REPORT #708

TAX SECTION

New York State Bar Association

Letter on Effect of Pledge of Stock

January 30, 1992

Table of Contents

Cover Letter:.....i

TAX SECTION
New York State Bar Association

January 30, 1992

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue 1111
Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Effect of Pledge of Stock on Ownership Changes under Section 382

Dear Commissioner Goldberg:

On November 29, 1991, the Internal Revenue Service (the "Service") released private letter ruling 9148015 (Aug. 23, 1991).[1]/ Although the underlying facts are not clear from the ruling as released, the ruling appears to hold that a nonrecourse pledge of 63 percent of the stock of a loss corporation by its shareholders to secure a loan to the corporation is an interest similar to an option under section 382(1)(3)(A) and Temp. Treas. Reg. § 1.382-2T(h)(4)(v) and that, because the pledge did not fall within the limited safe harbor of Temp. Treas. Reg. § 1.382-2T(h)(4)(x)(G), it resulted in an ownership change of the loss corporation under section 382(g).[2]/

---

[1]/ This letter was prepared by Steven C. Todrys, Co-Chair of our Committee on Net Operating Losses.

[2]/ All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code") or to Treasury regulations promulgated thereunder.

The Tax Section does not ordinarily comment on private letter rulings and, in writing this letter, we do not mean to challenge the holding of private letter ruling 9148015 on its particular facts.[3]/ However, the ruling raises an issue which has concerned practitioners since the promulgation of the temporary regulations under section 382: whether any pledge of loss corporation stock to secure a loan which is not covered by the limited safe harbor is an interest similar to an option.

Statutory and Regulatory Background

Section 382(a) limits the amount of taxable income that a corporation which undergoes an ownership change can offset in a post-change year with pre-change net operating losses ("NOLs"). In determining whether an ownership change has occurred, stock options are deemed exercised if such exercise would result in an ownership change, unless regulations provide otherwise. Section 382(1)(3)i(A)(iv). In addition, a similar rule applies in the case of "any contingent purchase, warrant, convertible debt, put, stock subject to a risk of forfeiture, contract to acquire stock, or similar interests." Section 382(1)(3)(A) (final flush language, emphasis added).

Temp. Treas. Reg. § 1.382-2T(h)(4) outlines the scope of the deemed exercise rule. In addition to following the Code in providing that interests similar to options are to be treated as options, it provides that "the extent to which an option is contingent or otherwise not currently exercisable shall be disregarded" for purposes of the deemed exercise rule. Temp. Treas. Reg. § 1.382-2T(h)(4)(iii). Finally, the regulation excludes from the deemed exercise rule a right to acquire stock by a domestic bank (as defined in section 581), an insurance company (as defined in Treas. Reg. § 1.801-3(a)), or a trust qualified under section 401(a) (such

[3]/ In fact, under our recommendations, a nonrecourse stock pledge could be treated as an interest similar to an option under circumstances which may be present in the ruling.

institutions hereinafter referred to as "Special Lenders"), solely as a result of a default under a loan agreement entered into in the ordinary course of the trade or business of the Special Lender. Temp. Treas. Reg. § 1.382-2T(h)(4)(x)(G) (hereinafter, the "Special Pledge Exemption").

Many practitioners have taken the position that the Special Pledge Exemption simply creates an explicit safe harbor for pledges of stock to Special Lenders. Those practitioners do not believe that stock pledged to secure a loan made by a person other than a Special Lender (such as a foreign bank) constitutes an interest similar to an option unless, perhaps, the purpose of the pledge is to transfer ownership of the stock, rather than secure the creditor's loan. There is a concern, however, that the Special Pledge Exemption could be read to imply that, absent the exemption, a pledge is an interest similar to an option.[4]/

---

[4]/ In an earlier report, the Tax Section identified the possibility that the Special Pledge Exemption could be read to suggest that, but for the exemption, a pledge would be treated as an option, but criticized this interpretation as inappropriate. See New York State Bar Association Tax Section, Committee on Net Operating Losses, Supplemental Report on Section 382. 44-45 (1988).

4./Some practitioners read the Special Pledge Exemption as applicable only when a loan is actually in default, eliminating the implication that a pledge is an option prior to default. This interpretation is - uncertain, but could be a basis for adopting the recommendations suggested below.

Presumably, if the Service did take the position that a pledge is an option it would argue that a pledge of stock gives the pledgee the option to acquire the underlying stock subject to the contingency of default on the obligation secured by the stock. As previously noted, the extent to which an option is contingent or otherwise not currently exercisable is generally disregarded for purposes of the deemed exercise rule. Temp. Treas. Reg. § 1.382-2T(h)(4)(iii).

Comments

The pledge of stock to secure a loan should not be treated as an interest similar to an option, absent circumstances that indicate an intention to effect a stock transfer to the lender. A lender's rights with respect to pledged stock (whether the loan is recourse or nonrecourse) do not ordinarily include the right to acquire ownership of the stock on a default. While a lender may take possession of the pledged stock on default (retaining dividends and exercising voting rights), it is obligated within a reasonable period to cause a sale of the stock on an arm's-length basis to itself or a third party. Uniform Commercial Code § 9-504. Any proceeds in excess of the loan amount are remitted to the borrower; any shortfall, in the case of a recourse loan, entitles the lender to pursue its remedies with respect to the borrower's other assets. Although a nonrecourse loan secured by stock may be viewed economically as giving the borrower a “put” option, the tax law does not treat it as such. If the nonrecourse loan is bona fide, the borrower will have no incentive to exercise its put (at least when the loan is made) because the value of the stock will exceed the loan amount. We recognize, however, that nonrecourse loans and pledge agreements create potential for taxpayer abuse and our recommendations attempt to address that problem.

Even if it were proper in some cases to treat a pledge as an option, the Special Pledge Exemption would be too limited. Bona fide loans secured by pledges of stock occur in the marketplace as a matter of course with a range of lenders not described in the Special Pledge Exemption. For example, a parent corporation may pledge the stock of valuable subsidiaries, including a subsidiary with NOLs, to secure a public offering of debt issued to purchasers that may or may not be Special Lenders. Even more commonly, a pledge of subsidiary stock may secure loans made by foreign banks or financial service companies, both of which are outside the Special Lender definition.[5]/

Recommended Solution

To clarify this issue, we recommend that the Service modify the regulations (or issue a revenue ruling) to state that a pledge of stock to secure a loan will not be treated as an interest similar to an option unless that the pledge was granted for the purpose of transferring the stock to the lender. Factors that would indicate a purpose to transfer the stock would include the fact that the loan was nonrecourse to other assets of the borrower (or that the borrower had no significant assets other than the pledged stock) and that the loan amount exceeds the value of the collateral. Factors that would indicate otherwise would include

[5]/ Terminating a pledge agreement by repaying the debt secured by a loss corporation's stock does not necessarily negate a prior ownership change. Such a termination presumably would be treated as a lapse of the option. The regulations permit filing amended tax returns if the lapse would render the section 382 limitation retroactively inapplicable, but such relief is available only for open years. Even with relief for open years, applying section 382 on an interim basis is a hardship.

the fact that the loan is similar to loans held by Special Lenders and that the loan was acquired from a Special Lender in an arm's-length transaction and was not modified.

To avoid disputes on this issue, we would also retain and expand the Special Pledge Exemption to create a safe harbor for pledges to secure loans made by any person regularly engaged in the business of lending money and any debt instrument issued in a public offering. To expand the exemption, the temporary regulations would be amended as follows:

(x) Options not subject to attribution. Paragraph (h)(4)(i) of this section shall not apply to

****

(G) Right to acquire loss corporation stock pursuant to a default under a loan agreement. Any right to acquire stock of a corporation by a person regularly engaged in the business of lending money, including a bank (as that term is defined in section 581 but including any corporation which would be a bank but for the fact it is a foreign corporation), an insurance company (as that term is defined in section 1.801-3(a)), or a trust qualified under section 401(a), solely as the result of a default under a loan agreement entered into in the ordinary course of the trade or business of such person, and any such right of a holder of a debt instrument issued in a public offering.

Respectfully submitted,

James M. Peaslee
Chair

Identical letter to:

The Honorable Kenneth W. Gideon
Assistant Secretary of the Treasury
for Tax Policy 3120 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20020

cc: Harry L. Gutman, Esq.
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

Abraham N.M. Shashy, Jr., Esq.
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3026
Washington, D.C. 20224

Thomas R. Hood, Esq.
Counsellor to the Commissioner
Internal Revenue Service 1111
Constitution Avenue, N.W.
Room 3316
Washington, D.C. 20224

Mary L. Harmon, Esq.
Special Assistant to Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3034
Washington, D.C. 20224

Stuart Brown, Esq.
Associate Chief Counsel (Domestic)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3527
Washington, D.C. 20224

Michael J. Graetz, Esq.
Deputy Assistant Secretary of the Treasury for Tax Policy Department of the Treasury 3108 Main Treasury 1500 Pennsylvania Avenue, N.W. Washington, D.C. 20220

Terrill A. Hyde, Esq.
Tax Legislative Counsel Department of the Treasury 3064 Main Treasury 1500 Pennsylvania Avenue, N.W. Washington, D.C. 20220

Andrew Dubroff, Esq.
Associate Tax Legislative Counsel Department of the Treasury 4013 Main Treasury 1500 Pennsylvania Avenue, N.W. Washington, D.C. 20220