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MEMORANDUM FOR NEW ENGLAND DISTRICT
ATTN: JOHN FEELEY,
International Examiner, International Groups 1111/1109

FROM: ELIZABETH KARZON
Chief, Branch 1 CC:INTL:BR1

SUBJECT:

This Field Service Advice responds to your request for assistance dated September 28, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Country T =
A =
B =
X =
Y =
Z =
Trust =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
x% =
y% =
z% =
x =
$x =

ISSUE:

Whether I.R.C. § 351 does not apply to the exchange described below because it was not undertaken for a valid business purpose.

CONCLUSION:

Based on the evidence presented to date, I.R.C. § 351 does not apply to the exchange described below because it was not undertaken for a valid business purpose. However, there should be additional factual development of this issue.

FACTS:

On Date 1, A voluntarily relinquished his U.S. citizenship and became a citizen of Country T. On that date, A owned a domestic grantor trust, which owned x% of the stock of X, a domestic corporation.[1]

On Date 2, Y was formed as a foreign corporation.[2]

On Date 3 (*i.e.*, when A was no longer a U.S. citizen), A transferred his entire interest in X to Y. A received all of the outstanding shares of Y stock in exchange for his X stock (the "Exchange").

On Date 4, A transferred his Y stock to Trust, a foreign trust, of which B are the beneficiaries.

X contemplated executing an initial public offering ("IPO") during the year that the transactions described above occurred, but that IPO did not actually take place until x years later on Date 7. A prospectus issued by X on or about Date 6 in connection with the contemplated IPO states that A transferred the X stock to Y in exchange for all of the Y stock in connection with an estate planning transaction.

When the IPO actually took place x years later, a percentage of the X stock held by Y was sold to the public at a gain of approximately $x. After this sale, Y held, and apparently continues to hold, shares of X stock representing approximately y% of all the shares entitled to vote and z% of the value of all classes of stock.

You have asked whether the Service can argue that I.R.C. § 351 does not apply to the Exchange because it was not undertaken for a valid business purpose. In that

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[1] A can be considered the owner of the X stock held by the grantor trust. See I.R.C. § 674(a).

[2] Y changed its name to Z on Date 5. For the sake of convenience, we will continue to refer to this corporation as Y.

case, then the Exchange would be treated as a taxable sale or exchange under I.R.C. § 1001.

I.R.C. § 1001 recognizes the gain from the Exchange. In the absence of I.R.C. § 877, A would not be taxed on the gain resulting therefrom because he was no longer a U.S. citizen at the time the Exchange occurred. However, under I.R.C. § 877, the Service could impose a tax upon A on the gain resulting from the sale of certain stock if he expatriated for tax avoidance reasons, *e.g.*, to avoid recognizing the gain on the sale of such stock. Thus, if I.R.C. § 1001 applies, so as to recognize the gain from the Exchange, and the other requirements of I.R.C. § 877 are satisfied,[3] A would nevertheless be taxed on the gain resulting from the Exchange.

LAW AND ANALYSIS:

Law:

The seminal case addressing the issue of business purpose in the corporate context is *Gregory v. Helvering*, 293 U.S. 465 (1935). The facts are that in 1928 petitioner was the owner of all of the stock of United Mortgage Corporation ("UMC"). One of UMC's assets was 1,000 shares of the stock of Monitor Securities Corporation. Petitioner: (1) formed Averill Corporation, (2) caused UMC to transfer all of its Monitor stock to Averill and Averill to issue all of its stock to her, (3) liquidated Averill, thus distributing all of the Monitor shares to her, and (4) sold the Monitor stock. The first two steps were intended to qualify as a tax-free reorganization under the predecessor to I.R.C. §§ 368(a)(1)(D) and 355.

The Supreme Court concluded that petitioner undertook these series of steps for the sole purpose of procuring a transfer of the Monitor shares to herself in order to sell them herself and, at the same time, diminish the amount of income tax which would result from a direct transfer of such shares to herself by way of a dividend.

Petitioner argued that since each element of the applicable Code section was satisfied, the transaction qualified thereunder. The petitioner further argued that her motive to escape tax should not alter the result.

The Court agreed that if a reorganization was effected under the applicable Code section, the petitioner's purpose is irrelevant. However, for the Court, "the question for determination is whether what was done, apart from the tax motive, was the

[3] The remainder of this memo will assume that these other requirements can be satisfied.

thing the statute intended." *Gregory*, 293 U.S. at 469. The Court noted that when the applicable Code section:

> speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here.

Id.

Thus, the Court described the transaction as an operation having no business or corporate purpose. In other words, it was not intended to reorganize a business or any part of a business. Rather, it was a device in the form of a reorganization for the purpose of distributing property tax-free to petitioner. Therefore, the Court held that the transaction:

> though conducted according to the terms of [the applicable Code section], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above realty and to deprive the statutory provision in question of all serious purpose.

Gregory, 293 U.S. at 470.

<u>Analysis:</u>

In *Gregory* the Code section at issue was, as noted above, the predecessor to I.R.C. §§ 368(a)(1)(D) and 355. In this case, the Code section at issue is I.R.C. § 351.

Section 351 is an exception to the general rule that a transfer of property by a transferor, in exchange for consideration received from the transferee of such property, is taxed to the transferor under I.R.C. § 1001. Instead, the transferor takes the same basis in the stock received from the transferee corporation as the aggregate basis that the transferor had in the property transferred to the transferee. Section 358(a)(1). Similarly, the transferee corporation takes the same basis in the property it received from the transferor as the transferor had in such property. Section 362(a)(1). Thus, the gain or loss inherent in the transferred property is not recognized at the time of the exchange. Rather, it is deferred until either the stock is sold by the transferor or the property is sold by the transferee (or both).

As in the case of a reorganization intended to qualify under I.R.C. § 368 (and 355), a taxpayer must have a business purpose for an exchange intended to qualify under I.R.C. § 351. *Caruth v. United States*, 688 F. Supp. 1129, 1138-41 (N.D. Tex. 1987), *aff'd*, 865 F.2d 644 (5th Cir. 1989). *See also*, Rev. Rul. 55-36, 1955-1 C.B. 340, Rev. Rul. 60-331, 1960-2 C.B. 189, Rev. Rul. 68-349, 1968-2 C.B. 143, Rev. Rul. 70-140, 1970-1 C.B. 73, and § 4.06(1) of Rev. Proc. 83-59, 1983-2 C.B. 575, 580.

A asserts that he transferred his X stock to Y, a holding company containing essentially no other assets (*i.e.*, other than his X stock), for valid business reasons, *i.e.*, to create additional insulating levels of protection, superior to holding the X stock directly.

In support of his position, A notes first that he and the co-owner of X were threatened with a lawsuit alleging that they were personally liable for damages for which X was allegedly responsible.

Second, A notes that indirect ownership of his X stock is best since he is planning to live in Country T. A notes that although Country T currently has a stable political environment, since it is still a developing country, there can be no guarantee that it will continue to have one.

Finally, A notes that while it is generally accepted in the United States that a corporation is a separate legal entity and that shareholders are not liable for the debts or liabilities of the corporation, the separate entity principle is not recognized in every jurisdiction, including some in which A might have business interests. Thus, A argues that levels of corporate ownership, and the existence of a trust between him and certain of his investments, including X, would enhance the protection afforded by corporate ownership alone.

A has not explained how interposing an additional corporation, Y, between himself and his X stock would make him less likely to be held liable for actions of X or make it less likely that his X stock would be seized. If a jurisdiction is going to respect the concept of limited liability (in which a shareholder is not held liable for the debts, including tort liabilities, of a business operating in corporate form), then interposing an additional corporation between him and X is unnecessary. On the other hand, if a jurisdiction is not going to respect such a concept (whether correctly or incorrectly), then interposing an additional corporation should not make any difference.

In addition, there is evidence that A undertook the Exchange for nonbusiness reasons. First, as noted above, a prospectus issued in connection with the contemplated IPO (in the year of the Exchange) stated that A undertook the Exchange in connection with an estate planning transaction. Second, the timing of the Exchange and of the contemplated IPO suggests that A transferred his X stock to Y so that Y could sell the X stock without any tax consequences to A.

For example, if instead of transferring his X stock to Y, A had sold some of his X stock pursuant to the IPO, A would have recognized gain under I.R.C. § 877. Similarly, if A had sold some of his Y stock, A would have recognized gain under I.R.C. § 877. However, by transferring his X stock to Y and then having Y sell some of the X stock pursuant to the IPO, A attempts to avoid paying tax on the sale of the X stock, because the gain that Y recognized is not subject to U.S. tax.

It is true that a taxpayer has the right "to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits[.]" *Gregory v. Helvering*, 293 U.S. at 469. However, the Supreme Court went to state, as noted above, that "the question for determination is whether what was done, apart from the tax motive, was the thing the statute intended." *Id.* The Court concluded that the transaction described therein was an operation having no business or corporate purpose and was not intended to reorganize a business or any part of a business.

Similarly, in this case, A has not provided convincing evidence of a corporate business purpose for transferring the X stock to Y. Moreover, a transfer of property that a transferor intends to qualify under I.R.C. § 351, but for which the transferor has no business purpose, is outside the scope of that section. *Id.* Instead, the evidence convincingly points to tax avoidance as the reason for the exchange. In the absence of a valid business purpose for the Exchange, the Service should argue that I.R.C. § 351 does not apply. Consequently, I.R.C. § 1001 applies to the Exchange. In that case, A can be taxed on the gain recognized by A on the Exchange under I.R.C. § 877.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

This Field Service Advice has been coordinated with the Office of Assistant Chief Counsel (Field Service) Corporate Branch and the Office of Assistant Chief Counsel (Corporate).
If you have any further questions, please call Grid Glyer at (202) 622-7930.

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