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Capital Loss Disputed: *Computer Sciences Corp. v. Commissioner*

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A taxpayer may desire to recognize a loss by reason of diminution in value of property, in order to offset other income, but without effecting a full disposition of the property. *Computer Sciences Corporation v. Commissioner* (Tax Court Docket No. 4823-21) reflects such a situation. The petitioner, Computer Sciences Corporation (CSC), entered into a series of transactions involving acquisition and sale of stock and a note of a subsidiary; the transactions were apparently intended to cause recognition of a capital loss to offset a capital gain realized by CSC in the same fiscal year. The Internal Revenue Service disallowed the loss and determined a tax deficiency. By order filed July 24, 2023, the Tax Court determined that the presence of unresolved factual questions led to denial of a motion by CSC for partial summary judgment to the effect that it was entitled to the capital loss.

FACTS IN *COMPUTER SCIENCES CORPORATION*

CSC was the parent of an affiliated group of corporations engaged in information technology businesses and filing a consolidated federal income tax return. In its fiscal year that ended March 29, 2013, CSC realized a capital gain of $752,000 ('000s omitted here and below) from sale of its consumer reporting business. From and after the time the sale was approved, the board of directors of CSC considered steps apparently intended to mitigate the income tax liability that would otherwise result from this gain. A transaction was ultimately implemented with respect to Covansys Corp., a subsidiary of CSC having no connection with the sold business.

The stock of Covansys, which CSC had acquired in 2007 for $1,300,000, was determined by valuation in March 2013 to have a value of $474,000, far less than its adjusted basis. CSC sought to recognize that loss, but without having Covansys leave the CSC consolidated group.

To achieve this result, CSC entered into a series of transactions with Bank of Tokyo-Mitsubishi UFJ (BTMU). After agreeing on March 22, 2013, to pay BTMU a "debt structuring fee" of approximately $3,400, CSC transferred on that date its stock of Covansys to CSC Consulting, Inc., another wholly owned subsidiary of CSC, in exchange for: participating Class A stock of Consulting having a face value of $62,500; Class B stock of Consulting with a fixed dividend and having a face value of $348,800; and a note to CSC from Consulting (referenced in the Tax Court order and below as the "Loan") having a principal amount of $62,600. CSC sold the Loan and the Class A stock to BTMU four days later for $62,600 and $62,500, respectively.

CSC reported its contribution of Covansys stock to Consulting as an exchange of property for stock within the scope of Internal Revenue Code section 351(a). Under that provision, no gain or loss is recognized if property is transferred to a corporation by one or more transferors solely in exchange for stock of the transferee and the transferor or transferors are in control of the transferee immediately after the exchange.

In this case, however, CSC received from Consulting, in addition to the Class A Stock, other property -- specifically, the Loan, and Class B stock of Consulting that was "nonqualifying preferred stock" (NQPS) under section 351(g). NQPS, which is preferred stock with specified features that make it resemble debt, is not treated as stock for purposes of section 351(a).

Where property is exchanged for stock and other property in an exchange otherwise qualifying under section 351(a), gain if any (but not loss) is recognized under section 351(b).

In these circumstances, Code section 358 provides that the tax basis of a transferor in stock other than NQPS received in the exchange is the tax basis of the property that it transferred to the corporation minus the fair market value of the other property received in the exchange. A valuation report determined the fair market value of the Loan and the Class B stock (NQPS) to be $62,600 and $348,800, respectively, or a total of $411,400. Thus, the basis of the Class A stock received by CSC was determined to be the basis of the property it transferred ($1,125,100) minus the fair market value of the other property received ($411,400), or $713,700.

The sale of the Class A stock to BTMU was therefore reflected by CSC on its tax return as resulting in a capital loss equal to the $62,500 received by CSC for such stock minus its basis in the stock of $713,700, or $651,200.

DISCUSSION

Before the Tax Court, the government made several arguments in opposition to the reported loss. It argued that the transactions should be viewed, under substance-over-form principles and the step transaction doctrine, as an integrated financing transaction in which, in substance, Consulting first entered into the Loan with, and issued its Class A stock to, BTMU, and then issued its Class B stock and transferred the cash received from BTMU to CSC in exchange for the Covansys stock.

It was further noted by the government that the ownership by CSC of the Class A stock and the Loan was transitory, and that BTMU had essentially committed to purchase the Loan and the Class A stock by the time CSC transferred Covansys to Consulting. The government asserted that the alleged section 351 transaction had no non-tax purpose and was undertaken solely to cause CSC to benefit from the basis computation provisions of section 358, and in an effort to avoid application of a consolidated return regulation that would otherwise have precluded current recognition of the built-in loss with respect to Covansys.

The government further argued that the terms of the Class A stock were such as to cause it to be debt for tax purposes rather than equity, taking into account that the stock was redeemable at CSC's option after five years and was required to be redeemed after ten years, that it provided for a dividend reset after five years intended to maintain the value of the stock, that the stock was effectively secured by an obligation of Consulting to maintain a specified amount of "qualified assets" that could include a receivable owed to Consulting by CSC, that BTMU had the right to elect a majority of the board of Consulting if two consecutive quarterly dividends on the stock were not timely paid, and that the Class A stock was treated by CSC as debt for financial accounting and SEC reporting purposes. If the Class A stock was debt for tax purposes, then at least arguably section 351 would have had no application to the transfer of Covansys stock to Consulting.

Another argument made by the government was that, even if the Class A stock was equity for some tax purposes, it was also NQPS and therefore not stock for purposes of section 351(a). NQPS is limited to certain "preferred stock," defined in section 351(g) as stock "which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent." Section 351(g) further provides that if there is not a "reasonable and meaningful likelihood" that dividends beyond any preference will be paid, the possibility of such dividends is disregarded in determining whether stock is NQPS.

The terms of the Class A stock provided that a holder could under certain circumstances receive a "participating dividend" if Consulting paid a dividend to CSC, and a "participating redemption premium" if, at the time the Class A stock was redeemed, the value of Consulting's common stock was determined by appraisal to exceed $782,200. Based on circumstances including the historical unprofitability of Consulting, that no dividend had ever been paid by Consulting to CSC, and the ability of CSC to withdraw funds from Consulting through means other than a dividend, the government asserted that neither a participating dividend nor redemption premium was likely to ever be paid with respect to the Class A stock, such that the rights of a holder to such amounts should be viewed as illusory.

The court concluded that resolution of the government's arguments required a facts-and-circumstances analysis which made summary judgment inappropriate. CSC apparently sought to avoid this result by submitting with its summary judgment papers declarations from employees of the parent corporation of CSC at the time the motion was submitted, as well as valuation reports and a tax basis study by an accounting firm; these materials contradicted the factual bases for many of the government's arguments. The court characterized the declarations and reports, however, as expert testimony that could not be used to establish the uncontroverted facts needed to support a motion for summary judgment. Rather, such material would be required to be admitted into evidence at trial. The declarants would then be subject to cross-examination, and the government would have the opportunity to submit other expert reports in rebuttal.

OBSERVATIONS

The conclusion of the *Computer Sciences Corporation* order, to the effect that a trial was needed to determine facts to be weighed by the court in determining whether the loss was allowable, was not surprising. There may have been no dispute regarding what documents were executed and even regarding what effect those documents had under corporate law. Moreover, the government's arguments may have raised issues that one could characterize as "legal" and therefore appropriate for summary judgment. Nevertheless, digging into the likely economic results of the transactions was necessary in order to determine whether the Code provisions cited by the taxpayer or the Code provisions and judicial doctrines cited by the government would be applied. Accordingly, summary judgment was denied.

Further proceedings in this matter may result in a decision that provides more guidance on the specific issues noted above. Meanwhile, planners and their clients should note that determining whether a transaction or a set of transactions may fit into a particular tax "pigeonhole" can be more art than science, leading, unfortunately, to the possibility of uncertain results and increased legal fees.

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