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Identifying the Real Owner—Tax Court Revisits Grants of Reciprocal Put and Call Options

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A frequently critical element in the negotiation of a joint venture is the "exit strategy." The parties may have a clear understanding as to who is likely to be bought out, possibly even for how much, and will desire that the agreement between them provide for the desired results with a minimum of uncertainty.

A common means of implementing an exit strategy is to provide for reciprocal options, with one (the "put") granting to the party expected to be the seller the right to sell its interest to the anticipated buyer, typically at a fixed price or at a price determined by formula or appraisal. The other option (the "call") will grant to the anticipated buyer the right to buy the interest of the other venturer.

One concern with respect to such arrangements is whether the grant of the reciprocal put and call options transfers to the anticipated buyer substantially all of the burdens and benefits of ownership with respect to the interest subject to the options, such that the buyer should be treated as the owner of that interest for tax purposes upon the grant of the options -- notwithstanding the parties' intentions to the contrary. The analysis tends to be extremely fact-specific, focusing on similarities and differences between the put and the call as well as other terms of the venture to assess whether it is almost certain that one of the options will be exercised -- in which case recharacterization of the transactions may well be appropriate.

The Tax Court recently revisited this issue in *Griffin Paper Corporation v. Commissioner* (T.C. Memo 1997-409). In *Griffin*, a Finnish forest products company referred to as KKO purchased land in Mississippi pursuant to a plan to build and operate a pulp mill. As a first step in the plan, Griffin Paper Corp. ("Griffin"), KKO's U.S. holding company, formed a wholly owned subsidiary ("X") to own a sawmill, the operation of which would provide a key raw material for the pulp mill.

The sawmill commenced operations in 1977 but generated losses for several years thereafter, with accumulated losses of $17.2 million through 1980. KKO decided to look for a partner, and in the fall of 1980 began serious discussions with Great Northern Nekoosa Corp. ("GNN"), a U.S. pulp and paper producer, to build a pulp mill on X's property.

These discussions resulted in a letter of intent, executed in November, 1980, that described a venture that would be owned 80% by GNN and 20% by KKO. Each of GNN and KKO would be responsible for a pro rata share of the venture's debt and equity, with KKO's contribution to include its sawmill operations, the pulp mill site, and related machinery and intangible property.

In 1981, internal projections indicated that the venture would generally incur losses through 1989, and the engineering firm selected by GNN reported substantial cost increases for building the pulp mill. Near the end of the year, KKO proposed that it instead sell the sawmill to GNN for cash.

GNN wanted to retain the joint venture structure, however, partly to benefit from KKO's experience in building pulp mills. In December, 1981, a stockholders' agreement and other documents were executed to form the joint venture.

Under the agreements, S, a subsidiary of GNN, acquired from X 95% of X's common stock for $56.7 million, and subscribed for 4,000 shares of nonvoting preferred stock of X. The preferred stock had a 6% noncumulative dividend and a redemption price of $10,000 per share (apparently with no mandatory redemption before liquidation). Griffin received 1,940 shares of the X preferred stock, and, after the closing, held 5% of the common stock.

X assumed $10 million of debt incurred by KKO in connection with the construction of the sawmill (reducing Griffin's net book investment in X to $21.5 million), and it was agreed that S would provide the funds necessary to construct and operate the pulp mill. It was also agreed that S would select eight members of the 10-member board of directors of X and that Griffin would select the other two members. The agreements also required the approval of holders of 96% of the common stock for certain transactions that would reduce Griffin's percentage interest in the common stock.

The stockholders' agreement granted to S a call, exercisable on six months' written notice on and after January 1, 1989, to purchase all of Griffin's common stock and preferred stock in X for $10,000 per share of preferred stock, approximately $59,000 per share of common stock, and 5% of the retained earnings of X as of a specified date apparently before the closing under the option. Under the same agreement, Griffin had the right, on six months' notice on and after January 1, 1989, to sell its preferred stock and common stock in X to S at the same price.

Griffin gave notice of exercise of the put on January 2, 1989, and sold its X stock to S in July, 1989 for $31.75 million.

The annual reports and federal income tax returns of GNN through 1988 indicated ownership by GNN (presumably through S) of 95% of the common stock of X. In tax returns for 1987 and thereafter, however, GNN treated the 1981 transactions as a purchase of Griffin's shares in X for a deferred payment of $31.75 million, a portion of which was treated as interest under IRC Search7RH483. GNN ultimately claimed, in its petition to the Tax Court, an interest deduction of $16.5 million for 1989 with respect to the alleged purchase of stock from Griffin in 1981.

GNN's case was consolidated with a petition filed by Griffin to redetermine an alleged income tax deficiency of $3.7 million for 1989 (presumably resulting from a "protective" assessment made by the IRS with respect to these transactions).

Before the Tax Court, GNN argued that it acquired the benefits and burdens of ownership of Griffin's X stock in 1981, because there was only a remote possibility that neither of the reciprocal options would be exercised and because the stockholders' agreement had effectively shifted the benefits and burdens of ownership of all of the X stock to GNN.

Griffin and the Commissioner argued, conversely, that Griffin retained the benefits and burdens of ownership of the stock until 1989, on the basis of the form of the transactions and the intentions of the parties.

The court concluded that the sale did not occur until 1989. The opinion notes, in support of this conclusion, that Griffin was the legal owner of stock in X; that Griffin had rights associated with stock ownership, including the right to appoint two directors and the right to receive any dividends declared with respect to its X stock; and that Griffin could sell its stock and could block a liquidation and certain dilutive transactions.

The court also noted that the documents did not refer to the 1981 transactions as a sale, and that there was no promissory note, stated amount due or stated interest indicative of a debtor/creditor relationship. In addition, according to the opinion, GNN's financial statements and tax returns consistently indicated ownership of 95% of the common stock of X (although this seems inconsistent with the statement elsewhere that GNN's 1987 and later returns reflected treatment of the 1981 transactions as a sale).

The court also relied on *Penn-Dixie Steel Corp. v. Commissioner* (69 T.C. 837 (1978)), in which the Tax Court concluded that a grant of reciprocal options with respect to stock did not result in a transfer of ownership of the stock for tax purposes. The court found in that case that there was significant uncertainty as to whether either the put or call would be exercised, and therefore that the transactions in which the put and call were granted did not sufficiently commit the parties to a transfer of the stock so as to constitute a sale.

In *Penn-Dixie*, however, the buyer's call, for a period of one year, could be exercised only after the lapse of the seller's put (also exercisable for one year). The *Penn-Dixie* opinion states that "a different result might obtain if the put and call were exercisable and expired on the same date," and then cites Rev. Rul. 72-543 (1972-2 C.B. 87). In that ruling, regarding a sale/leaseback effected to finance the reconstruction of an ocean freight vessel, the lessor held a put and the lessee held a call exercisable on the same date and for the same price, and the IRS concluded that the seller/lessee was the owner of the vessel for tax purposes.

Griffin does not refer to Rev. Rul. 72-543. The opinion does discuss, but quickly dismisses, GNN's reliance on *Kwiat v. Commissioner* (T.C. Memo 1992-433). In that Tax Court memorandum decision, involving a purported lease of industrial shelving with reciprocal put and call options exercisable at different times and for different prices, the existence of the options was found to be sufficient to shift the benefits and burdens of ownership such that the lessors were not the owners of the property for tax purposes.

The *Griffin* opinion notes that, in *Kwiat*, the "'pertinent inquiry' was 'whether the purported lessor maintained the risk of economic depreciation and benefit of appreciation at the end of the lease term'"; and observes that "[t]hat is not the case here." It is not clear, however, why the same sort of analysis regarding the allocation of the economic burdens and benefits that was used in *Kwiat* was not applied in *Griffin*.

A strong argument can be made that, in *Griffin*, excessive weight was given to the form of the transaction and the purported intentions of the parties, and that insufficient consideration was given to the foreseeable economic consequences, as of December, 1981, of the agreements executed at that time.

KKO, as a stockholder with a put at a price that was apparently greater than the value of its investment when the joint venture was entered into (based on the terms of the 1981 transaction), appears to have had no significant risk of loss.

KKO's opportunity to benefit from appreciation in the stock of X seems slight, taking into account that the preferred stock had a noncumulative dividend and that the common stock held by Griffin represented, after 1981, a small minority position. It seems unlikely that dividends would be paid on the preferred stock, or on the common stock for the first five years of operations in light of the anticipated losses in those years; and any dividends paid thereafter on the common would not likely provide to Griffin a competitive return on its overall investment (which might be viewed for this purpose as the minimum put price).

In addition, if a sale of the stock or assets of X ultimately occurred for an amount that, when allocated to Griffin's stock, exceeded the call price, S would surely exercise its call first. Thus, the circumstances as of the end of 1981 suggested that Griffin's stock position would not appreciate to the benefit of Griffin or yield significant income, and therefore that Griffin should simply exercise its put as soon as possible -- which is what Griffin did.

Conclusions

The *Griffin* case, in concluding that no present transfer occurred even in what appears to be a fairly strong case for such a recharacterization, suggests that the Tax Court will rarely, if ever, treat reciprocal put and call options at the same price as effecting a transfer of the benefits and burdens of ownership of stock or other equity interests. Since *Griffin* is a memorandum decision, however, it should not be assumed that the entire Tax Court would concur with the analysis and conclusions expressed in the opinion. It should also be kept in mind that, as indicated by *Kwiat* and *Penn-Dixie* (and elsewhere), a taxpayer arguing substance over form generally has a heavier burden of proof than the government would have, if making a similar argument.

Griffin may also encourage more aggressive positions, in the form of reciprocal options that virtually assure a sale at a later date. Such tactics are potentially to the substantial detriment of the fisc in situations where, for example, a present sale would trigger a substantial tax liability. Thus, the IRS may well regret this victory, and take the opposite position in other cases. It seems virtually certain that *Griffin* will not be the final word in this area.