

1 **BOARD OF EQUALIZATION**
2 **STATE OF CALIFORNIA**
3

4 In the Matter of the Appeal of:) **FORMAL OPINION**
5) **2007-SBE-002**
6 **LARRY GEISEL AND RHODA GEISEL**) Case No. 358724
7)
8)

9 Representing the Parties:

10 For Appellants: Larry Geisel

11 For Respondent: D. Todd Watkins, Tax Counsel

12 Counsel for the Board of Equalization: Grant S. Thompson, Tax Counsel
13

14 **I. Introduction**

15 This appeal is made pursuant to section 19045 of the Revenue and Taxation Code¹ from
16 the action of the Franchise Tax Board (FTB or respondent) on the protest of Rhoda Geisel and Larry
17 Geisel against a proposed assessment of additional income tax in the amount of \$92,424 for the year
18 ended December 31, 2000. The core issue in this appeal is whether appellant Larry Geisel engaged in a
19 taxable sale transaction by transferring stock to Derivium Capital, LLC (“Derivium”) in a transaction
20 that was documented as a nonrecourse loan.²

21 In the transaction, appellant transferred 15,000 shares of Alteon WebSystems, Inc.
22 (“Alteon”) stock to Derivium. Shortly after receiving appellant’s shares, Derivium sold 15,000 shares of
23 Alteon stock and delivered 90 percent of the sale proceeds, or \$946,310.62, to appellant.

24 Derivium and appellant documented the transaction as a nonrecourse loan that was
25 secured solely by the transferred shares. The purported loan accrued interest at 10.5 percent,
26 compounded annually, and could not be repaid prior to the end of the three-year loan term. Derivium
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28 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.

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

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

12 **II. Factual and Procedural Background**

13 Appellant entered into a “Master Agreement to Provide Custodial Services” (the “Master
14 Agreement”) with Derivium on or about June 7, 2000.³ Pursuant to the terms of the Master Agreement,
15 Derivium agreed to arrange a three-year nonrecourse loan in the amount of \$946,310.62 to appellant and
16 provide custodial services with respect to the stock pledged to secure the purported loan.

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

21 As collateral for the loan, appellant transferred 15,000 shares of Alteon stock to
22 Derivium. The Master Agreement and related documentation stated that the loan amount was intended
23 to constitute 90 percent of the “hedged value” of the shares, which “hedged value” was listed as
24 \$1,051,456.25. Although the documentation refers to the “hedged value” of the shares, the evidence
25 suggests that Derivium sold the “pledged” shares within a day of receiving them, and the amount stated
26 as the “hedged value” of the shares was equal to the cash that Derivium received from its sale of Alteon
27 shares.

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

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

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

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

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

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

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

25	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.
26		
27	June 12, 2000	Derivium acknowledges receipt of appellant's 15,000 shares of Alteon stock, which shares are valued at \$1,035,000.
28	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

1 June 13, 2000 Derivium sends appellant an “Activity Confirmation” reporting a “hedged value” of
2 the Alteon stock as \$1,051,456.25 (i.e., an amount equal to the gross proceeds
3 received by Derivium from its sale of Alteon stock), and a loan amount of
4 \$946,310.62 (90 percent of the “hedged value”).

5 June 15, 2000 Appellant receives a statement, dated June 15, 2000, indicating that he received
6 \$946,310.62 from Derivium on that date.

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

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

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

17 The FTB later issued a Notice of Action (NOA) that allowed appellants a tax basis in the
18 stock equal to 10 percent of the stock’s fair market value. The NOA explained that because the cash
19 received by appellants in the transaction equaled 90 percent of the stock’s fair market value, the
20 remaining 10 percent of the stock’s value was allowed as appellants’ basis in the stock. As a result,
21 income from the stock sale was reduced to \$946,310, and the total additional tax due was reduced to
22 \$92,424. The NOA also indicated that appellants were California residents at the time of the 90 percent
23 stock loan transaction. Appellants then timely filed this appeal.

24 **III. Legal Background**

25 It is well established that “the simple expedient of drawing up papers [is not] controlling
26 for tax purposes when the objective economic realities are to the contrary.” (*Frank Lyon Co. v. United*
27 *States* (1978) 435 U.S. 561, 573 [citing *Commissioner v. Tower* (1946) 327 U.S. 280, 291] [*Frank Lyon*
28 *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

1 governs over form”), cert. den. (2007) 127 S. Ct. 1339; *Grodt & McKay Realty* (1981) 77 T.C. 1221;
2 *Appeal of Alameda Bancorporation, Inc., et al.*, 95-SBE-001, Mar. 9, 1995 [*Alameda*
3 *Bancorporation*].)⁴

4 In order to determine whether ownership of property has been transferred, we examine
5 the distribution of the burdens and benefits of ownership in light of all the surrounding facts and
6 circumstances. (See *Grodt & McKay Realty, supra*, 77 T.C. 1221; *Alameda Bancorporation*.) When
7 determining whether ownership of stock has been transferred, courts consider, in particular, which party
8 suffers from a decline in the stock’s value or benefits from an increase in the stock’s value, which party
9 has the right to vote the shares and receive dividends on the shares and which party has the right to sell
10 the shares. (See *Miami National Bank v. Commissioner* (1977) 67 T.C. 793; *Hall v. Commissioner*
11 (1950) 15 T.C. 195 affd. (9th Cir. 1952) 194 F.2d 538.)

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

15 The petitioner had no dominion or control over the shares until they were delivered to
16 him There is no evidence that the petitioner was entitled to vote the shares prior to
17 that time or that he was entitled to share in any dividends which might be declared by the
18 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.

19 (*Id.* at p. 200.)

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

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28 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.)

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

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

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

8 Although *Provost* is an old case that involved a stamp tax, it remains good law and has
9 been cited favorably in more recent cases involving the income tax. (See, e.g., *H.J. Heinz Co. v. United*
10 *States* (Fed.Cl. 2007) 76 Fed.Cl. 570, 582; *Commissioner v. Wilson* (9th Cir. 1947) 163 F.2d 680; see
11 generally Shapiro, *Taxation of Equity Derivatives* (2003, as supplemented through 2006) T.M. Portfolios
12 188 at p. A-20.) In *Wilson, supra*, the Ninth Circuit Court of Appeals determined that a stock borrower
13 who sold “short” the borrowed stock could not add to his tax basis amounts that were paid to the stock
14 lender.⁵ In reaching this conclusion, the court quoted the following passage from *Dart v. Commissioner*
15 *of Internal Revenue* (4th Cir. 1935) 74 F.2d 845, 847):

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

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

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

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

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28 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.

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

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

18 **IV. Discussion**

19 Appellant's primary contention is that the transaction constituted an ordinary loan that he
20 intended to repay. The FTB's primary argument is that appellant transferred most of the benefits and
21 burdens of owning the Alteon stock to Derivium, without any obligation to repay the cash that appellant
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23 ⁶ See, e.g., IRS Gen. Couns. Mem. 36948 (Dec. 10, 1976). General Counsel Memoranda 36948 is not citable as precedent,
24 and we refer to it only to provide historical background. In the brokerage transactions addressed by the IRS, government
25 securities equal to at least 100 percent of the value of the loaned stock were deposited as collateral, and, at the close of the
26 transaction, the stock borrower typically returned stock to the lender. The IRS applied an "open transaction" theory,
27 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).)

28 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.)

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

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

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

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

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

- 23 • transferred his securities to Derivium, an entity that was not a broker and was not
24 affiliated with a broker;
- 25 • was not required to post additional collateral if the value of the stock declined
26 (and therefore would never receive a margin call, even if the stock purportedly
27 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).

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

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

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

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

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26 ¹⁰ Nor can one draw an analogy between appellant's loan and a subordination agreement by which a brokerage customer
27 permits a brokerage firm to use his securities to meet the brokerage's net capital requirements under stock exchange rules.
28 (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.

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

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

15 In any event, regardless of whether the shares were actually sold, it is uncontested that
16 Derivium controlled the shares, could vote the shares, was free to sell the shares and had no obligation to
17 return the pledged shares to appellant. In addition, Derivium had no obligation during the loan term to
18 transfer to appellant any dividends that were paid on his Alteon stock. The Master Agreement stated
19 that any dividends would be applied to reduce accrued interest, so appellant would only obtain the
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21 ¹¹ On October 16, 2006, this court ruled, after a trial, that the purported loans constituted sales for purposes of the California
22 Corporations Code. We note that on November 5, 2003, another California Superior Court had ruled, in the context of a
23 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.

24 ¹² Derivium later produced an account statement showing "collateral" of 27,472 shares of Nortel Networks Corporation.
25 (Late in 2000, Nortel acquired Alteon in a transaction intended to constitute a tax-free exchange of stock.) In light of the fact
26 that the Master Agreement permitted appellant's collateral to be sold and the evidence suggesting that Derivium actually sold
27 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.

28 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).)

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

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

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

18 Thus, appellant gave up all his rights in the specific stock transferred and received in
19 return (i) cash equal to 90 percent of the fair market value of the stock, (ii) the purported ability to
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21 ¹⁴ We recognize that securities brokers may, without triggering gain, replace securities held in a margin account by a
22 brokerage customer with identical securities. However, as we have previously outlined, appellant's transaction differs
23 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.

24 ¹⁵ Appellant received cash equal to 90 percent of the fair market value of the stock. With an interest rate compounded
25 annually at 10.5 percent, the loan pay-off amount at the maturity of the purported loan, in three years, would be
26 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.)

27 ¹⁶ We note that appellant's 90 percent stock loan transaction is far different from a variable prepaid forward contract such as
28 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).)

1 indefinitely defer taxation of his gain and (iii) what amounted to an option to acquire equivalent stock if
2 Alteon stock had appreciated by approximately 21 percent or more at the end of the three-year term.¹⁷
3 In this context, the fact that appellant transferred the stock at a 10 percent discount from its fair market
4 value did not give him an “equity” interest that ensured that the purported loan was likely to be repaid.¹⁸
5 Instead, the 10 percent discount was the cost of obtaining both an expected tax benefit¹⁹ and the
6 opportunity to acquire equivalent stock if Alteon’s stock price appreciated by approximately 21 percent
7 or more.

8 If Derivium or the purported lender believed that the transaction constituted a bona fide
9 loan that was likely to be repaid, one would expect Derivium or the purported lender to have taken
10 actions to ensure that shares could be delivered to appellant when he repaid the loan. For example, if
11 Derivium regarded the transaction as a bona fide loan, it presumably would have retained the pledged
12 shares or hedged against an increase in the value of Alteon stock (e.g., by purchasing a call option to
13 purchase replacement shares at the end of the three-year term). However, there is no credible evidence
14 to suggest that Derivium or the purported lender took any steps demonstrating an expectation that the
15 purported loan would be repaid, and some evidence to the contrary.²⁰
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18 ¹⁷ One court explained that “the lure by which the product was sold, was as a tax shelter” and “there was little expectation
19 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.)

20 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
21 evaluated whether the taxpayer had pledged sufficient collateral to ensure that the loan was likely to be repaid) [*Waddell*].

22 ¹⁹ If appellant had simply directed his broker to sell his Alteon shares at their fair market value, his state and federal tax
23 liability would have exceeded \$270,000, and he would have received after-tax proceeds of less than \$800,000 (i.e., less than
24 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
25 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.)

26 ²⁰ As noted previously, it appears that Derivium immediately sold the Alteon shares that it acquired. During testimony in
27 connection with other litigation surrounding Derivium’s 90% Stock Loan transaction (which was submitted in this appeal),
28 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.

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

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

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

19 Although the IRS views Derivium's 90% Stock Loan transaction as a tax-fraud scheme
20 and has sought to prevent the marketing of the transaction,²² it has permitted the ordinary commercial
21 practice of lending shares to securities brokers on a nontaxable basis. (See discussion *ante*, in footnote 6
22 and related text.) As we have previously pointed out, this ordinary commercial practice involves
23 transactions in which the stock lender does not reduce its risk of loss or potential for gain. Today, these
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25 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
26 note is likely, then the note is too contingent to be recognized for tax purposes." Accordingly, although we consider the
27 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.

28 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).

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

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

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

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28 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.) *Appeal of Larry Geisel and Rhoda Geisel*

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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.

Geisel_FO_gst