INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
X =
Year 1 =
Year 5 =
Date 1 =
a =
b =
c =
d =
e =
f =
g =
h =
i =
j =

ISSUE(S):

Whether, under § 165 of the Internal Revenue Code, Taxpayer may claim a loss deduction upon the expiration of a "purchase option agreement" to acquire X if Taxpayer instead acquires X by other means.

CONCLUSION(S):

Taxpayer is not entitled to deduct the claimed loss under § 165. Rather, Taxpayer's basis in the "purchase option agreement" is capitalized and added to its basis in X.

FACTS:

Taxpayer, a publicly traded company, conducts research, development, of certain technologies (Technologies) it has developed, some of which it performs with public financing rather than with its own funds.

Taxpayer wished to conduct certain R&D with public financing. To that end, in Year 1 Taxpayer created X a separate corporation. Investment units of X (X Investment Units) were sold in an initial public offering (IPO); each X Investment Unit consisted of one share of callable X stock and a callable warrant to purchase one share of Taxpayer stock.[1] X received approximately a dollars, after fees, from the IPO.

Taxpayer and X entered into a number of agreements, all terminating at the end of Year 5. Pursuant to a Service Agreement, Taxpayer agreed to provide financial, legal, and administrative services to X at cost (X had no work force of its own). Pursuant to a Technology License Agreement, Taxpayer granted X a worldwide, exclusive right and license to the Technologies in exchange for b dollars. X agreed that it would not, without first obtaining Taxpayer's consent, sublicense, disclose, or otherwise transfer any rights in the Technologies (or any improvements thereon). Pursuant to a Research and Development (R&D) Agreement, Taxpayer agreed to conduct R&D on behalf of X for compensation of c dollars (which accounted for almost all of the remaining funds raised by the IPO).

Under a Purchase Option Agreement (POA) that was part of the IPO, Taxpayer had a right, but not an obligation, to purchase all of the callable X stock before the end of Year 5, with the "strike price" increasing over the intervening years to d dollars per share. Taxpayer characterizes its rights as an option.[2] The POA specified that the option could be exercised only as to all of the issued and outstanding shares of X stock. The POA also provided that the callable warrants for Taxpayer stock will terminate upon exercise by Taxpayer. Taxpayer claims, and the field does not challenge, basis of e dollars in the POA.

[1] Each X Investment Unit also included an additional warrant to purchase a share of Taxpayer stock, but these warrants separated from the investment units in Year 1 and traded independently; they are not involved in the transactions at issue.

[2] Taxpayer claims that the POA is an "option" for federal income tax purposes, and for purposes of this discussion we will treat it as such: however, this memorandum does not hold that the POA is an option for all federal income tax purposes.

The POA set forth a methodology for its amendment:

> [The POA] may not be released, discharged, amended or modified in any manner except by an instrument approved by [Taxpayer] and the holders of record of two-thirds (2/3) of [X common stock]; provided, however, that, except as expressly provided herein, [the POA] may not be amended to change … the amounts of the [POA] Exercise Price ... without the approval of [Taxpayer] and the consent of the holders of record of ninety-five percent (95%) of the [X] Common Stock.

Also, pursuant to a note (Note), Taxpayer lent f dollars to X, repayment of which was due to Taxpayer on the date following termination of the POA. The Note could not be prepaid and was subject to significant restrictions. While the Note was outstanding, X and its shareholders were prohibited from taking any action or permitting any action to be taken inconsistent with Taxpayer's rights under the POA. Also, X was not permitted to issue additional capital stock, borrow more than a certain amount, declare or pay dividends utilizing funds committed to pay Taxpayer under the R&D Agreement, or merge, liquidate, or sell all or substantially all of its assets without Taxpayer's approval.

Taxpayer concluded that the R&D relating to the Technologies had not demonstrated clinical efficacy by the ninth month of Year 5 (the last year to exercise the option). Although Taxpayer wished to reacquire the Technologies from X, it believed that the value of the X stock, based on the value of the Technologies, was significantly below the POA strike price of d dollars per share, and Taxpayer sought to acquire the X Investment Units through a tender offer of g dollars per unit.

In its tender offer statement filed with the Securities and Exchange Commission, Taxpayer stated:

> [Taxpayer] believes that the value of X is significantly below the current [POA] exercise price [of d dollars per share] and, absent unforeseen progress in the [R&D], [Taxpayer] does not intend to exercise the [POA].

The holders of the X Investment Units initially objected to the tender offer, but, following a due diligence review ordered by a Special Committee formed by X's board of directors, the tender offer was approved in principle. Subsequently, but before the end of Year 5, Taxpayer and over 95 percent of the X Investment Unit holders entered into a purchase agreement whereby Taxpayer paid g dollars per X Investment Unit, for a total of h dollars. The tender offer purchase agreement provided that the transaction "constitutes the entire agreement and supercedes all prior agreements or undertakings, both written and oral, among the parties, or any of them, with respect of the subject matter hereof...."

On Date 1 of Year 5, X merged with Taxpayer; all outstanding shares of X stock were cancelled and the remaining shareholders of X received j dollars in cash per share.

Taxpayer made an election under § 338 with respect to the purchase of the X Investment Units, allocating i dollars of the purchase price to the X stock and the remainder to the callable warrants for Taxpayer stock. X was subsequently liquidated into Taxpayer, and Taxpayer reacquired all rights in the Technologies.

Taxpayer claimed a loss deduction for Year 5, equal to its e dollars basis in the unexercised option on Date 1 of Year 5. Examination disallowed the deduction, asserting that Taxpayer did not suffer a loss as a result of these transactions, and that Taxpayer's basis in the option was a capital expenditure related to the acquisition of X and, ultimately, the reacquisition of the Technologies. The agent argues that Taxpayer did not abandon its goal of acquiring X and, ultimately, reacquiring the Technologies. Because Taxpayer achieved its goal, there is no loss. The expiration of the POA did not result in Taxpayer's abandonment of a capital asset.[3]

LAW AND ANALYSIS:

Statutes and Regulatory Interpretations

Section 165(a) provides a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise."

Section 1.165-1(b) of the Income Tax Regulations provides rules regarding the nature of deductible losses:

> To be allowable as a deduction …, a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and … actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

Taxpayer maintains that the tender offer purchase agreement was a separate transaction unrelated to the POA, and that the expiration, unexercised, of the option results in a loss of Taxpayer's investment pursuant to specific rules relating to options.

Section 1234(a)(1) addresses character; it does not determine the existence of a loss. It provides in relevant part that "loss attributable to failure to exercise … an option to buy or sell property shall be considered to be … loss from the sale or exchange of property that has the same character as the [underlying] property." Section 1234(a)(2) further provides that, for purposes of applying § 1234(a)(1), an option shall be deemed sold or exchanged on the day it expired. See Rev. Rul. 78-182, 1978-1 C.B. 265. Consistent with § 1234's overall character focus, § 1234(a)(2) simply provides sale or exchange treatment if loss is attributable to an option's lapse.

In Rev. Rul. 56-406, 1956-2 C.B. 523, the Service considered the application of the wash sale rules under § 1091 to option transactions, holding that if an individual taxpayer, not a dealer in stocks or securities, sells stock options of a corporation at a loss and simultaneously purchases stock of the same corporation, the loss is allowable unless the stock options are considered "substantially identical property" to the shares of the stock.

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[3] The agent suggests as an alternative theory that the tender offer, as a factual matter, constitutes a modification of the POA, and therefore the POA did not expire unexercised. Because of the highly factual nature of this inquiry, and because some aspects of the underlying facts regarding this issue are in dispute, we believe it would not be in the interest of sound tax administration to make a conclusion on this argument in a technical advice memorandum. For purposes of this technical advice memorandum only, we will assume that the POA was not exercised, but rather expired unexercised, during Year 5.

Section 1.165-2(a) provides:

> A loss incurred in a business, or in a transaction entered into for profit, and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed a deduction under section 165(a) for the taxable year in which the loss is actually sustained.

Case Law

To be entitled to an abandonment loss, a taxpayer must show: (1) an intention on the part of the owner to abandon the asset and (2) an affirmative act of abandonment. *United States v. S.S. White Dental Manufacturing Co.*, 274 U.S. 398 (1927); *A.J. Indus., Inc. v. United States*, 503 F.2d 660, 670 (9th Cir.1974); *CRST Inc. v. Commissioner*, 92 T.C. 1249, 1257 (1989), *aff'd*, 909 F.2d 1146 (8th Cir.1990). When the taxpayer has not relinquished possession of an asset, there must be a concurrence of the act of abandonment and the intent to abandon, both of which must be shown from the surrounding circumstances. *A.J. Indus., Inc. v. United States*, *supra*. Abandonment of an intangible property interest should be accomplished by some express manifestation, *Citron v. Commissioner*, 97 T.C. 200, 210 (1991), and the finder of fact is entitled to look beyond the taxpayer's formal characterization. *Laport v. Commissioner*, 671 F.2d 1028, 1032 (7th Cir.1982), *aff'g* T.C. Memo.1980-355.

Generally if a taxpayer engages in multiple separate and distinct transactions, costs allocable to abandoned transactions are deductible even if other transactions are completed. *Sibley, Lindsay & Curr Co. v. Commissioner*, 15 T.C. 106 (1950), *acq.*, 1951-1 C.B. 3. Further, if a taxpayer engages in a series of transactions and abandons one of those transactions, a loss is allowed even if the taxpayer later proceeds with a similar transaction. *Tobacco Products Export Co. v. Commissioner*, 18 T.C. 1100, 1104 (1952), *modified*, 21 T.C. 625 (1954), *nonacq.*, 1955-2 C.B. 11; *Portland Furniture Mfg. Co. v. Commissioner*, 30 B.T.A. 878 (1934); *Doernbecher Mfg. Co. v. Commissioner*, 30 B.T.A. 973 (1934), *acq.*, XIII-2 C.B. 6, *aff'd*, 80 F.2d 573 (9^{th} Cir. 1935). In summary, deductions are permitted upon the abandonment of separate and distinct transactions even if subsequent or alternative independent transactions are pursued.

In *Chevy Chase Land Co. v. Commissioner*, 72 T.C. 481, 487 (1979), the taxpayer incurred expenses with respect to a long-term commercial lease of undeveloped real estate it owned, but the lease transaction was abandoned because necessary zoning changes would not be approved. The Tax Court, applying a “practical” test (citing *Lucas v. American Code Co.*, 280 U.S. 445 (1930)), allowed the taxpayer to deduct the expenses related to the commercial development activities, finding that the taxpayer had abandoned all plans for commercial development because the lease had no continuing value to the taxpayer.

However, if the potential transactions are alternatives, only one of which can be completed, no abandonment loss is proper unless the taxpayer abandons the entire transaction. *Haspel v. Commissioner*, 62 T.C. 59, 72-73 (1974) (expenses for discharged architect not deductible where the building was constructed); *see also*

Driscoll v. Commissioner, 147 F.2d 493 (5th Cir. 1945). In *Galt v. Commissioner*, 19 T.C. 892 (1953), *aff'd in part and rev'd in part on another issue*, 216 F.2d 41 (7th Cir. 1954), the court rejected the taxpayer's efforts to deduct expenses attributable to unsuccessful efforts to lease property that was ultimately leased during that year, noting that the expenses were incurred to attain a single objective.

In *Nicolazzi v. Commissioner*, 79 T.C. 109 (1982), *aff'd*, 722 F.2d 324 (6th Cir. 1983), the taxpayers filed 600 applications to acquire oil and gas leases through a lottery program, but acquired only one of the leases; the taxpayers claimed an abandonment loss deduction for the fees related to the 599 unsuccessful applications. The court focused on the identification of the relevant "transaction," finding that the lottery program was an integrated program designed to acquire at least one lease, and that, applying the "substance over form" mandate, the relevant transaction was the taxpayers' investment in the program. The fees were, therefore, capital expenditures incurred in acquiring an oil and gas lease. See also Rev. Rul. 71-191, 1971-1 C.B. 77, and Rev. Rul. 67-141, 1967-1 C.B. 153.

In *FRGC Investment, LLC v. Commissioner*, T.C. Memo. 2002-276, *aff'd without published opinion* 89 Fed. Appx. 656 (9th Cir. 2004), a partnership incurred expenses with respect to an agreement to buy undeveloped real estate that was contingent upon the approval of certain zoning changes, but because it appeared that a zoning change would not be approved the purchase agreement was cancelled. However, the seller subsequently offered new terms and the partnership purchased the undeveloped real estate. The partnership claimed an abandonment loss for expenditures related to the first agreement. The court stated:

> Although a remote possibility of future use does not necessarily preclude abandonment, we cannot ignore the language in [§ 1.165-1(b)] that requires that substance, not mere form, shall govern in determining a deductible abandonment loss…. An otherwise abandoned expenditure, if part of an integrated plan that is implemented, is not an abandonment loss under section 165.

FRGC Investment, LLC (citations omitted). The court found that the partnership's subsequent acquisition of the property at issue was inconsistent with its claim that it had abandoned the project. The court found that, in substance, the first agreement was merely a step in the partnership's continuing and successful attempts to acquire the property.

Discussion

In applying § 165 to the transactions at issue, it is essential to look at their substance, rather than form, to determine whether, in fact, Taxpayer suffered a bona fide loss upon expiration of the POA.

Taxpayer's claimed loss deduction is not supported by § 1234. Even if the POA were an option, § 1234 does not operate to make the lapsed option a loss. Rather, § 1234 establishes the character of gains and losses arising from dealing in option transactions. The question of whether there is a loss is governed by § 165 or the cases and rulings that afford open transaction treatment for options. See Rev. Rul. 78-182, 1978-1 C.B.

265; Rev. Rul. 58-234, 1958-1 C.B. 279; *Virginia Iron Coal & Coke Co. v. Commissioner*, 37 B.T.A. 195, *aff'd*, 99 F.2d 919 (4th Cir. 1938).

We think Taxpayer's reliance on Rev. Rul. 56-406 is misplaced. First, there was no threshold question in Rev. Rul. 56-406 as to whether there was an abandonment. The ruling focused on whether, if a taxpayer disposes of property *at a loss* and subsequently acquires other property, the loss deduction is nevertheless disallowed under the § 1091 wash sales provisions. Thus, the ruling is concerned with the disallowance of an otherwise allowable deduction, and not whether there is a deductible loss in the first place. Rev. Rul. 56-406 does not provide the converse rule (urged by Taxpayer) that the expiration of an option results in a deductible loss in every case absent a disallowance under § 1091.[4]

In full context, all of the facts and circumstances indicate that the POA and the tender offer purchase agreement were parts of a concerted effort to reacquire property. In viewing the transactions between Taxpayer and X, it is clear that Taxpayer considered the Technologies valuable, and at all relevant times Taxpayer maintained control over X and the Technologies. The Technology Agreement and the Note severely limited independent action on X's part that could be in any way inconsistent with Taxpayer's interests in the Technologies and in X. The POA was carefully crafted to provide Taxpayer the exclusive right to acquire X in its entirety (and only in its entirety) during the term of the POA, and thus regain control of the Technologies. At no time did Taxpayer evidence any intention of abandoning its interest in X and the Technologies. The acceptance by the X shareholders of the tender offer purchase agreement, followed by the Date 1, Year 5, "squeeze out" merger, rendered the POA moot prior to the POA's stated expiration date, and so at no time did Taxpayer loosen its hold on X.

Taxpayer suggests that the POA and the tender offer purchase agreement are "separate and distinct transactions" because the POA was not "necessary and integral" to the completion of the tender offer purchase agreement. Taxpayer contends that it could have entered into the tender offer purchase agreement without having entered into the POA, and that when it entered into the POA it did not anticipate making the tender offer. We disagree with this "but-for" analysis. Under the case law cited above, the full context of the transactions is determinative. Multiple transactions need not be part of an integrated plan from the outset. Rather, if seemingly separate transactions,

[4] We do not contest Taxpayer's assertion that in most circumstances a holder of an option may claim a loss on an expired option even though the taxpayer subsequently purchases property of the type underlying the option, as contemplated by Rev. Rul. 56-406. Taxpayer suggests an example of an individual purchasing an option to acquire 100 shares of stock in a large, publicly traded corporation, but because of a downturn in the stock value the individual purchases the stock on the market and lets the option expire. We agree that a loss upon the expiration of the option would be allowable under these circumstances. However, we believe there is a distinctly different situation if, as here, the property underlying the option is a unique property (unlike a small number of a corporation's outstanding shares), the exercise of the option and the subsequent acquisition are mutually exclusive mechanisms for acquiring this property, and the acquirer has evidenced a pattern of maintaining dominion over the underlying property (with no indication it intends to relinquish the underlying property).

whether contemporaneous or in series, have a *single objective*, the loss deduction must be disallowed if the objective is achieved.[5]

Based on the foregoing, it is clear that Taxpayer suffered no loss. Taxpayer had no intention of abandoning its efforts to acquire X and the Technologies, nor did it perform any affirmative act suggesting that it was abandoning its efforts toward that goal. Taxpayer's investment in the POA was made to ensure the acquisition of X and the Technologies, and this goal was ultimately achieved. The tender offer methodology merely provided a more economically feasible means of acquiring X and the Technologies than the POA did. Taxpayer's basis in the POA should be added to its basis in X and subsequently allocated to its basis in the Technologies upon liquidation of X.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.

[5] Further, the fact that the POA provided for the modification of its terms indicates that Taxpayer recognized that the acquisition of X would not necessarily occur on the POA's original terms.