Kerkorian's Company Claims Sale, Not Redemption

by Robert W. Wood • San Francisco

An interesting Tax Court petition has been filed, in which Kirk Kerkorian's Tracinda Corp. is contesting an IRS determination that the well-publicized transaction in which Tracinda acquired the United Artists stock owned by MGM was a redemption rather than a sale. See *Tracinda Corp. v. Commissioner*, T.C. Docket No. 14786-96 (filed July 10, 1996). Before 1986, Tracinda and its sole shareholder, Kirk Kerkorian, had already owned more than 50% of MGM/UA Entertainment ("MGM"). MGM, in turn, already owned about 40% of United Artists (then known as MGM/UA Communications).

In March of 1986, Tracinda acquired 49 million shares of United Artists from MGM. The purchase price was a whopping $447 million. MGM's basis in the shares that were sold was an even more gargantuan $719 million, so it had a sizable $272 million loss—a loss that was realized but not recognized on the sale.

In an indisputably related transaction that happened the same day, MGM was then merged with TBS Acquisition Corp., a wholly-owned subsidiary of Turner Broadcasting Systems. The merger was structured as a reverse triangular merger of MGM and TBS Acquisition Corp., with Tracinda receiving one share of Turner Preferred plus $20 in cash for each MGM share surrendered. Tracinda used the cash to purchase the United Artists shares from MGM, so no cash was actually produced at the closing. Thus, when MGM departed the Tracinda group, it took the $447 million purchase price with it.

Thereafter, between March of 1986 and November of 1990, Tracinda kept gobbling up more United Artists shares, acquiring 3 million additional United Artists shares from the former MGM (since renamed Turner Entertainment). The purchase price for these acquisitions amounted to another $25 million. But while Tracinda was busy gobbling up United Artists shares, it was equally busy selling them. In fact, between March of 1986 and November of 1990, Tracinda sold 17 million United Artists shares. Finally, on November 1, 1990, Tracinda sold its remaining 35 million shares of United Artists for $753 million.

A Sale's a Sale

The IRS disallowed the $178 million loss that was claimed by Tracinda, arguing that the movement of United Artists shares to Tracinda was a redemption of MGM shares for United Artists shares. Thus, says the IRS, no loss is allowed. As a backup argument, the IRS contends that both Sections 267(a) and 267(f) do not allow the preservation of any part of the MGM loss in Tracinda's basis.

In the Tax Court, Tracinda is contending that in November of 1990 it sold its remaining 35 million shares of United Artists stock to an unrelated purchaser for $753 million, and its basis in the stock was at least $493 million. Tracinda further claims that at least $178 million was attributable to the loss incurred by MGM on its sale of the stock to Tracinda.

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A big issue in the Tax Court proceeding is the size of Tracinda's basis in this last 35 million United Artists shares, plus the size of Tracinda's gain in its fiscal year ended January 31, 1991. Put simply, Tracinda argues that it should be entitled to a good share of MGM's $272 million loss on its March 1986 sale of the United Artists shares.

Tracinda is arguing that this transaction was in substance a sale and not a redemption, and that there was substantial authority for Tracinda to treat the MGM loss as an adjustment to its basis in its United Artists shares. Ultimately, what all of this fuss comes down to is Tracinda's contention that the IRS is wrong in determining that the 1986 transaction was a redemption. According to the IRS, the MGM stock was redeemed for United Artists stock, and therefore no loss was recognized by MGM. Plus, the Service has an alternative contention under Section 267, that Section 267(f) did not apply to increase Tracinda's basis in the MGM stock by the amount of the United Artists loss.

Substance Over Form

In an argument that all corporate taxpayers have probably made at one time or another, Tracinda is arguing that the substance of this transaction was a sale, not a redemption. Indeed, Tracinda claims that there was substantial authority for treating the MGM loss as an adjustment to basis in the United Artists stock. The "substantial authority" argument is made because the Tax Court proceeding involves an asserted $55 million in deficiencies, plus $11 million in substantial understatement penalties under Section 6662(d).

The critical part of all of this seems to be Section 267. Section 267(f) covers losses on transactions between members of a controlled group. However, a 50% rather than 80% control standard applies. And, instead of disallowing losses in the manner of Section 267(a), Section 267(f) merely defers the recognition of a loss between group members until something happens to restore it.

In large part, this mimics the deferred intercompany transaction rules set out in the consolidated return regulations. Under Section 267(f)(1) and the then-prevailing regulations, it was necessary for there to be a sale or exchange. The primary argument of the IRS, therefore, is that there was no sale or exchange. Indeed, in the Service's view the transaction was a redemption of the MGM shares (in exchange for United Artists shares). The argument is difficult for the IRS, inasmuch as the proceeds of this transaction remained with MGM when it left the Tracinda group.

Tax luminary Lee Sheppard of Tax Analysts (who usually seems to ruminate in favor of taxing big companies and big investors) has pointed out that cases are pending involving *both* Tracinda and the former MGM—the latter entity having also claimed the disputed losses. See Sheppard, "The Affirmative Use of Anti-Abuse Rules," *Tax Notes*, October 7, 1996, p. 18. Nonetheless, even Ms. Sheppard acknowledges that the IRS has its work cut out for it, particularly given recent step transaction authority:

> "Basically, the IRS is trying to reverse the order of the steps and perhaps add another step to the transaction to find a section 311(a) distribution." *Id.* at p. 21.

Time will tell. ■

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