STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**FORMAL OPINION**
	2007-SBE-002
LARRY GEISEL AND RHODA GEISEL	Case No. 358724

Representing the Parties:

For Appellants: Larry Geisel

For Respondent: D. Todd Watkins, Tax Counsel

Counsel for the Board of Equalization: Grant S. Thompson, Tax Counsel

I. Introduction

This appeal is made pursuant to section 19045 of the Revenue and Taxation Code[1] from the action of the Franchise Tax Board (FTB or respondent) on the protest of Rhoda Geisel and Larry Geisel against a proposed assessment of additional income tax in the amount of $92,424 for the year ended December 31, 2000. The core issue in this appeal is whether appellant Larry Geisel engaged in a taxable sale transaction by transferring stock to Derivium Capital, LLC ("Derivium") in a transaction that was documented as a nonrecourse loan.[2]

In the transaction, appellant transferred 15,000 shares of Alteon WebSystems, Inc. ("Alteon") stock to Derivium. Shortly after receiving appellant's shares, Derivium sold 15,000 shares of Alteon stock and delivered 90 percent of the sale proceeds, or $946,310.62, to appellant.

Derivium and appellant documented the transaction as a nonrecourse loan that was secured solely by the transferred shares. The purported loan accrued interest at 10.5 percent, compounded annually, and could not be repaid prior to the end of the three-year loan term. Derivium

[1] Unless otherwise specified, all references to a "section" or "sections" are to sections of the Revenue and Taxation Code.

[2] Appellants are married and apparently filed a joint return for the 2000 tax year. Appellant Larry Geisel is referred to herein as appellant or appellant-husband.

had no right to demand early repayment of the loan or to demand additional collateral to secure the loan, even if the transferred shares declined in value, and it had no recourse against appellant if he determined not to repay the loan. The transaction agreement stated that Derivium was free to sell the shares that it received from appellant, but that it had to return an equivalent number of Alteon shares to appellant if he repaid the purported loan at maturity. Appellant did not repay the purported loan at maturity, and he did not report any taxable income from the transaction at any time.

Based on our examination of the transaction and its surrounding circumstances, we conclude that appellant transferred appreciated stock in return for cash and the right to acquire an equivalent number of shares of Alteon stock in three years, without any real obligation to return the cash received or any demonstrated intent to repay the purported loan. Accordingly, and for the reasons discussed below, we conclude that the transaction was a taxable sale.

II. Factual and Procedural Background

Appellant entered into a "Master Agreement to Provide Custodial Services" (the "Master Agreement") with Derivium on or about June 7, 2000.[3] Pursuant to the terms of the Master Agreement, Derivium agreed to arrange a three-year nonrecourse loan in the amount of $946,310.62 to appellant and provide custodial services with respect to the stock pledged to secure the purported loan.

Although Derivium agreed to act as custodian and arrange financing, the actual financing for the transaction was purportedly provided by Diversified Design Associates Limited ("DDA"), a company organized in Ireland. DDA later assigned the loan to Bancroft Ventures Limited, an Isle of Man corporation.

As collateral for the loan, appellant transferred 15,000 shares of Alteon stock to Derivium. The Master Agreement and related documentation stated that the loan amount was intended to constitute 90 percent of the "hedged value" of the shares, which "hedged value" was listed as $1,051,456.25. Although the documentation refers to the "hedged value" of the shares, the evidence suggests that Derivium sold the "pledged" shares within a day of receiving them, and the amount stated as the "hedged value" of the shares was equal to the cash that Derivium received from its sale of Alteon shares.

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[3] Derivium had previously done business under the name of First Security Capital, LLC.

Under the terms of the Master Agreement, Derivium would receive dividends paid on the stock and apply them to reduce accrued interest on the loan, which compounded annually at a 10.5 percent rate.

During the term of the loan, Derivium had the exclusive power to exercise voting rights with respect to the shares transferred to it by appellant. The Master Agreement also gave Derivium the unconditional right to sell or assign the shares and retain the benefits of any such sale or assignment during the loan term, regardless of whether appellant was then in compliance with the loan's terms.

Appellant was not permitted to make any payments of principal or interest until the loan matured. If appellant repaid the loan at maturity, Derivium was required to return to appellant the same number of shares of Alteon stock as appellant transferred to Derivium (as adjusted for stock splits and similar events).

If appellant did not repay the loan, Derivium was freed from its contractual obligation to return to him the same number of shares of Alteon stock that appellant transferred to Derivium (as adjusted for stock splits and similar events). This was Derivium's sole remedy. Neither Derivium nor the purported lender had recourse against appellant personally.

The Master Agreement also provided that appellant could renew the loan for an additional term or terms on Derivium's then-prevailing terms and conditions for loans. Appellant could renew the loan for no additional fee if the value of the stock at maturity was equal to or greater than approximately 111 percent of the loan pay-off amount. If the value of the stock was less than approximately 111 percent of the loan pay-off amount, a renewal fee of approximately 4.5 percent to 6.5 percent of the original collateral value would be required (with the exact fee amount depending on the market capitalization of the stock).

The following timeline summarizes the transactions undertaken in connection with the Master Agreement.

June 7, 2000	Appellant directs his broker, Solomon Smith Barney, to transfer 15,000 shares of Alteon Stock to Derivium's account at J.C. Bradford & Co.
June 12, 2000	Derivium acknowledges receipt of appellant's 15,000 shares of Alteon stock, which shares are valued at $1,035,000.
June 12 – 13, 2000	Transaction confirmations issued by Derivium's broker indicate that a total of 15,000 shares of Alteon were sold from Derivium's account for aggregate gross proceeds of $1,051,456.25

June 13, 2000	Derivium sends appellant an "Activity Confirmation" reporting a "hedged value" of the Alteon stock as $1,051,456.25 (i.e., an amount equal to the gross proceeds received by Derivium from its sale of Alteon stock), and a loan amount of $946,310.62 (90 percent of the "hedged value").
June 15, 2000	Appellant receives a statement, dated June 15, 2000, indicating that he received $946,310.62 from Derivium on that date.

Derivium ceased doing business and filed for bankruptcy at some point following the year 2000. It is not clear from the record in this appeal what became of Bancroft Ventures Limited, the Isle of Man entity that purportedly held the loan.

Appellants filed a California Nonresident or Part-Year Resident Income Tax Return for the year 2000 on September 7, 2001. On this return, appellants reported wage income of $168,140 from appellant-husband's employment with a company located in San Francisco, California.

On July 5, 2005, the Franchise Tax Board issued a Notice of Proposed Assessment (NPA) to appellants. The NPA stated that appellants failed to report $1,051,456 of taxable income earned through the 90 percent stock loan transaction. The NPA further stated that appellants had not provided evidence of stock basis. As a result, the FTB initially assigned a tax basis of zero in the stock.

The FTB later issued a Notice of Action (NOA) that allowed appellants a tax basis in the stock equal to 10 percent of the stock's fair market value. The NOA explained that because the cash received by appellants in the transaction equaled 90 percent of the stock's fair market value, the remaining 10 percent of the stock's value was allowed as appellants' basis in the stock. As a result, income from the stock sale was reduced to $946,310, and the total additional tax due was reduced to $92,424. The NOA also indicated that appellants were California residents at the time of the 90 percent stock loan transaction. Appellants then timely filed this appeal.

III. Legal Background

It is well established that "the simple expedient of drawing up papers [is not] controlling for tax purposes when the objective economic realities are to the contrary." (*Frank Lyon Co. v. United States* (1978) 435 U.S. 561, 573 [citing *Commissioner v. Tower* (1946) 327 U.S. 280, 291] [*Frank Lyon Co.*].) It is the substance of a transaction, not the labels attached to the transaction by the parties, that determines tax consequences. (See *Commissioner v. Tower*, *supra*; *Arevalo v. Commissioner* (5th Cir. 2006) 469 F.3d 436, 439 (noting that "the Supreme Court has repeatedly stressed that . . . substance governs over form"), cert. den. (2007) 127 S. Ct. 1339; *Grodt & McKay Realty* (1981) 77 T.C. 1221; *Appeal of Alameda Bancorporation, Inc*., *et al.*, 95-SBE-001, Mar. 9, 1995 [*Alameda Bancorporation*].)[4]

In order to determine whether ownership of property has been transferred, we examine the distribution of the burdens and benefits of ownership in light of all the surrounding facts and circumstances. (See *Grodt & McKay Realty*, *supra,* 77 T.C. 1221; *Alameda Bancorporation*.) When determining whether ownership of stock has been transferred, courts consider, in particular, which party suffers from a decline in the stock's value or benefits from an increase in the stock's value, which party has the right to vote the shares and receive dividends on the shares and which party has the right to sell the shares. (See *Miami National Bank v. Commissioner* (1977) 67 T.C. 793; *Hall v. Commissioner* (1950) 15 T.C. 195 affd. (9th Cir. 1952) 194 F.2d 538.)

In *Hall*, *supra*, the taxpayer argued that he became the owner of shares when, pursuant to an employment contract, his employer issued shares in his name. The tax court rejected the taxpayer's argument, explaining that:

> The petitioner had no dominion or control over the shares until they were delivered to him . . . . There is no evidence that the petitioner was entitled to vote the shares prior to that time or that he was entitled to share in any dividends which might be declared by the Company. The petitioner could not sell the shares which were being held by the treasurer [of the employer] until they were delivered to him, and the unfettered right of sale is one of the most important attributes of ownership.

(*Id.* at p. 200.)

In *Provost v. United States* (1926) 269 U.S. 443, the United States Supreme Court applied similar reasoning when it considered whether ownership was transferred in a securities lending transaction. The taxpayer in *Provost* transferred shares to a broker and, in return for transferring the shares, received a cash "deposit" and the right to receive the same number of shares on the repayment of the cash. The Court rejected the taxpayer's argument that the transaction was simply a nontaxable pledge of stock as security for a loan and explained that:

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[4] We note that, although tax authorities may challenge the stated form of a transaction, a taxpayer is generally bound by the form in which he or she cast the transaction. (*Palo Alto Town & County Village, Inc. v. Commissioner* (9th Cir. 1977) 565 F.2d 1388, 1390.)

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

> [u]pon the physical delivery of the certificates of stock by the lender, with the full recognition of the right and authority of the borrower [i.e., the stock broker that will then short sell the borrowed shares] to appropriate them to his short sale contract, and their receipt by the purchaser, all the incidents of ownership in the stock pass to him.

(*Id.* at pp. 455 - 456.)

Thus, the Court held that a transfer of stock for cash, in return for the contractual promise to return the same number of shares in the future upon the repayment of the cash advanced, results in a transfer of ownership.

Although *Provost* is an old case that involved a stamp tax, it remains good law and has been cited favorably in more recent cases involving the income tax. (See, e.g., *H.J. Heinz Co. v. United States* (Fed.Cl. 2007) 76 Fed.Cl. 570, 582; *Commissioner v. Wilson* (9th Cir. 1947) 163 F.2d 680; see generally Shapiro, *Taxation of Equity Derivatives* (2003, as supplemented through 2006) T.M. Portfolios 188 at p. A-20.) In *Wilson*, *supra*, the Ninth Circuit Court of Appeals determined that a stock borrower who sold "short" the borrowed stock could not add to his tax basis amounts that were paid to the stock lender.[5] In reaching this conclusion, the court quoted the following passage from *Dart v. Commissioner of Internal Revenue* (4th Cir. 1935) 74 F.2d 845, 847):

> As was said by the Supreme Court in the case of [*Provost*]: Neither the lender nor the borrower retains any interest in the stock which [is] the subject matter of the [short sale] transaction and which has passed to and become the property of the purchaser. Neither the borrower nor the lender has the status of a stockholder of the corporation whose stock was dealt in, nor any legal relationship to it.

(*Wilson*, *supra* at p. 682.)

Thus, under *Provost* and later cases, a transfer of stock for cash, in return for the promise to return equivalent shares in the future upon the repayment of the cash advanced, generally results in a transfer of ownership for tax purposes.

In the decades following *Provost*, the Internal Revenue Service (IRS) affirmed that *Provost* remained good law, but nevertheless permitted the ordinary commercial practice of

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[5] A sale of borrowed stock (i.e., a "short" sale) is not deemed to be closed, and therefore taxable to the borrower/seller, until the borrower/seller has delivered replacement stock to the stock lender to close the short sale. (Treas. Reg. 1.1233-1(a)(1).) It should be noted that appellant did not short sell borrowed stock; he transferred stock that he owned to Derivium.

loaning securities to securities brokers on a nontaxable basis, based on various theories.[6] In these brokerage transactions, the stock lender typically received payments equivalent to any dividends on the stock and could demand the return of equivalent stock at any time, with five business days' notice. In most cases, the broker and the stock lender transferred cash between one another to ensure that the cash advanced as collateral always equaled the value of the transferred stock. (See Sen.Rep. No. 95-762, 2d Sess. 1978-2 C.B. 357, 359 (1978).) Thus, the stock lender retained all the risk of loss and potential for gain with respect to the transferred stock. Despite its apparent desire to permit this type of ordinary brokerage transaction to occur on a nontaxable basis, the IRS was, by 1978, refusing to issue rulings regarding whether a securities lending transaction constituted a taxable sale. (*Id.*)

In order to remove this legal uncertainty, and permit the established practice of loaning securities to stock brokers for use in "short" sale transactions, Congress enacted Internal Revenue Code (IRC) section 1058, which permits ordinary stock lending transactions to occur on a nontaxable basis, provided that several requirements are met.[7] IRC section 1058 requires that payments be made to the stock lender in amounts equivalent to any dividends received on the stock, that the loan "not reduce" the lender's risk of loss or opportunity for gain, that the borrower return identical stock to the lender, and that the loan satisfy such other requirements as the IRS may by regulation prescribe.[8]

IV. <u>Discussion</u>

Appellant's primary contention is that the transaction constituted an ordinary loan that he intended to repay. The FTB's primary argument is that appellant transferred most of the benefits and burdens of owning the Alteon stock to Derivium, without any obligation to repay the cash that appellant

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[6] See, e.g., IRS Gen. Couns. Mem. 36948 (Dec. 10, 1976). General Counsel Memoranda 36948 is not citable as precedent, and we refer to it only to provide historical background. In the brokerage transactions addressed by the IRS, government securities equal to at least 100 percent of the value of the loaned stock were deposited as collateral, and, at the close of the transaction, the stock borrower typically returned stock to the lender. The IRS applied an "open transaction" theory, reasoning that the transactions constituted a nontaxable exchange of stock for stock, as long as identical stock was returned to the stock lender. We decline to extend this theory to appellant's transaction, in which cash was received with no real obligation to repay the cash, and note that open transaction treatment is generally restricted to those rare and extraordinary cases in which the property received has no reasonably ascertainable fair market value. (See Treas. Reg. § 1.1001-1(a).)

[7] Section 18031 incorporates IRC section 1058.

[8] Proposed regulations under IRC section 1058 provide that stock loans must be terminable by the lender on five business days' notice and further provide that stock loans that do not comply with the requirements of IRC section 1058 constitute taxable transactions. (Treas. Prop. Reg. § 1.1058-1.)

received from Derivium. Thus, the FTB argues that the transaction was, in reality, a taxable sale that the parties merely disguised as a loan. In the alternative, the FTB argues that appellant should be taxed on the gain realized as a result of the sale of appellant's Alteon stock by Derivium.

Before discussing whether appellant's transaction constituted a taxable sale, we first want to dispel any notion that the transaction resembled an ordinary loan transaction. In an ordinary margin loan transaction with a stock broker, an investor obtains a *recourse* loan from a licensed and regulated securities broker.[9] If the customer's stock declines to a value below the amount due under the loan, or becomes worthless, the customer is personally liable for the loan and the broker can sue the customer for payment. Thus, if the value of the stock held in the customer's margin account declines precipitously, the customer may have to sell other personal assets (such as his or her home or car) in order to repay the margin loan. As a result, the customer retains all of the economic risk associated with ownership of the stock in his or her margin account.

In addition, the customer is not permitted to borrow more than 50 percent of the value of the securities held by the broker in the customer's margin account. The customer must agree to post additional collateral, or repay the loan or a portion thereof, if the value of the securities declines and the broker issues a margin call. At any time, the broker may call the loan or the customer may repay the loan (or replace the collateral with other collateral of equal or greater value).

For these reasons, it is very likely that an ordinary margin loan that is extended by a securities broker will be repaid, even if the value of the securities in the customer's margin account declines substantially. At all times, the brokerage customer retains the risks and potential rewards of owning the securities held in his or her margin account.

Unlike an investor who receives an ordinary margin loan from his broker, appellant:

- transferred his securities to Derivium, an entity that was not a broker and was not affiliated with a broker;
- was not required to post additional collateral if the value of the stock declined (and therefore would never receive a margin call, even if the stock purportedly pledged as security for the loan became worthless);

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[9] See *Racine v. Commissioner* (2007) 493 F.3d 777, 781 (noting that margin loans constitute recourse debt for which a brokerage customer is personally liable).

- received a *nonrecourse* loan, secured only by the shares that were transferred to Derivium;
- received a loan equal to 90 percent of the value of the shares pledged to secure the loan (rather than a loan equal to only 50 percent of the value of the shares);
- was not permitted to, and could not be required to, pay any principal or interest on the loan for a period of three years; and
- could not replace the pledged stock with other stock or property of equal or greater value during the loan term.[10]

Nor can it be argued that appellant's loan is similar to an ordinary loan that is secured by tangible property. Unlike an ordinary borrower who grants a lender a security interest in real property or other tangible assets owned by him, appellant completely forfeited his right to use or control the pledged property. Appellant could not prevent the purported lender from selling the "pledged" property outright, even if appellant was then fully complying with the loan terms, and appellant did not have the right to reacquire the pledged property at the end of the loan term.

Appellant's transaction is thus unlike a normal brokerage transaction and unlike an ordinary loan that is secured by tangible property. Although Derivium widely marketed its 90% Stock Loan product, we are aware of no published decision holding that it constitutes a bona fide loan for tax purposes.

In order to determine whether appellant's transaction constituted a taxable sale, we will examine the distribution of the burdens and benefits of ownership. (See discussion, *ante*, in Section III, and cases and decisions cited therein.) Thus, we will consider which party possesses and controls the property, which party obtains income from the property, which party suffers from a decline in the property's value or benefits from an increase in the property's value and how the parties treated the transaction.

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[10] Nor can one draw an analogy between appellant's loan and a subordination agreement by which a brokerage customer permits a brokerage firm to use his securities to meet the brokerage's net capital requirements under stock exchange rules. (See, e.g., *Cruttenden v. Commissioner* (9th Cir. 1981) 644 F.2d 1368.) Unlike shares transferred subject to a broker under a subordination agreement, appellant did not retain the right to vote the shares and receive dividends on the shares. Nor did he have the power to replace the shares with substitute collateral during the term of the agreement. Finally, broker subordination agreements reflect "the peculiar requirements of the brokerage industry" (*Id*. at 1374), and, as noted previously, Derivium was neither a broker nor affiliated with a broker.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Here, following Derivium's receipt of appellant's Alteon stock, Derivium obtained complete and unfettered control of the stock. Pursuant to the terms of the Master Agreement, Derivium had the unconditional right to pledge the shares, vote the shares or sell the shares.

In fact, it appears that Derivium sold the shares immediately after receiving them. The record shows that, within a day of receiving appellant's 15,000 shares of Alteon stock, Derivium sold the same number of shares of Alteon stock. Thus, although there is no document specifically identifying the shares sold as being those shares received from appellant, the timing of the sales by Derivium suggests that it sold the same shares that were transferred to it by appellant. Also, the FTB submitted a deposition from the chief executive officer of Derivium, Dr. Charles Cathcart, that was submitted in *People of State of California v. Derivium Capital LLC, et al.,* Sacramento Superior Court Case No. 02AS05849, in the course of litigation concerning whether or not the stock loan transactions constituted sales for purposes of the California Corporations Code.[11] The deposition indicates that Derivium typically sold shares that it received from customers as collateral.[12] Thus, a preponderance of the evidence indicates that Derivium immediately sold appellant's Alteon shares.[13]

In any event, regardless of whether the shares were actually sold, it is uncontested that Derivium controlled the shares, could vote the shares, was free to sell the shares and had no obligation to return the pledged shares to appellant. In addition, Derivium had no obligation during the loan term to transfer to appellant any dividends that were paid on his Alteon stock. The Master Agreement stated that any dividends would be applied to reduce accrued interest, so appellant would only obtain the

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[11] On October 16, 2006, this court ruled, after a trial, that the purported loans constituted sales for purposes of the California Corporations Code. We note that on November 5, 2003, another California Superior Court had ruled, in the context of a summary judgment motion, that the loans were bona fide for purposes of the California Corporations Code. (See *In re Derivium Capital LLC* (S.D.N.Y. 2006) 2006 U.S.Dist. Lexis 31427 (discussing the history of Derivium and surrounding litigation).) In any event, neither determination requires us to reach the same conclusion for tax purposes.

[12] Derivium later produced an account statement showing "collateral" of 27,472 shares of Nortel Networks Corporation. (Late in 2000, Nortel acquired Alteon in a transaction intended to constitute a tax-free exchange of stock.) In light of the fact that the Master Agreement permitted appellant's collateral to be sold and the evidence suggesting that Derivium actually sold the shares, the account statement may have been inaccurate or may indicate only that appellant would be entitled to this number of Nortel shares if he repaid the purported loan, not that any specific shares were then held by Derivium for appellant's account.

[13] Although we reach our decision today on a different basis, we note that appellant might recognize taxable gain as a result of Derivium's sale of his shares if Derivium sold the shares as appellant's agent. (Cf. *Richard J. Hutcheson, et ux.* (1996) T.C. Memo 1996-127 (holding that a taxpayer may be liable on his agent's sale of his shares, even if the sale was contrary to the taxpayer's expectations).

economic benefit of any dividends if the purported loan was repaid at the end of the term. Taken together, these facts weigh in favor of the FTB's determination that Derivium owned the shares for tax purposes.

Moreover, appellant had no risk of loss or potential for gain with respect to the specific shares transferred. Derivium was free to sell the "pledged" shares and retain the proceeds from any such sale, subject only to the contractual requirement that it deliver the same number of shares of the same issuer to appellant if he repaid the purported loan at the close of the transaction. Thus, this appeal does not involve a "pledge" of property in the ordinary sense, because Derivium did not promise to retain the transferred property as security for its purported loan to appellant.[14]

The most that can be said regarding appellant's potential for loss or gain is that he had some potential to obtain future appreciation in the value of Alteon's stock if it appreciated above the loan pay-off amount (i.e., if the stock appreciated by approximately 21 percent).[15] If the value of Alteon stock declined, whether by 20 percent or 90 percent, or simply failed to appreciate by more than approximately 21 percent, the result to appellant would be the same – he would retain the cash he obtained at the outset of the transaction. On the other hand, if Alteon stock had appreciated by approximately 21 percent or more by the maturity date, appellant might elect to repay the purported loan and obtain a number of shares equivalent to the number of shares that he transferred to Derivium.[16]

Thus, appellant gave up all his rights in the specific stock transferred and received in return (i) cash equal to 90 percent of the fair market value of the stock, (ii) the purported ability to

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[14] We recognize that securities brokers may, without triggering gain, replace securities held in a margin account by a brokerage customer with identical securities. However, as we have previously outlined, appellant's transaction differs significantly from an ordinary margin loan because, unlike a brokerage customer who secures a margin loan, appellant materially limited his potential for gain or loss.

[15] Appellant received cash equal to 90 percent of the fair market value of the stock. With an interest rate compounded annually at 10.5 percent, the loan pay-off amount at the maturity of the purported loan, in three years, would be approximately 121 percent of the fair market value of the stock when appellant entered into the transaction. (Any dividends paid would reduce accrued interest; however, there is no indication that the stock was expected to pay enough dividends to significantly reduce accrued interest.)

[16] We note that appellant's 90 percent stock loan transaction is far different from a variable prepaid forward contract such as that described in IRS Revenue Ruling 2003-7, 2003-1 C.B. 363 (Jan. 2003). Appellant only obtains appreciation in the event that the stock appreciates by approximately 21 percent. In contrast, participants in a variable prepaid forward contract typically retain 100 percent of the first 25 percent of the stock's appreciation and 20 percent of any appreciation thereafter. In addition, participants retain the right to reacquire the specific shares pledged as part of the transaction, while appellant only has the right to acquire an equivalent number of shares. (See IRS Private Letter Ruling 200604033 (Oct. 20, 2005) (discussing Revenue Ruling 2003-7).)

indefinitely defer taxation of his gain and (iii) what amounted to an option to acquire equivalent stock if Alteon stock had appreciated by approximately 21 percent or more at the end of the three-year term.[17] In this context, the fact that appellant transferred the stock at a 10 percent discount from its fair market value did not give him an "equity" interest that ensured that the purported loan was likely to be repaid.[18] Instead, the 10 percent discount was the cost of obtaining both an expected tax benefit[19] and the opportunity to acquire equivalent stock if Alteon's stock price appreciated by approximately 21 percent or more.

If Derivium or the purported lender believed that the transaction constituted a bona fide loan that was likely to be repaid, one would expect Derivium or the purported lender to have taken actions to ensure that shares could be delivered to appellant when he repaid the loan. For example, if Derivium regarded the transaction as a bona fide loan, it presumably would have retained the pledged shares or hedged against an increase in the value of Alteon stock (e.g., by purchasing a call option to purchase replacement shares at the end of the three-year term). However, there is no credible evidence to suggest that Derivium or the purported lender took any steps demonstrating an expectation that the purported loan would be repaid, and some evidence to the contrary.[20]

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[17] One court explained that "the lure by which the product was sold, was as a tax shelter" and "there was little expectation that any borrower would ever redeem his stock at the end of the loan period." (*In re Derivium Capital LLC, supra,* 2006 U.S.Dist. Lexis 31427, p. 3.)

[18] Cf. *Waddell v. Commissioner* (1986) 86 T.C. 848, 901 – 907, affd. (9th Cir. 1988) 841 F.2d 264 (in which the tax court evaluated whether the taxpayer had pledged sufficient collateral to ensure that the loan was likely to be repaid) [*Waddell*].

[19] If appellant had simply directed his broker to sell his Alteon shares at their fair market value, his state and federal tax liability would have exceeded $270,000, and he would have received after-tax proceeds of less than $800,000 (i.e., less than 76 percent of the value of the shares), rather than the $946,310.62 (i.e., 90 percent of the value of the shares) that he actually received without paying any taxes. (The foregoing estimate conservatively assumes that appellant had held the shares for longer than one year and thus would be eligible for the preferential federal tax rate applicable to long-term capital gain, which was 20 percent in 2000. If appellant had held the shares for less than a year, his after-tax proceeds from an outright sale would have been less than $600,000, after taking into account the then current maximum federal tax rate of 39.6 percent.)

[20] As noted previously, it appears that Derivium immediately sold the Alteon shares that it acquired. During testimony in connection with other litigation surrounding Derivium's 90% Stock Loan transaction (which was submitted in this appeal), Derivium's chief executive officer, Dr. Charles Cathcart, was unable to establish that any attempt was made to hedge against an increase in the value of securities received from customers. We note that, while the apparent lack of hedging suggests that Derivium did not expect the purported loan to be repaid, the presence of such hedging would not necessarily establish that Derivium regarded the transaction as a bona fide loan that was likely to be repaid. Instead, if hedging had occurred, it might suggest only that Derivium believed that replacement shares might have to be returned to appellant if he exercised his effective option to acquire Alteon shares three years in the future.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Similarly, appellant has provided no credible evidence that, when he entered into the transaction, he viewed it as a bona fide loan obligation that he expected to repay.[21] Appellant may have believed that he might repay the purported loan if the value of the stock appreciated over 21 percent. However, the contractual right to acquire stock three years in the future, at what amounts to a fixed purchase price that substantially exceeds the stock's current price, more closely resembles an option than a loan.

In summary, when the relative benefits and burdens of ownership are examined, appellant retained only one right: the right to obtain, not his transferred shares, but the same number of shares of the same issuer, in three years, if he repaid the amount due under the purported loan. While this contractual right has value, Derivium clearly obtained, at a minimum, most of the benefits and burdens related to ownership of the stock transferred by appellant.

This conclusion is reinforced by the Supreme Court's decision in *Provost,* which is discussed *ante* in Section III of this opinion. In fact, the stock lender in *Provost* retained more indicia of ownership than appellant. Among other things, as the value of the stock changed, the parties in *Provost* would transfer cash between them in order to ensure that the lender held cash equal to the full market price of the stock as security for the return of the same number of shares of stock. Thus, unlike appellant, the stock lender retained 100 percent of the risk of gain or loss resulting from appreciation or depreciation in the value of the stock.

Although the IRS views Derivium's 90% Stock Loan transaction as a tax-fraud scheme and has sought to prevent the marketing of the transaction,[22] it has permitted the ordinary commercial practice of lending shares to securities brokers on a nontaxable basis. (See discussion *ante,* in footnote 6 and related text.) As we have previously pointed out, this ordinary commercial practice involves transactions in which the stock lender does not reduce its risk of loss or potential for gain. Today, these

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[21] As the tax court stated in *Waddell*, *supra* at 904, "if we cannot conclude at the outset of the transaction that payment of the note is likely, then the note is too contingent to be recognized for tax purposes." Accordingly, although we consider the surrounding circumstances and the intent of the parties when they entered into the transaction, we do not consider later events, such as a later unforeseen decline in the value of the purported collateral that makes repayment unlikely.

[22] See http://www.usdoj.gov/tax/txdv07727.htm (providing a link to a complaint filed by the United States Department of Justice, at the request of the Chief Counsel of the IRS, to obtain an injunction preventing the further marketing of Derivium's 90% Stock Loan transaction; the complaint was filed on September 17, 2007, in the United States District Court for the Northern District of California, San Francisco Division).

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

types of transactions are exempted from tax by IRC section 1058. Our decision today involves a very different transaction, in which the taxpayer has, among other things, greatly reduced his potential for gain or loss and is therefore not eligible for the exemption provided by IRC section 1058. As a result, our decision will have no impact on the ordinary commercial practice of lending shares to securities brokers on a nontaxable basis.

In deciding this appeal, we are mindful that, where the substance of a transaction matches its form, the government should "honor the allocation of rights and duties effectuated by the parties." (*Frank Lyon Co.*, *supra* 435 U.S. 561, 583 -584.) However, *Frank Lyon Co.* involved a sale and leaseback transaction that was structured in cooperation with federal banking authorities. The Court respected the form in which the transaction was cast in large part because the taxpayer "exposed its very business well-being to [the] real and substantial risk [that loans secured by the property would not be repaid]." (*Id*. at p. 577.) Unlike the taxpayer in *Frank Lyon Co.*, appellant received a fully nonrecourse loan and thus was free to walk away from the loan without endangering his other assets. Moreover, appellant has not established that he and the other parties to the 90 percent stock loan transaction treated the transaction in a manner that was consistent with its stated form as a loan. In this appeal, the description of appellant's 90 percent stock loan transaction as a "loan" is a meaningless label, rather than an accurate description of the rights and duties of the parties.

Appellant raised a number of arguments in his appeal that we have not addressed in this decision. For example, appellant argued, without presenting any credible evidence, that he was not a resident of California, although he owned a residence here, signed transaction documents indicating a California address, worked for a company in San Francisco and received his mail in California. Appellant also argued that he never held shares, only options to acquire shares, when the documentation for his transaction makes no mention of any options (and, in any event, if a taxable sale occurred, a sale of options would also be taxable). Although we do not address all of appellant's arguments in this decision, we have considered them and found them to be without merit.[23]

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[23] Appellant also argued that the FTB violated constitutional due process and that the FTB's collection of the amount due is foreclosed by application of bankruptcy laws. We have declined to consider these contentions, which is consistent with our prior decisions regarding these types of arguments. (See *Appeal of Robert G. and Jean C. Smith*, 81-SBE-145, Oct. 27, 1981; *Appeal of Aimor Corp.*, 83-SBE-221, Oct. 26, 1983; *Appeals of Walter R. Bailey*, 92-SBE-001, Feb. 20, 1992.)

V. Conclusion

Appellant transferred appreciated stock in return for cash, without any real obligation to return the cash received or any demonstrated intent to repay the purported loan. Under our prior decisions regarding the benefits and burdens of ownership and applicable case law, this transaction constitutes a taxable sale.

Accordingly, the action of the FTB is sustained.

ORDER

Pursuant to the views expressed in the opinion, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to sections 19047 and 19333 of the Revenue and Taxation Code, that: the action of the Franchise Tax Board on the protest of Rhoda Geisel and Larry Geisel against a proposed assessment of additional income tax in the amount of $92,424 for the year ended December 31, 2000, is sustained.

Done at Sacramento, California, this 12th day of December, 2007, by the State Board of Equalization, with Board Members Ms. Yee, Ms. Chu, Mr. Leonard, Ms. Steel and Ms. Mandel* present.

Betty T. Yee, Chair

Judy Chu, Ph.D., Member

Bill Leonard, Member

________________, Member

________________, Member

*For John Chiang per Government Code section 7.9.

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