any amount paid by the employee.\textsuperscript{240} The subsidiary’s exposure for gain recognition was significant because the subsidiary received the stock as a capital contribution from the parent corporation and therefore took a carryover (zero) basis in the stock.\textsuperscript{241} This is the so-called “zero basis” problem.\textsuperscript{242}

\textsuperscript{233} See Warren, supra note 20. Section VI of this paper provides a description of the proposal.

\textsuperscript{234} See id. If the option is sold (or otherwise disposed of) in an arm’s-length transaction, Section 83 applies to the transfer of money or other property received in the transaction in the same manner as it would have applied to the transfer of property pursuant to the exercise of the option. However, the arm’s-length rule does not apply to a sale or other disposition of an option to a person related to the service provider that occurs on or after July 2, 2003.

\textsuperscript{235} I.R.C. § 83(h) (2004).

\textsuperscript{236} I.R.C. § 1032(a) (2000).

\textsuperscript{237} Treas. Reg. § 1.1032-3 (as amended in 2000). The applicable regulations also apply generally to one corporation using the stock of another corporation to acquire stock or property or pay compensation for services performed. The regulations were eventually adopted in final form. T.D. 8883, 2000-1 C.B. 1151.

\textsuperscript{238} See Jasper L. Cummings, Jr., Using Compensatory NQSOs and Restricted Stock with Section 355—New, Clear Guidance from IRS, 96 J. TAX'N 71, 73 (2002).

\textsuperscript{239} Treas. Reg. § 1.1001-2(a)(1) (as amended in 1980).

\textsuperscript{240} Treas. Reg. § 1.83-6(b) (as amended in 2003).

\textsuperscript{241} I.R.C. § 362(a) (2000). See Cummings, supra note 238. Significant gain might also result from value fluctuations occurring between the time that the stock was purchased from
The Service provided limited relief against a subsidiary recognizing such gain or loss on a transfer from a majority shareholder of a corporation to an employee of the corporation.\textsuperscript{243}

The regulations enacted under Section 1032 codified the rule that no gain or loss will be recognized on the disposition of an issuing corporation's stock by a subsidiary.\textsuperscript{244} Under the regulations, the transaction is treated as if the subsidiary purchased the parent's stock for fair market value with cash contributed by the parent, allowing the subsidiary to obtain a carryover basis from the issuing corporation\textsuperscript{245} in the parent's stock as of the moment when the subsidiary transfers the stock to an employee.\textsuperscript{246} As a result, the subsidiary will avoid gain or loss recognition on the use of the parent stock (or options on the parent's stock\textsuperscript{247}) in transactions that will be taxable to the recipient of the stock.\textsuperscript{248} The regulations significantly expanded the scope of Section 1032 by providing nonrecognition to transactions that do not even involve a corporation's own stock.

Nonrecognition treatment is provided if four requirements are met: (1) the subsidiary acquires the stock directly or indirectly from the parent in a transaction in which the basis of the stock of the parent in the hands of the parent would be determined, in whole or in part, with respect to the parent's basis in the stock;\textsuperscript{249} (2) the subsidiary immediately transfers the stock to the employee as compensation for services; (3) the subsidiary does

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\textsuperscript{243} Cummings, \textit{supra} note 238.

\textsuperscript{244} See Rev. Rul. 80-76, 1980-1 C.B. 15.

\textsuperscript{245} Note that the "zero basis" regulations apply more generally where the "acquiring corporation" uses stock of another corporation as consideration for an "exchange," including a transfer of stock for services. The acquiring corporation is treated as "purchasing" the stock of the issuing corporation for fair market value with cash contributed to the acquiring entity by the issuing corporation. Treas. Reg. § 1.1032-3(b) (as amended in 2000).

\textsuperscript{246} Treas. Reg. § 1.1032-3(c)(1) (as amended in 2000); see also I.R.C. §§ 358, 722 (2000).

\textsuperscript{247} Treas. Reg. §1.1032-3(d) extended the application of the nonrecognition treatment to a corporation's options to buy or sell its own stock. Treas. Reg. §1.1032-3(d) (as amended in 2000).

\textsuperscript{248} Treas. Reg. § 1.1032-3(b) (as amended in 2000).

\textsuperscript{249} I.R.C. §§ 362(a), 723 (2000).
not receive a substituted basis in the stock of the parent;\textsuperscript{250} and (4) the parent’s stock is not exchanged for stock of the parent.\textsuperscript{251}

Under a subsequent revenue ruling, the Service addressed an issue not covered by the “zero basis” regulations: whether a lapse of time between the deemed cash purchase and the actual transfer of the shares would result in adverse tax consequences.\textsuperscript{252} In the ruling, the Service held that neither party in a spin-off transaction recognized gain or loss when either the vesting restrictions lapsed on employee-held restricted stock, or upon exercise of compensatory stock options that were distributed to employees in connection with the spin-off.\textsuperscript{253}

Although the ruling dealt with a particular spin-off transaction, it further expanded the scope of the “zero basis” regulations by holding that a lapse of time between the deemed cash purchase by the subsidiary and the actual transfer of the shares to the employee does not affect the applicability of Section 1032.\textsuperscript{254} The transaction is treated as if the subsequent vesting and exercise occurred on the date of original grant, when there would have been no zero basis concern.\textsuperscript{255}

Considering the intent underlying the zero basis regulations and Section 1032 in its entirety, the holding is logical; the ruling adheres to the constructs of the regulations by avoiding the creation of income simply because there is a period of time between the date of grant and the date of lapse or issuance following a spin-off.\textsuperscript{256} A commentator noted that the decision “provides a welcome clarification of the rule in related situations that a corporate taxpayer will not be in jeopardy of accidentally triggering gain from transactions involving stock of its parent corporation.”\textsuperscript{257}

\textsuperscript{250} I.R.C § 7701(a)(42) (2005).
\textsuperscript{251} Treas. Reg. § 1.1032-3(c) (as amended in 2000).
\textsuperscript{253} See Rev. Rul. 2002-1, 2002-1 C.B. 268.
\textsuperscript{254} See id.
\textsuperscript{255} See Rizzi, supra note 252, at 48.
\textsuperscript{256} See id.
\textsuperscript{257} Id. at 45.
VI. THE NEED TO REVISIT NONRECOGNITION TREATMENT UNDER SECTION 1032

Aggressive tax planning among high-income individuals and corporations through the use of equity derivatives results in the collection of less tax revenue, creating an inefficient and unfair tax system.\textsuperscript{258} Wealthy investors use derivatives to reduce the tax burden on their investments, although such strategies are not available to less sophisticated taxpayers.\textsuperscript{259} This reality is at least partially due to the fact that the current version of Section 1032 is not equipped to deal with modern equity derivatives.\textsuperscript{260} To that end, certain transactions clearly fall either within or outside the scope of Section 1032. Equity derivatives, which may be the economic equivalent of transactions that are within the scope of Section 1032, are utilized to game the system; invoking Section 1032 when losses are realized and claiming that the transaction falls outside of Section 1032 when there are realized gains.\textsuperscript{261}

Several recent commentaries sought to address these issues by proposing modifications to Section 1032 that would, in theory, cause equity derivatives to be treated in a manner that is consistent with economically equivalent transactions.\textsuperscript{262} The common theme of the commentaries is that the current incarnation of Section 1032 does not adequately address equity derivatives and that a change to the provision is required.\textsuperscript{263} The sentiment is echoed in comments made by Eric Solomon\textsuperscript{264} with regard to Section 1032, that "the potential for whipsaw if clear. . . . The situation is unstable and action is necessary."\textsuperscript{265}

\textsuperscript{258} See Schizer, supra note 105.
\textsuperscript{259} See id.
\textsuperscript{260} See Jeff Strnad, Taxing New Financial Products: A Conceptual Framework, 46 STAN. L. REV. 569, 569 (1994) ("The tax law has struggled to keep up with the development of new financial instruments. . . . Unfortunately, the lack of a uniform theory . . . has led to rules that are often haphazard, incomplete, and inconsistent.").
\textsuperscript{261} See id.
\textsuperscript{262} See Warren, supra note 20; see also Deconstructing Code Sec. 1032, supra note 22; Scarborough, supra note 11.
\textsuperscript{263} See Deconstructing Code Sec. 1032, supra note 22.
\textsuperscript{264} Eric Solomon is, as of April 2006, the Department of the Treasury's Deputy Assistant Secretary for Regulatory Affairs in the Office of Tax Policy. United States Dept. of Treasury, Treasury Officials, at http://www.ustreas.gov/organization/bios/solomon-e.html.
An essential element of tax law is that economically equivalent transactions are to be treated in a similar manner.\textsuperscript{266} The policy goal is realized through consistency and symmetry in the letter and the application of the tax code.\textsuperscript{267} Consistency will ensure that all economically comparable transactions are taxed the same way, notwithstanding the form that the taxpayer chooses.\textsuperscript{268} Absent consistency, taxpayers may structure investments that otherwise do not make economic sense, resulting in waste and inequity in the application of the tax laws.\textsuperscript{269}

Symmetry—requiring that both sides of a transaction are taxed under the same timing rule and rate—is equally essential to the tax system.\textsuperscript{270} Symmetry makes tax collection efforts easier because the government does not collect or lose any revenue when both sides to a transaction offset each other; the government’s share of gains perfectly cancels out its share of losses, leaving net revenue of zero.\textsuperscript{271} In addition, symmetry provides for equivalent treatment by requiring that any tax advantage to one side of a transaction is matched by an offsetting tax cost to the other side.\textsuperscript{272}

As a result of the lack of consistency and symmetry with respect to the taxation of equity derivatives, a corporation may utilize a “wait and see” attitude, and, depending on the result, can either shield itself from gain recognition pursuant to Section 1032 or structure the transaction so that it falls outside Section 1032, allowing the corporation to recognize a loss.\textsuperscript{273} It has been pointed out that even if the scope of Section 1032 was clear, the current system allows for electivity; a corporation can choose in advance to

\begin{footnotes}
\item[266] See Schizer, \textit{supra} note 105.
\item[267] See id.
\item[269] See Schizer, \textit{supra} note 105.
\item[271] See Schizer, \textit{supra} note 105.
\item[272] See \textit{id.}
\item[273] See \textit{Deconstructing Code Sec. 1032, supra} note 22.
\end{footnotes}
have gains be within Section 1032 or losses fall outside the nonrecognition framework.\textsuperscript{274}

For example, consider a situation where a corporation lends money and the amount to be repaid to the corporation at maturity is dependent in part on the value of the corporation's stock at that time.\textsuperscript{275} In a case where the corporation receives back an amount at least equal to the loan, the transaction is the economic equivalent of a loan with a fixed principal amount combined with a purchase of a cash settled call option by the corporation.\textsuperscript{276} There is an open question as to the proper tax treatment of the transaction: whether the bifurcated view of the transaction should be taken into account, allowing for nonrecognition of any amount received by the corporation that reflects an appreciation of the stock.\textsuperscript{277}

Several responses to remedy the argued uncertainty and inconsistency have been proposed, including: (1) further amendment to Section 1032, extending nonrecognition treatment to non-option transaction that produce equivalent results to option transactions; (2) a repeal of the 1984 Amendment to Section 1032, which extended nonrecognition status to the lapse or acquisition of an option by a corporation; (3) a targeted approach, addressing forward contracts and equity swaps; (4) required integration of a corporation's offsetting position in an effort to prevent excess deductions or incomes; and (5) modification of the current tax treatment of nonstatutory employee stock options.\textsuperscript{278}

The most logical proposal is an extension of Section 1032 to provide nonrecognition treatment to non-option transactions that produce tax results that are equivalent to option transactions. This proposal is strongly supported by at least one commentator\textsuperscript{279} and the New York State Bar Association's Tax Section (hereinafter "Bar Association").\textsuperscript{280} Under the proposal put forward by the Bar Association, nonrecognition treatment would be afforded for derivatives issued or purchased by a corporation to the extent that they reference changes in the value of the corporation's stock or distributions on the corporation's stock.\textsuperscript{281} The Bar Association's

\begin{itemize}
  \item \textsuperscript{274} See id.
  \item \textsuperscript{275} Exploring the Boundaries of Section 1032, supra note 81, at 556.
  \item \textsuperscript{276} Id.
  \item \textsuperscript{277} See id.
  \item \textsuperscript{278} See Warren, supra note 20.
  \item \textsuperscript{279} See Deconstructing Code Sec. 1032, supra note 22; Exploring the Boundaries of Section 1032, supra note 81, at 564.
  \item \textsuperscript{280} See Warren, supra note 20.
  \item \textsuperscript{281} See Bolonga, supra note 265.
\end{itemize}
proposal requires a corporation to recognize taxable gain with respect to any transaction in which: (1) a corporation acquires its own stock; (2) the corporation enters into a contract to sell its own stock on a substantially contemporaneous basis; and (3) substantially all the corporation's expected return in respect of the transaction is attributable to the time value of its net investment—a "cash-and-carry" transaction.\(^\text{282}\)

Further extension of Section 1032 nonrecognition has over seventy years of historical support.\(^\text{283}\) For example, as enacted in 1954, Section 1032 expanded the scope of nonrecognition beyond those transactions that were covered by the pre-1934 regulations and rulings; applying such treatment not only to a corporation’s transactions involving newly issued stock (as was previously provided), but also to transactions involving treasury stock.\(^\text{284}\) In addition, under the regulations promulgated shortly after the enactment of Section 1032, services were included within the nonrecognition framework, ensuring consistent tax treatment to economically equivalent transactions, i.e., providing the same tax treatment to a corporation’s sale of its shares for cash and subsequent transfer of the cash to the service provider as to a direct transfer of the shares to the service provider.\(^\text{285}\)

Under the 1984 Amendment to Section 1032, Congress further expanded the scope of the provision to address almost all situations that may arise where a corporation experiences gain or loss due to price changes in its stock.\(^\text{286}\) As noted in the legislative history, the amendment was enacted for the specific reason of applying consistent tax treatment to economically equivalent transactions, i.e., providing the same tax consequences to a corporation’s repurchase of a warrant as to the holder’s exercise of a warrant, followed by the issuing corporation’s repurchase of

\(^{282}\) See id.

\(^{283}\) See Deconstructing Code Sec. 1032, supra note 22.


\(^{286}\) See Deconstructing Code Sec. 1032, supra note 22.
the newly issued stock.\textsuperscript{287} As noted by a commentator, Congress "expressly chose to eliminate inconsistencies in section 1032 through broadening . . . that section."\textsuperscript{288}

The intent to address the tax treatment of economically equivalent transactions through expansion of Section 1032 is further evidenced by the enactment of the zero basis regulations. As discussed above, the regulations do not even require that the transaction involve the corporation’s own stock; nonrecognition treatment is provided to certain transactions where a corporation is dealing in the stock of another corporation.\textsuperscript{289} The regulations deem such transactions to be the economic equivalent of the acquiring corporation purchasing the stock of the issuing corporation for fair market value with cash contributed by the issuing corporation.\textsuperscript{290}

Section 1032’s inability to appropriately address transactions involving equity derivatives is a byproduct of Congress’s tendency to formulate incremental and piecemeal modifications to the corporate tax regime—it is not the byproduct of any concerted effort to specifically exclude such transactions from the Section 1032 framework.\textsuperscript{291} The historical development of Section 1032 indicates that Congress intended nonrecognition treatment to apply beyond the limited circumstances where a corporation engages in sales or purchases of its stock for fair market value; such an interpretation is not contemplated in any of the legislative enactments or administrative rulings related to Section 1032.\textsuperscript{292} Therefore, consistent tax treatment will result only where all economically equivalent transactions are provided nonrecognition treatment under Section 1032. This requires a broadening of Section 1032 to include all economically equivalent transactions within the regime.

Critics claim that expanding Section 1032 might result in increased complexity in the tax system because of the need to bifurcate certain financial instruments that derive their value in part from the value of the issuers stock, such as a contingent debt instrument or an equity swap.\textsuperscript{293} Complexity may arise because unless there is a unique bifurcation of any given instrument, different bifurcations will produce different tax

\textsuperscript{288} Exploring the Boundaries of Section 1032, supra note 81, at 564.
\textsuperscript{289} See T.D. 8883, 2000-1 C.B. 1151.
\textsuperscript{290} See id.
\textsuperscript{291} See Rands, supra note 6, at 41-42.
\textsuperscript{292} See Exploring the Boundaries of Section 1032, supra note 81, at 565.
\textsuperscript{293} See Warren, supra note 20.
consequences. Additionally, as long as the tax treatment of the discrete parts of the instrument is inconsistent, discontinuities will result following such bifurcation.

In order to address this issue, an "all-or-nothing" rule has been proposed, whereby application of Section 1032 would depend on the source of payments under an instrument; Section 1032 would apply only if the payments due under an instrument were based predominantly on the value of the stock of the issuer. However, application of this rule might lead to inconsistent treatment of similar instruments based upon the difficulty with providing a workable definition of "predominately." It is also noteworthy that the Service's attempt at a similar rule in the context of debt/equity classification did not work.

Despite these issues, an expansion of Section 1032 would go a long way in reducing the "wait and see" problem discussed above, assuming that the amendment to Section 1032 is written in a broad enough manner to provide nonrecognition treatment for any taxable gain or loss resulting from any transaction that arises from changes in value of the corporation's stock.

A second proposal to address the inconsistent treatment afforded by Section 1032 contemplates a repeal of the 1984 Amendment that provided nonrecognition treatment with respect to any lapse or acquisition of an option to buy or sell its stock. The proposal is grounded in the anti-deferral function of the corporate income tax, i.e., the corporate income tax requires current recognition of realized income that would otherwise be deferred until a shareholder receives a dividend or sells the stock. It is argued that absent the imposition of a corporate-level tax, shareholders' taxable income would not accurately reflect income realized for their benefit through the equity stake in the corporation.

295. See id.
296. Exploring the Boundaries of Section 1032, supra note 81, at 565-66.
297. Id.
298. Id at 566.
299. See id.
300. See Warren, supra note 20.
301. See id; see also Anthony P. Polito, supra note 129, at 768-71 (discussing the anti-deferral function of the corporate income tax).
302. See Warren, supra note 20.
Bearing the anti-deferral function in mind, the proposal would provide symmetry to at least one example cited by a commentator: a transaction where there is no recognized gain to a corporation with respect to an option premium received from a lapsed option, even though the holder of the lapsed option is entitled to an immediate deduction.\footnote{303. See id. Looking to the anti-deferral function of the corporate income tax, it is noted that the shareholders of the corporation are enriched though the corporation’s unrecognized gain of the option premium. Gain recognition is deferral until sale or other disposition of the corporation’s stock by the shareholders. See I.R.C. § 1032(a) (2000); I.R.C. § 162(a) (2005).}

However, it is noted that nonrecognition treatment would still be afforded when options are physically settled, so a further modification to Section 1032 is proposed whereby a corporation would recognize gains or losses in dealings in its own stock, unless the corporation is purchasing or selling its stock for fair market value.\footnote{304. See Warren, supra note 20. This transaction would have the same result as described in infra note 348; shareholders of the corporation are enriched though the corporation’s nonrecognized gain of the option premium. Gain recognition is deferral until sale or other disposition of the corporation’s stock by the shareholders.} It is argued that nonrecognition treatment is properly limited in this manner, because in such a transaction there is no resulting economic impact to the shareholders.\footnote{305. See Warren, supra note 20. See also Rands, supra note 6, at 52; Honabach, supra note 8, at 7.}

It is asserted that current law does not provide consistent tax treatment when there is a repurchase of a corporation’s own stock at a discount or a premium, because such a transaction increases or decreases the net worth of shareholders, and gain or loss recognition by the corporation should be required.\footnote{306. See Warren, supra note 20. See also U.S. v. Kirby Lumber Co., 284 U.S. 1 (1931).} Inconsistent tax treatment results because shareholders of the corporation experience gain deferral through the nonrecognition treatment afforded to the corporation, even though the party on the other side of the transaction has to immediately recognize gain or losses.\footnote{307. See Warren, supra note 20. See also Deconstructing Code Sec. 1032, supra note 22.}

There are several potential issues with the proposal, including the legislative and administrative enactments related to Section 1032 discussed above, which express the intent to cast a wide net with regard to gain and loss nonrecognition.\footnote{308. See Deconstructing Code Sec. 1032, supra note 22.} It has been argued that the 1984 Amendment was actually intended to narrow the scope of Section 1032 by seeking to address uncertainty with respect to the provision, rather than meaning to significantly expand the rule.\footnote{309. See Exploring the Boundaries of Section 1032, supra note 81, at 558.}

However, in consideration of the
subsequent zero basis regulations, as well as the legislative initiatives to deal with forward contracts and to clarify and broaden the applicability of Section 1032, it is not likely that there was any Congressional intent to limit the scope of Section 1032.\textsuperscript{310}

Another proposal contemplates a middle-of-the-road approach that targets specific equity derivatives, rather than a sweeping modification of Section 1032.\textsuperscript{311} The proposal focuses on imbalances, rather than inconsistencies, in the current system.\textsuperscript{312} A rule is suggested that for specific instruments, the gain-loss ratio must be one: if gains are not taxable, losses must not be deductible.\textsuperscript{313} To this end, it is proposed that Section 1032 be modified to specifically address the uncertainty concerning the treatment of equity swaps and forward contracts.\textsuperscript{314} The proponent believes that once the rules regarding these instruments are modified, “risk-based arbitrages become much less likely since market uncertainty, reinforced by the securities law, serves as an important constraint on tax planning.”\textsuperscript{315}

Despite the fact that the proposal would address the inequitable treatment of derivatives, it does not go far enough, and continues the piecemeal approach that created the situation faced today. Rather than perpetuating this short-step trend, it makes sense to amend Section 1032 in a manner that is forward-looking, and will limit the ingenuity of investment bankers.

Another proposed response involves the identification of offsetting positions and the required integrated treatment of such positions.\textsuperscript{316} This approach has already been taken with respect to other Code provisions.\textsuperscript{317} However, the identification of offsetting positions may prove difficult and reliance on the mechanism would be unworkable, given that corporations are likely to manipulate their positions so that they were not “offsetting”

\textsuperscript{310} See Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal, supra note 68; Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal, supra note 68.
\textsuperscript{311} See Schizer, supra note 105, at 1934.
\textsuperscript{312} See id.
\textsuperscript{313} See id.
\textsuperscript{314} See id.
\textsuperscript{315} Section 1032 should not allow a corporation to earn what is, in effect, tax-free interest income through a combination of a purchase of its own stock simultaneous with the purchase of a put and sale of a call. See id. at 1935.
\textsuperscript{316} See Warren, supra note 20.
within the meaning of the Code.\textsuperscript{318} As noted by one commentator, "without consensus about the fundamental unit into which components are to be aggregated and a clearer ability to identify all offsetting positions, complete integration . . . is not feasible."\textsuperscript{319}

A final proposal addresses the issues raised by nonstatutory employee stock options under Section 83 and nonrecognition treatment under Section 1032.\textsuperscript{320} As discussed above, by virtue of regulations under Section 83, an employer issuing a compensatory stock option that has a readily ascertainable value will be required to take an immediate deduction because the employee is subject to tax upon grant of the option.\textsuperscript{321} The immediate deduction may result in a deemed disposition of the property, resulting in an immediate gain to the employer less any basis the employer had in the option.\textsuperscript{322} Nonrecognition treatment might not be available because the "property" transferred by the corporation is an option on the employer’s stock, rather than stock, as required for nonrecognition treatment by Section 1032.\textsuperscript{323}

It has been proposed that recognition be precluded by requiring the employer to deduct the value of the stock option in the year of issue or vesting, with no further tax consequences.\textsuperscript{324} Although this proposal might alleviate the issues raised by the interaction of Section 83 with Section 1032, it does not address the systemic problems inherent in Section 1032 discussed above. Additionally, employee stock options represent only a small percentage of the types of transactions that are subject to Section 1032.\textsuperscript{325} Also, employee stock options are a significant cost and

\textsuperscript{318.} See Warren, supra note 20. See also Deconstructing Code Sec. 1032, supra note 22.

\textsuperscript{319.} See Schenk, supra note 294, at 580.

\textsuperscript{320.} See Deconstructing Code Sec. 1032, supra note 22.

\textsuperscript{321.} I.R.C. § 83(h) (2005). As discussed above, an alternate theory is that when the employer is treated as the writer of a call option to the employee, the employer will not recognize any immediate gain or loss on its receipt of the option premium—the provision of the services by the employee. See Rev. Rul. 78-182, 1978-1 C.B. 265 Ruling B, 1. Rather, the employer is allowed to "wait and see" in order to determine whether its gain or loss will be recognized. Id. In the event that the employee exercised the option, the option premium is deemed to be an additional amount realized by the corporation. Rev. Rul. 78-182, 1978-1 C.B. 265 Ruling B, 3. Treatment of the transaction in this manner converts the option transaction into a sale of the stock itself, and the employer will therefore be shielded from gain recognition by virtue of Section 1032. I.R.C. § 1032(a) (2000).

\textsuperscript{322.} Treas. Reg. § 1.83-6(b) (as amended in 2003).

\textsuperscript{323.} I.R.C. § 1032(a) (2000).

\textsuperscript{324.} See Warren, supra note 20.

\textsuperscript{325.} See id.
corporations will therefore undertake such transactions with the purpose of compensating employees, rather than the realization of a tax benefit.\textsuperscript{326}

Also of concern is the lack of symmetry that will result by only taxing employees at the time of exercise of the option, with the corporation’s deduction only at the time of grant or vesting of an option.\textsuperscript{327} Alternatively, any regime that will tax the employees upon the grant of the option will prove difficult, given that the employees may not have the money to pay the tax.\textsuperscript{328}

\textbf{VII. CONCLUSION}

The answer to the question posed in the title of this paper, "Are we there yet?", is "not yet." The current version of Section 1032 does not adequately address the significant growth of equity derivatives during the past decade. As a result, while economically equivalent transactions are subject to Section 1032, many equity derivatives may escape application of the provision. This uncertainty creates the potential for whipsaw; taxpayers invoking Section 1032 to recognize losses and claiming inapplicability of the provision to escape gain recognition.

Based upon the legislative, judicial and administrative rulings related to Section 1032, as well as the underlying policy goals of the provision, the correct approach is to expand the scope of the nonrecognition rule to include all non-option transactions that are economically equivalent to option transactions. This modification will not only address the current issue regarding equity derivatives and employee stock options, but will create a reliable rule that is broad enough to address financial instruments and transactions that are not currently contemplated. As a result, Congress will not have to revisit the issue yet again.

Upon enactment of the revised provision, one can finally answer: "\textit{We're here . . .}\n
\textsuperscript{326} See id.
\textsuperscript{327} See Deconstructing Code Sec. 1032, supra note 22.
\textsuperscript{328} See id.
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