OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

Attn:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE) CC:DOM:FS

SUBJECT: Stock Redemption

This Field Service Advice responds to your memorandum dated December 4, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

CorpA =

CorpB =

EntityX =

Date1 =

Date2	=
Date3	=
Date4	=
Date5	=
$aa	=
$bb	=
$cc	=
$dd	=
$ee	=
$ff	=
$gg	=
$hh	=
$ii	=
x%	=
#m	=
#n	=
#p	=
#q	=
#r	=

ISSUES:

1. What legal theories, if any, should be developed to challenge the taxpayer=s reporting of a transaction in which the taxpayer redeemed stock for less than its aggregate trading value?

2. Assuming an economic substance approach is viable, what facts should be developed in connection with that argument?

CONCLUSIONS

1. As discussed below, we have considered various possible theories that could arguably override the nonrecognition provisions in this case. [redacted]

2. See the response to issue 1 below.

FACTS:

As of Date1, CorpB owned approximately x% of the shares of CorpA stock. CorpB was the largest shareholder of CorpA and was represented on CorpA=s board of directors roughly in proportion to its stock interest.

On Date2, CorpB redeemed #m shares of its CorpA stock, using the redemption proceeds to finance another investment. CorpB retained #n shares after this redemption.

At the time of the redemption, the redeemed shares had an aggregate trading value of approximately $aa. In the redemption, CorpB received from CorpA consideration valued at $bb, comprising: (a) $cc in cash (b) $dd in short term CorpA notes, and (c) warrants valued at $ee. CorpA obtained the funds for the transaction from three sources: (1) $ff from operational cash flow; (2) $cc from EntityX, which used CorpA shares to finance existing employees benefit programs ; and (3) $gg of equity securities. As a result of its actions to raise the necessary capital, CorpA received a lower credit rating than it had previously held.

The warrants issued to CorpB in the transaction provided it the option to reacquire the same number of shares (i.e., #m) that it sold to CorpA. The warrants and CorpB=s retention of #n of CorpA common shares constituted the principal elements in the transaction because they purportedly allowed CorpB to treat the redemption as a dividend and avoid paying capital gains on the transaction.

The warrant certificates granted the holder the right to buy a specific number of shares of CorpA common stock at a stipulated price within a certain time period: #p shares for a #r-day period ending on Date3 at a price of $hh per share; #q shares for a #r-day period ending on Date4 at a price of $ii per share; and #q shares for a #r-day period ending on

Date5 at a price of $ii per share. The warrants were subject to various conditions, including limitations on sales to parties other than CorpA.

After redeeming CorpB=s shares at less than the aggregate trading price, CorpA subsequently sold a portion of the redeemed shares to investors at the prevailing trading price and transferred another block of the redeemed shares to a trust to finance CorpA=s employee benefit programs. As a result, it has been suggested that CorpA also received tax benefits in the form of avoided capital gains on these dispositions of the redeemed shares.

Issue 1. Taxpayer=s Reporting of the Redemption

LAW AND ANALYSIS

Under I.R.C. ' 311(a), a corporation does not recognize either gain or loss on a distribution with respect to its stock (other than a complete liquidation) of its stock (or rights to acquire its stock) or property. The only exception to this rule is for the distribution of appreciated property under I.R.C. ' 311(b).

A corporation recognizes neither gain nor loss on the receipt of money or property in exchange for its own stock, including treasury stock. I.R.C. ' 1032(a). Similarly, no gain or loss is recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock, including treasury stock.

In the instant case, CorpA distributed property and warrants valued at $bb to CorpB in redemption of #m shares of CorpA having an aggregate trading value of approximately $aa. Under the rule of section 311(a), CorpA would recognize no gain or loss on this redemption. (Based on the facts presented, section 311(b) would not apply because CorpA did not distribute any appreciated property to CorpB.) Under section 1032(a), it would similarly not recognize any gain on the subsequent resale of any of the redeemed shares, or on the transfer of redeemed shares to finance employee benefit programs, at the higher prevailing trading price.

You have requested our views on whether there are any legal theories under which CorpA should recognize income or gain on either the redemption or the subsequent disposition of the redeemed shares, notwithstanding the nonrecognition provisions of I.R.C. '' 311(a) and 1032(a).

We have considered the possible theories discussed below. Our consideration is based on the information provided with your request, and we understand that additional facts may be developed during the course of the audit. For purposes of this memorandum, we have

assumed that CorpB received the tax benefits discussed above but have not determined whether it was entitled to such benefits. In addition, we have assumed that CorpB could have obtained more from third parties than the $bb that CorpA paid for the stock in the redemption.[1/]

A. Bargain Redemption **B** Economic Substance

As a general rule, a taxpayer is entitled to minimize the amount of his taxes by any means that the law permits. *See Gregory v. Helvering*, 293 U.S. 465, 469 (1935). However, this rule is not absolute and does not give effect to transactions that are motivated solely by tax savings and have no independent economic substance. *See Knetsch v. United States*, 364 U.S. 361, 366 (1960); *ACM Partnership v. Commissioner*, T.C. Memo. 1997-115, 73 T.C.M. (CCH) 2189, 2215, *aff-d in part, rev-d in part*, 157 F.3d 231 (3d Cir. 1998).

Although the transaction at issue appears to be a redemption by CorpA of stock from CorpB for $bb, the fact (as assumed) that CorpB could have obtained more than $bb in a sale to third parties suggests the following possible recast to account for CorpA=s purported bargain redemption. Under this theory, CorpA would be viewed as paying CorpB a redemption price equal to the amount that third parties would have paid, and CorpB would then be treated as remitting to CorpA an amount equal to the difference between $bb and the redemption payment as a fee for structuring the transaction to facilitate the tax savings (or alternatively, as CorpA=s share of the tax savings realized by CorpB). Under this theory, the payment from CorpB would be treated as ordinary income to CorpA.

B. Adjustment under Section 482

As discussed in your request, it is well established that section 482 may override non-recognition treatment. *See National Securities Corporation v. Commissioner*, 137 F.2d 600 (3d Cir.), *cert. denied*, 320 U.S. 794 (1943); *Eli Lilly & Co. v. Commissioner*, 856 F.2d 855, 860-864 (7th Cir. 1988); *Rooney v. United States*, 281 F.2d 681 (9th Cir. 1962); *Aiken Drive In Theatre Corp. v. United States*, 281 F.2d 7 (4th Cir. 1960); *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir.), *cert. denied*, 344 U.S. 874 (1952); *General Electric Co. v. United States*, 83-2 U.S.T.C. **&** 9532 (Ct. Cl. 1983); *Ruddick Corp. v. United States*, 643 F.2d 747 (Ct. Cl. 1981); *Bank of America v. United States*, 79-1 U.S.T.C. **&** 9170 (N.D. Cal. 1979); *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252, 357-

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[1/] Although the amount that CorpB could have obtained by selling its stock to third parties is a factual question that would need to be determined, the maximum such amount appears to be $aa, the aggregate trading price at the time of the redemption.

367 (1987); *Foster v. Commissioner,* 80 T.C. 34, 157-159 (1983), *aff=d*, 756 F. 2d 1430 (9th Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986); *Aladdin Industries, Inc. v. Commissioner*, T.C.M. 1981-245. *See also* Rev. Rul. 80-198, 1980-2 C.B. 113; Rev. Rul. 77-83, 1977-1 C.B. 139; G.C.M. 35186 (1973). The regulations under section 482 reaffirm this principle. Treas. Reg. ' 1.482-1(f)(1)(iii).

In order to make an adjustment under section 482, there are two prerequisites: First, CorpA and CorpB must be "two . . . organizations . . . owned or controlled directly or indirectly by the same interests." Second, a section 482 allocation must be "necessary in order to prevent evasion of taxes or clearly to reflect the income" of either CorpA or CorpB.

Under the regulations the element of common control depends on a determination of whether there is Aany kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised.@ Treas. Reg. ' 1.482-1(i)(4). The determination of common control is based on all the facts and circumstances. *See Brittingham v. Commissioner*, 66 T.C. 373, 397 (1976), *aff=d per curiam*, 598 F.2d 1375 (5th Cir. 1979); *Charles Town, Inc. v. Commissioner*, T.C. Memo. 1966-15, *aff=d*, 372 F.2d 415, 419-20 (4th Cir.), *cert. denied*, 389 U.S. 841 (1967); *B. Forman Company, Inc. v. Commissioner*, 453 F.2d 1144 (2d Cir.1972), *cert. denied*, 407 U.S. 934 (1972), *reh=g denied*, 409 U.S. 899 (1972), *rev=g*, 54 T.C. 912 (1970); *Dallas Ceramic Co. v. U.S.*, 598 F.2d 1382 (5th Cir. 1979); *R.T. French Co. v. Commissioner*, 60 T.C. 836 (1973). Under Treas. Reg. ' 1.482-1(i)(4), a corporation can be Acontrolled@ to where there is Acontrol resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose.@

The second prerequisite to application of section 482 is that an allocation is needed to prevent evasion of taxes or clearly to reflect income. Under the regulations whether an allocation is needed to prevent evasion of taxes or clearly to reflect income depends generally on whether Athe results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm=s length result).@

If these prerequisites are met, an adjustment under section 482 would be similar to the recast discussed above. In particular, the amount paid by CorpA for CorpB=s stock would be adjusted to reflect the amount third parties would have paid for the stock, and CorpB would make a corresponding payment to CorpA as a service fee as compensation for agreeing to structure the redemption to facilitate CorpB=s tax savings.

In our view it would be difficult to establish common control in this matter. There is no apparent basis for concluding that CorpB controlled CorpA regarding the price CorpA paid

to redeem its shares. We have considered that control may be found to exist even where there is less than majority stock ownership, as indicated by the cases cited above. For example, in *Charles Town, Inc. v. Commissioner*, *supra,* control was held to exist, even though controlling parties held only 2 percent of a corporation=s stock, based on the existence of Aactual and effective control,@ evidenced, among other things, by additional facts relating to intercorporate agreements and the actual exercise of effective control of the business of the corporation. Yet in CorpA=s and CorpB=s case there do not appear to be facts or circumstances present to suggest that CorpB=s x% interest in CorpA enabled CorpB to control CorpA with respect to the purported below market redemption price, which benefitted CorpA and not CorpB. Nor do there appear to be facts or circumstances to suggest that CorpA controlled CorpB. Although CorpA was represented on CorpB=s board and was able to redeem its shares at a bargain price, it does not appear that CorpA had any ownership interest in CorpB.

Particularly problematic is the fact that CorpB owned only a minority interest in CorpA. While not precluding a finding of common control, the existence of a large majority of non-overlapping shareholders would mean that the courts would practically require a persuasive showing of why the parties are commonly controlled, or, even so, why the consideration they agreed to is not arm=s length given the incentive of CorpA to take into account the interests of its majority shareholders. *See*, *e.g.*, *Brittingham*, *supra*; *R.T. French*, *supra*. In *Brittingham*, the Court stated that Ait is not necessary that the same person or persons own or control each controlled business before section 482 can be applied, but there must be a common design for the shifting of income in order for different individuals to constitute the >same interests.=" The Court nevertheless found that a family relationship was not sufficient for a finding of control, where one of the related individuals Aowned no interest in [one of the corporations] and exercised no control over the affairs of either corporation@ and where the other related individuals, Aalthough brothers, each had his own family, and each was financially independent of the other.@ *Id. at 398. Accord, Dallas Ceramic Co., supra*. In *R.T. French Co.*, the Court found that where two commonly controlled corporations, one 100 percent owned and one 51 percent owned by the same interests, entered into an agreement, the existence of a substantial minority interest in the second corporation operated effectively to prevent a transaction that was not at arm=s length. Similarly, in the instant case, CorpA was arguably under an obligation to the rest of its shareholders to pay the lowest price possible for the redemption.

These facts support the conclusion either that CorpA and CorpB were not commonly controlled or that any bargain price CorpA was able to achieve for the benefit of those non-overlapping shareholders was by arm=s length negotiation. Moreover, it appears from the available facts that the price actually negotiated was the result of arm=s length bargaining.

For these reasons, we do not believe the available facts support the application of section 482 in this case.

C. Clear Reflection of Income under Section 446(b)

I.R.C. ' 446(b) provides, in pertinent part, that if the method of accounting used by the taxpayer does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. Thus, the Commissioner has broad discretion to determine whether a taxpayer=s method of accounting clearly reflects income and to require a taxpayer to change its method of accounting to a method that does clearly reflect income. *Commissioner v. Thor Power Tool*, 432 U.S. 522 (1979); *Brown v. Helvering*, 291 U.S. 193, 204 (1934); *Prabel v. Commissioner*, 882 F.2d 820 (3d Cir. 1989); *Commissioner v. O. Liquidating Corp.*, 292 F.2d 225 (3d Cir. 1961).

The term Amethod of accounting@ is not defined in either the Code or the regulations. AMethod of accounting@ has been defined as:

> the particular means for determining when to recognize assets, liabilities, and items of income and expense. Consistently, the underlying assumption of tax accounting is that a method of accounting determines the time when an item of income or expense is to be recognized or reported for tax purposes.

Stephen F. Gertzman, *Federal Tax Accounting* & 2.01[1] (1988).

In this case, we would not be seeking a change in the taxpayer=s overall method of accounting, but rather a change in the treatment of one item. In numerous cases the courts have reiterated that for purposes of section 446, the term "method of accounting" refers not only to the taxpayer's overall method of accounting but also refers to the treatment of any material item. *Diebold, Inc. v. United States*, 891 F.2d 1579 (Fed. Cir. 1989), *cert. denied*, 498 U.S. 823 (1990); *Knight-Ridder Newspapers v. United States*, 743 F.2d 781 (11th Cir. 1984); *Witte v. Commissioner*, 513 F.2d 391, 393 (D.C. Cir. 1975); *Fruehauf Trailer Co. v. Commissioner*, 356 F.2d 975 (6th Cir.), *cert. denied*, 385 U.S. 822 (1966); *First National Bank of Gainesville v. Commissioner*, 88 T.C. 1069, 1085 (1987); *Primo Pants Co. v. Commissioner*, 78 T.C. 705, 721 (1982); *Dorr-Oliver Inc. v. Commissioner*, 40 T.C. 50 (1963). A change in the treatment of a material item is a change in method of accounting. Treas. Reg. '' 1.446-1(e)(2)(ii)(a) and 1.481-1(a)(1); *Ryan v. Commissioner*, 42 T.C. 386 (1964); *H. F. Campbell Co. v. Commissioner*, 53 T.C. 439 (1969), *aff'd,* 443 F.2d 965 (6th Cir. 1971). In fact, in *Peoples Bank & Trust Co. v. Commissioner*, 415 F.2d

1341 (7th Cir. 1969), the Seventh Circuit stated that "[a] change in a single item is a change in method of accounting."

In this connection, Treas. Reg. ' 1.446-(1)(e)(2)(ii) provides: AA change in method of accounting includes a change in the overall plan of accounting for gross income or deduction or a change in the treatment of a material item used in the plan. . . . A material item is any item which involves the proper time for the inclusion of an item or the taking of a deduction.@ Many courts have followed the language of the regulations, that is, concluding that a material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. *Woodward Iron Co. v. United States*, 396 F.2d 552 (5th Cir. 1968); *Hamilton Industries v. Commissioner*, 97 T.C. 120 (1991); *Wayne Bolt & Nut Co. v. Commissioner*, 93 T.C. 500 (1989); *Primo Pants Co. v. Commissioner*, 78 T.C. 705, 721 (1982). In *Knight-Ridder Newspapers v. United States, supra* at 798, citing to Treas. Reg. ' 1.446-(1)(e)(2)(ii), the Eleventh Circuit, said "The essential characteristic of a ‹material item: is that it determines the timing of income or deduction."

Accordingly, the courts have found the following to be changes in the treatment of a material item: change from reporting state property taxes on ratable method to lump sum method (*Woodward Iron Co. v. United States, supra*); change from capitalizing assets to depreciating them (*Southern Pac. Transp. Co. v. Commissioner*, 75 T.C. 497, 681-687(1980)); change from deducting bonuses in the year authorized to the year received (*Summit Sheet Metal Co. v. Commissioner*, T.C.M. 1996-563); revaluation of opening and closing inventory using new method (*Wayne Bolt & Nut Co. v. Commissioner, supra*; *Pacific Enter. & Subs. v. Commissioner*, 101 T.C. 1 (1993)); and a change in how certain inventory items classified (*Hamilton Industries v. Commissioner, supra*).

Moreover, courts have interpreted the clear reflection of income standard to require that a taxpayer=s method of accounting Arepresent ‹economic reality.=@ *ACM Partnership, supra,* 73 T.C.M. at 2214, *citing Prabel v. Commissioner, supra,* 882 F.2d at 826-827. In *Prabel*, the Third Circuit sustained the Commissioner=s discretion under section 446(b) to disallow an accrual method taxpayer=s accrual of interest deductions using the ARule of 78s@ method of accounting for its long-term obligations because that method resulted in a distortion of the taxpayer=s income. 882 F.2d at 826-828.

Although section 446(b) gives the Commissioner the discretion to require a taxpayer to change from a method of accounting that does not clearly reflect income, in this case we would be seeking to change how the transaction is taxed rather than the time for claiming either income or deductions. While a change from treating an item as a capital asset to treating it as an expense is a change in method of accounting, that recharacterization involves a change in the timing for claiming the deduction. Here, the recharacterization would not involve a change in timing but would turn what would ordinarily be a

nonrecognition transaction into a taxable event for CorpA. That is not a recharacterization or change in a material item within the confines of section 446(b).

For the foregoing reasons, we do not think that an argument based on section 446(b) would apply to this transaction.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As noted above, we do not believe section 482 or section 446(b) would apply in this case. Nor do we believe the bargain redemption/economic substance theory discussed above would be a viable argument in litigation.

A. We recognize that, as a result of the expected tax savings, CorpB was no doubt willing to accept less than it could have obtained from third parties for its stock. CorpB sought to convert its investment in CorpA stock into cash in order to make another investment. Under the Date2 redemption, CorpB expected to have a substantially lower tax liability than it would have had in any other transaction to convert its investment into cash. Although CorpB may have received less from CorpA in the redemption than it would have received if it sold the stock to third parties, CorpB likely viewed its net after-tax position as substantially better than it would have been if CorpB had exchanged its stock at a higher price value entirely for cash in either a redemption by CorpA or a sale to any other purchaser. Thus, CorpB was able to maximize the amount of cash available (after taxes) to use for its other investment. In a sense, however, by taking a lower nominal price for its stock, CorpB effectively shared a portion of its expected tax savings with CorpA.

On the other hand, while CorpB could probably have received a greater price for its stock on the open market, only CorpA was in a position to structure a transaction that would arguably give CorpB the expected tax savings. CorpA had an obligation to the rest of its shareholders to pay the lowest price possible to redeem CorpB=s shares. It was, therefore, in CorpA's best interest to seek to realize for itself the maximum possible share of the tax savings expected by CorpB in the transaction.
Against this background, we do not believe a court would find that CorpA should be treated as receiving income in the redemption transaction. As discussed above (under the Law and Analysis section), we considered recasting the transaction as a redemption at the price third parties would have paid and a payment of a fee (equal to the difference between $bb and the redemption price) from CorpB to CorpA. Under that recast, the fee would be ordinary income to CorpA. Based on the available facts, however, we believe that such a position would face overwhelming hazards.

We recognize that a transaction must have economic substance in order to be taxed according to its form, as held in *ACM Partnership, supra*. However, the facts of this case are distinguishable from those in *ACM Partnership* and other Aeconomic substance@ cases because the transaction between CorpA and CorpB actually resulted in the redemption the CorpA stock held by CorpB. After the transaction, CorpB held only #n shares of CorpA instead of the [redacted] shares that it previously held. As a result, CorpB was no longer able to elect [redacted] members of the CorpA board of directors and or otherwise influence the management of CorpA. In short, the available facts strongly indicate that this was not a sham transaction and was not consummated solely to obtain tax benefits that flow from the form (but not the substance) of the transaction.

We are fully aware that this transaction was controversial, and we view it as abusive. However, we believe that the abuse principally lies with CorpB=s treatment of the redemption, and we do not perceive CorpA=s treatment as involving any abuse. The Service has not previously treated an apparent sharing of tax benefits in an arm=s length transaction as resulting in income to the party that receives the benefit of a better price because the other party will have certain legitimate tax savings on the transaction. The Service has considered taking such a position in other similar transactions where the parties have negotiated a price that admittedly takes into account the tax savings by one of the parties. As a matter of policy, however, the Service has rejected such a position. To take such a position in this case would represent a radical departure from past practice and would have ramifications well beyond this case.

For the foregoing reasons, we do not recommend pursuing this theory.

B. On the section 482 theory, even if the common control requirement were satisfied, we believe that the facts do not support a conclusion that an allocation is needed to prevent evasion of taxes or clearly to reflect income. Under the regulations, the question of whether an allocation is needed to prevent evasion of taxes or clearly to reflect income depends generally on whether Athe results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm=s length result).@ Treas. Reg. ' 1.482-1(b). In our view, CorpA has a persuasive argument that the redemption price conformed to an arm's length result.

While it might be true that CorpB could have received a better price for its shares on the open market, that possibility does not mean that the redemption price CorpB negotiated with CorpA was not an arm=s length price. CorpB could only qualify for the dividend received deduction through a redemption of shares by CorpA. The dollar value of the tax benefits associated with the dividend received deduction appears to have been more than

sufficient to compensate CorpB for the purported bargain purchase price at which it allowed its shares to be redeemed. As noted, CorpA was arguably under an obligation to the rest of its shareholders to exact the lowest price possible for the redemption. It was, therefore, in CorpA's best interest to seek to realize for itself the maximum possible share of the tax benefit presumably claimed by CorpB in the transaction, by demanding to pay a lower price per share for the redeemed shares. At arm's length, parties may share the dollar value of tax or non-tax benefits to either resulting from a transaction based on the relative strengths of their competitive bargaining positions. *See* Treas. Reg. ' 1.482-1(d)(4)(ii)(C) (location savings from operation in a low-cost jurisdiction do not automatically belong to the low-cost operator, but are divided depending on the relative competitive positions of buyers and sellers in each market). *See also Eisenberg v. Commissioner*, 155 F.3d 50 (2d Cir. 1998) (the fair market value of stock in a closely held corporation was appropriately adjusted under Treas. Reg. ' 25.2512-1 to reflect the potential tax on the built-in capital gain of the building that was the sole asset of the corporation).

Issue 2. Further Factual Development

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

In light of our response to issue 1, we have not identified any facts that need to be developed.

Please call if you have any further questions.

By: _____
STEVEN J. HANKIN
Acting Chief
Corporate Branch

cc: Regional Counsel
Assistant Regional Counsel (LC)