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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

Attn:

FROM: Deborah Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Section 351 Transfer

This Field Service Advice responds to your memorandum dated November 3, 1999. 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

Corp1	=
Corp2	=
Corp3	=
Corp4	= .
Corp5	=
Corp6	=
Corp9	=
Corp10	=
Corp11	=
Country3	=
Year1	=

Year2	=
Year3	=
Date1	=
Date2	=
Date3	=
<u>a</u>	=
<u>b</u>	=
<u>c</u>	=
$a	=
$b	=
$c	=
$d	=
$e	=
$f	=
#a	=
#b	=
#c	=
#d	=
#e	=
#f	=
#h	=
#i	=
#j	=
#tt	=
Type1	=
Type2	=

ISSUES

1. Whether the transfer of properties by Corp1, Corp2, and Corp3 to Corp9 on Date2, qualified as a non taxable transaction under I.R.C. § 351.

2. Whether Corp9 was entitled to a carryover basis in the properties it received from Corp1 in Year2.

3. Whether Corp1 incurred a capital loss as a result of the sale of #tt% of the Corp9 auction preferred stock it received in exchange for properties transferred to Corp9 on Date2

4. Whether I.R.C. § 269 can be applied to disallow loss on the future sale of the Corp1 properties by Corp9.

5. Whether section 482 can be applied to adjust the loss that a group filing a consolidated return purports to recognize on the sale of a portion of one class of stock, received by one member of the group (Corp1) in a section 351 exchange, for built-in loss property, where other group members (Corp2, and Corp3) participating in the same section 351 exchange, received other classes of stock in the new company (Corp9), in exchange for built-in gain property.

CONCLUSIONS

1. [redacted]

2. [redacted].

3. [redacted] Corp1's entitlement to a capital loss as a result of the sale of #tt% of the Corp9 auction preferred stock it received in exchange for properties transferred to Corp9 on Date2 should not be challenged.

4. [redacted], taxpayer's loss on any future sale of the Corp1 properties by Corp 9 should not be challenged under I.R.C. § 269.

5. [redacted], It should not be argued that I.R.C. § 482 be applied to adjust the loss that a group filing a consolidated return purports

to recognize on the sale of a portion of one class of stock, received by one member of the group (Corp1) in a section 351 exchange, for built-in loss property, where other group members (Corp2, and Corp3) participating in the same section 351 exchange, received other classes of stock in the new company (Corp9), in exchange for built-in gain property.

FACTS

Corp1, Corp2, and Corp3 are wholly owned subsidiaries of Corp4 which is in turn a wholly owned subsidiary of Corp5. Corp5 is a wholly owned Subsidiary of Corp6. Corp6 is a Country 3 holding company. Corp6 files a consolidated income tax return.

Corp2 and Corp3 owned and operated a and b properties. These properties were highly productive. Corp1 owned and operated a, b, and c properties in the Country3. Many of the Corp1 properties were marginally productive or nonproductive. These development properties were referred to as assets.

Also in late Year1 or Year2, Corp5 management recognized a need for increased capital to offset its markedly decreased earnings that would allow Corp5 to continue to develop those properties that showed the most promise. The vehicle selected to raise cash was the issuance of auction preferred stock (APS) in a newly-formed subsidiary.

Corp5 formed Corp9 on or about Date1. On or about Date2, Corp1, Corp2, and Corp3 contributed assets in exchange for stock of Corp9 in a transaction that Corp5 contends qualifies as an I.R.C. § 351 transaction. The Corp2 and Corp3 properties transferred to Corp9 were income producing properties. The Corp1 properties transferred to Corp9 consisted mostly of non-producing properties.

The assets contributed by Corp1 had a combined tax basis of $a and a total fair market value of only $b. Corp2 and Corp3, on the other hand, transferred producing a and b properties that had a combined tax basis of $c and a fair market value of $d.

Corp2 and Corp3 received #a shares and #b shares of Corp9 common stock respectively, and #c shares and #d shares of Corp9 non-voting preferred stock, respectively, in exchange for the assets they transferred to Corp9. Corp1 received #e shares of Corp9 APS in exchange for the assets it transferred to Corp9. An additional #f shares of Corp9 APS were privately sold for $e per share to institutional investors through Corp11.

On Date3, Corp1 sold #h shares of its APS to outside investors for $f. Immediately after the sale, Corp4 constructively owned approximately #i% of Corp9's combined voting preferred stock and common stock and #j% of the non voting preferred stock.

The newly transferred assets" from Corp1 could not have been developed without a substantial expenditure of capital; nevertheless, according to the Private Placement Memorandum, Corp9 did not intend to make any substantial or significant capital expenditures in the advancement of its business.

Under the terms of the APS, a holder of Corp9 APS, such as Corp1, had virtually no power to influence the management of the issuing corporation, i.e., Corp9. If an owner of APS should attempt to intervene in the management of the corporation, Corp9 had the right to redeem an entire series of APS at any time.

Corp9 commenced operations on Date2. Corp9 does not file a consolidated income tax return with Corp6, although it is included in Corp5's reporting group for financial accounting purposes.

Corp9 has no regular employees. Corp9 retains the services of Corp5 employees through a "Services agreement" with Corp5 and the contributing subsidiaries.

Corp9 also retained the services of asset managers for its properties, through a separate "Employment Agreement" with Corp10, a newly formed Company.

Corp5, Corp10, and the contributing subsidiaries, entered into a Revolving Credit and "Cash Management Agreement," which provides that Corp10 will advance excess cash (including net cash resulting from the proceeds of a and b production) to Corp5, and that Corp5 will pay Corp10 interest on such advances at a rate equal to the prime rate less one percent.

Sometime in late Year1 or early Year2, Corp5 Management was advised by its inside counsel that preferred stock could be used to raise needed capital without incurring additional debt. This initial idea to use preferred stock evolved into Corp5's decision to use auction preferred stock and allowed Corp9 to achieve its goal of acquiring additional capital.

Corp5 described the purpose of Corp9 as follows: "Corp9 will enable Corp5 to maximize the value of the assets, compared to other alternatives (e.g., sale or other disposal of the undeveloped and non producing assets)."

Corp9's dominant objective was to monetize Corp5's domestic Type1 and Type2 assets by bringing in cash from outside investors.

LAW

Section 351

Section 351 of the Internal Revenue Code generally provides for the non-recognition of gain or loss upon the transfer of property to a corporation in exchange for stock in circumstances where, immediately after the exchange, the transferors are in control of the corporation to which the property was transferred.

In a qualifying section 351 transaction, the assets retain a carryover basis in the hands of the transferee. I.R.C. § 362(a). The transferor's basis in the stock received in the transaction is equal to the basis of the transferred assets I.R.C. § 358(a). Under Section 351, control is defined as the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock. I.R.C. § 368(c).

The purpose of section 351 is to "facilitate movement into the corporate form by preventing immediate recognition of gain or loss when there has been a mere change in the form of ownership". Hempt Bros, Inc. v. United States, 354 F. Supp. 1172 (M.D. Pa 1973).

Doctrine of Substance over Form

In determining the tax consequences of a transaction, including whether transactions qualify for favorable non-recognition treatment, the courts will look at the substance of the transaction or relationship, not merely its form. Commissioner v. Court Holding, 324 U.S. 331, 334 (1945).

The inquiry into whether transactions have sufficient substance to be respected for tax purposes turns on both the objective economic substance of the transactions and the subjective business motivation behind them. Kirchman v. Commissioner, 862 F.2d 1486 (11th Cir. 1989). The objective and subjective prongs of the inquiry are related factors, both of which form the analysis of whether the transaction had sufficient substance apart from its tax consequences. ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998).

Doctrine of Economic Substance

While a taxpayer may structure a transaction to minimize tax liability, that transaction must have economic substance apart from tax consequences, if it is to be respected for tax purposes. See Kirchman v. Commissioner, 862 F.2d 1486

(11th Cir. 1989). Where an entity is created that has no real economic effect and which affects no cognizable economic relationship, the substance of a transaction involving the entity will control over its form. Zmuda v. Commissioner, 79 T.C. 714, 720 (1982). Transactions which serve no economic purpose other than the generation of tax losses are accorded no tax effect. Knetsch v. United States, 364 U.S. 361 (1960).

Compaq Computer Corp. v. Commissioner, 113 T.C. No.17 (1999) involved a prearranged transaction designed to eliminate typical market risks. P purchased and immediately resold American Depository Receipts (ADR's) of a foreign corporation on the floor of the NYSE. The court held the transaction lacked economic substance and business purpose. The Court found that every aspect of the transaction was deliberately predetermined and designed to yield a specific result and to eliminate all economic risks and influences from outside market forces.

In Frank Lyon Co. v. United States, 435 U.S. 561 (1978), the Supreme Court stated that a genuine multi-party transaction with economic substance compelled or encouraged by business or regulatory realities imbued with tax independent considerations, and not shaped by solely tax avoidance features, should be respected for tax purposes. In Frank Lyon Co., the Supreme Court held, that the arrangement of a contemplated business transaction, in a tax advantaged manner, should be respected, where as a prearranged loss transaction designed solely for the reduction of tax should not be respected.

Business Purpose Doctrine

Under the general "business purpose doctrine," long recognized by the Supreme Court, transactions that have no legitimate business purpose and that are undertaken purely for tax avoidance reasons are not recognized for tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935). Nonetheless, it is also well recognized that a taxpayer may prearrange, change and divide business activities among business entities. Normally, a choice to transact business in corporate form will be recognized for tax purposes as long is there is a business purpose or the corporation engages in business activity. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

Courts have hinted at the concept of business purpose requirement in section 351 repeatedly. Opinions discussing other section 351 issues often indicate that the taxpayer have a valid business purpose for the transaction in question. Hempt Bros., Inc. v. United States, 490 F.2d 1172 (3d Cir. 1974). Perhaps the most thorough judicial exploration of the business purpose doctrine in section 351 is in Caruth v. United States, 688 F. Supp. 1129, 1138-1141 (N.D. Tex. 1987). In Caruth, the court explains that section 351 is tied very closely to the reorganization provisions, and reasons that the doctrines applicable there are equally valid for capital contributions. Under Caruth, the business purpose requirement for section 351 transactions appears to be the same as the business purpose requirement for acquisitive reorganizations.

Section 269

Section 269(a) provides that if a corporation (or, in certain situations, its property) is acquired for the principal purpose of evading or avoiding Federal income tax by securing the benefit of deductions, credits, or other allowances that the acquiring person or corporation would not otherwise enjoy, the Secretary may disallow such deductions, credits, or other allowances. Accordingly, section 269(a) is not applicable unless the tax evasion or avoidance motive is the principal purpose for the acquisition. In the context of section 269, “principal purpose” means that the evasion or avoidance purpose must outrank, or exceed in importance, any other purpose. Capri Inc. v. Commissioner, 65 T.C. 162, 178 (1975).

The intent or purpose of the acquiring person or corporation at the time of the acquisition is examined in determining the principal purpose. Southern Dredging Corp. v. Commissioner, 54 T.C. 705, 718 (1970).

There are three elements which must be present in order for section 269 to be applied. First, there must be an acquisition directly or indirectly of control of a corporation or there must be an acquisition of assets with a carryover basis of a target not controlled before the acquisition by the acquiring corporation or its shareholders. Second, at the time of the acquisition, the primary purpose of each acquisition must be tax evasion or avoidance, and third, the taxpayer must secure the benefit of a deduction, credit or allowance which it would not otherwise enjoy.

Control for purposes of section 269 is the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock of the corporation. Formation of a new corporation is an acquisition of control for purposes of section 269. James Realty Co. v. United States, 280 F.2d 394 (8th Cir. 1960).

In order for section 269 to apply, the principal purpose of the acquisition must be tax evasion or tax avoidance. The phrase “evasion or avoidance” is not defined. However, Treas. Reg. §1.269-1(b) states that evasion or avoidance is not limited to cases involving criminal penalties or civil penalties for fraud. The phrase “principal purpose” merely requires that the tax avoidance purpose outrank or exceed in importance any of the non-tax business purposes for the acquisition. It is not necessary for tax avoidance to be the sole purpose for the acquisition for section 269 to apply according to Treas. Reg. §1.269-(3)(a). In addition, the determining factor is the intention or purpose of the taxpayer at the time of the acquisition. Hawaiian Trust Co. Ltd., Trustee v. United States, 291 F.2d 761 (9th Cir. 1961).

Transactions identified under I.R.C. § 269 as being indicative of tax avoidance, include a corporation which acquires property with an aggregate carryover basis which is materially greater than its aggregate fair market at the time of acquisition, and subsequently uses the property to create tax-reducing losses or deductions

Section 482

I.R.C. section 482 provides as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Treas. Reg. § 1.482-1A(b)(1) provides:

The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of the controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income[1] of each controlled taxpayer.

Treas. Reg. § 1.482-1A(d)(1) provides: "The appropriate adjustments may take the form of an increase or decrease in gross income, increase or decrease in deductions (including depreciation), increase or decrease in basis of assets (including inventory), or any other adjustment which may be appropriate under the circumstances" (emphasis added). Accord Treas. Reg. § 1.482-1(a)(2). Treas. Reg. § 1.482-1A(d)(5) provides: "Section 482 may, when necessary to prevent the avoidance of taxes or to clearly reflect income, be applied in circumstances described in sections of the Code (such as section 351) providing for nonrecognition of gain or loss" (emphasis added).

Finally, it is well-established that section 482 is applicable in the consolidated return context. Treas. Reg. § 1.482-1A(b)(2) provides:

> Section 482 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate taxable income. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Issue1-Section-351

Business Purpose

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[1] Treas. Reg. § 1.482.1A(a)(6) defines a controlled taxpayer's "true taxable income" as "the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto)."

Arguably, the transfer of properties by Corp1, Corp2, and Corp3 to Corp9 on Date2 did not qualify as a non-taxable transaction under I.R.C. § 351, because the transaction lacked business purpose and economic substance.

However, the taxpayer will argue, that a purpose for the Corp9 transaction was to raise cash without incurring additional debt. This appears to be a valid business purpose for entering into the Corp9 transaction. The fact that this purpose could have been accomplished simply by Corp5 issuing auction preferred stock or merely by Corp2 and Corp3 transferring assets to Corp9 in exchange for the auction preferred stock is not relevant in determining whether the taxpayer's stated purpose for the Corp9 transaction of raising cash without incurring additional debt, is a valid business purpose. The Service cannot substitute its own business judgment for that of Corp5. In other words, poor business judgment on the part of Corp5 should not effect whether Corp5's stated business purpose for the Corp9 transaction of raising cash without incurring additional debt should be respected. J. H. Rutter Rex Mfg. Co. v. Commissioner, 853 F. 2d 1275 (5th Cir. 1988).

Arguably, Corp5's stated business purpose for the transfer of Corp1 properties to Corp9 (to "monetize" the Corp1 assets by isolating them in Corp9 for future development) was not a valid business purpose, because no capital expenditures were ever made by Corp9 to develop the properties. However, Corp5 may argue, that they should be allowed to arrange their business affairs as they please, and the fact that capital expenditures have not yet been made to the Corp1 properties transferred to Corp9 should be of no consequence to the determination of business purpose. Esmark v. Commissioner 90 TC. 171 (1988). [redacted]

Economic Substance

As contrasted with Compaq, in the instant case, [redacted], that the purpose of the Corp9 transaction was to allow Corp5 to raise cash without incurring additional debt. In addition every aspect of the Corp9 transaction was not deliberately predetermined and designed to yield a specific result and to eliminate all economic risks and influences from outside market forces. For example, there is always the possibility that the Corp1 properties transferred to Corp9 could increase in value before there ultimate sale. Therefore, there may not be any loss when the Corp1 properties are ultimately sold.

As contrasted with Frank Lyon, in the instant case, [redacted] that Corp1's transfer of its assets to Corp9, in exchange for APS stock, had some economic substance. As a result of this transaction, Corp1's non productive assets were isolated away from Corp1 and cash was raised without debt. This transaction appears to have economic substance. Thus, arguably, the transfer of the Corp1 assets to Corp9 served a business purpose other than the generation of tax losses, and therefore, the transfer of properties by Corp1, Corp2, and Corp3 to Corp9 should be considered a non taxable 351 transfer.

Issue-2 entitlement to carryover basis

The issue here is whether Corp9 was entitled to a carryover basis in the properties it received from Corp1 in Year2. [redacted] that the transfer of property from Corp1 to Corp9 had economic substance and business purpose, and that therefore, the transfer of properties by Corp1, Corp2, and Corp3 to Corp9 should be considered a section 351 transfer, Corp9 will be entitled to the carryover basis in the Corp1, Corp2, and Corp3 properties received.

Issue-3-capital loss on stock.

The issue here is whether Corp1 incurred a capital loss, as a result of the Date3 sale of #tt% of the Corp9 auction preferred stock, it received in exchange for properties transferred to Corp9 on Date2.

[redacted] that the transfer of property from Corp1 to Corp9 had economic substance and business purpose, and that therefore, the transfer of properties by Corp1, Corp2, and Corp3 to Corp9 should be considered a non taxable section 351 transfer, Corp1's basis in the Corp9 auction preferred stock will be equal to the carryover basis of the Corp1 assets transferred from Corp1 to Corp9. Therefore, Corp1 should incur a capital loss, as a result of the Date3 sale of #tt% of the Corp9 auction preferred stock, because the basis of the auction preferred stock will be equivalent to the basis of the assets transferred by Corp1 to Corp9.

Issue 4-Section 269

Arguably, I.R.C § 269 can be applied to disallow built in loss on the future sales of the Corp1 properties by Corp9. However, the taxpayer will argue, that the principal purpose for the Corp9 transaction, was to raise cash without debt and to isolate Corp1's unproductive assets, and therefore, because tax avoidance was not the principal purpose for the Corp9 transaction, I.R.C. § 269 does not apply, to disallow the built in loss on any future sale of the Corp1 properties by Corp9. [redacted] Therefore, I.R.C. 269 should not be applied to disallow built in loss on the future sale of the Corp1 properties by Corp9, [redacted] that the principal purpose for the acquisition of the Corp1 properties by Corp9 was not tax avoidance.

Issue 5-Section 482 reallocation

Although we believe the section 351 transaction results in a distortion of income among the consolidated group members Corp1, Corp2 and Corp3, we do not recommend a section 482 theory be pursued in this case. The detailed statutory and regulatory provisions governing Subchapter C and consolidated returns appear to permit the result taxpayer achieved in this case. First, sections 358 and 362 generally provide that for section 351 transactions the basis of property (including built-in gains and losses) permitted to be received by the corporation contributing the property and to be acquired by the newly formed corporation acquiring the property shall be the same as that in the hands of the transferor corporation. Thus, Corp1's basis in the APS retains the built-in loss attributes of the underlying contributed property and Corp9 acquires a carry-over of the same basis, including built-in losses, in the contributed property; and, accordingly, Subchapter C permits the duplication of built-in losses in this case. [redacted] Based upon the facts presented, we believe that a court, as in Eli Lilly & Co., would respect the form of the Corp1 transaction.

Reallocation of income.

In your memo, you have stated that the income received by Corp1 from the sale of the #h shares of auction preferred stock must be reallocated to Corp2 and Corp3, since they are viewed as the true owners of this stock. You have also stated that Corp2's and Corp3's transfers to Corp9 will be respected for I.R.C. § 351 purposes.

If it is determined that I.R.C. § 351 does not apply to the Corp9 transaction, because the transfer of Corp1 properties to Corp9 lacked business purpose, the Corp1 property transfer to Corp9 as well as the Corp2 and Corp3 property transfers to Corp9 will be treated as property sales. Corp1, Corp2, and Corp3 will be treated as selling their property to Corp9 in exchange for stock. In other words, Corp2's and Corp3's transfers to Corp9 will not be respected for purposes of I.R.C. § 351.

Further factual development

[redacted]

Summary

The taxpayer has a [redacted], that the Corp9 transaction had business purposes of raising cash without additional debt and isolating Corp1's unprofitable assets. Therefore, the field should not pursue the argument, that the transfer of properties by Corp1, Corp2, and Corp3 to Corp9 does not qualify as a nontaxable transaction, under I.R.C. § 351, because of lack of business purpose and economic substance. Likewise, the I.R.C. § 269 argument should not be pursued, because of the [redacted] that the Corp9 transaction was done primarily for business reasons. In addition, the I.R.C. § 482 argument should not be pursued, because of the lack of evidence of a tax avoidance scheme on the part of the taxpayer.

Please call (202) 622-7930 if you have any further questions.

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