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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR RICHARD H. GANNON, SPECIAL LITIGATION ASSISTANT
CC:LM:MCT:PHI

FROM: Jasper L. Cummings, Jr.
Associate Chief Counsel (Corporate) CC:CORP

SUBJECT: Merger and Exchange Transactions

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LEGEND

CorpA	=
CorpB	=
CorpC	=
CorpD	=
CorpE	=
CorpF	=
CorpG	=
CorpH	=
CorpJ	=
CorpK	=
X	=
Date1	=
Date2	=
Date3	=
Date3A	=
Date4	=
Date5	=
Date6	=
Date7	=
Date7A	=
Date8	=
Date9	=
Date10	=
Date11	=

Date12	=
Date13	=
Date14	=
Date15	=
Date16	=
Date17	=
Date18	=
Date19	=
Date20	=
Year1	=
#a	=
#b	=
#c	=
#d	=
#e	=
#f	=
#g	=
#h	=
#i	=
#j	=
#k	=
#l	=
#m	=
#n	=
#o	=
#p	=

#q	=
#r	=
#s	=
#t	=
#u	=
#v	=
#w	=
#x	=
#y	=
#z	=
#aa	=
#bb	=
$$aa	=
$$bb	=
$$cc	=
$$dd	=
$$ee	=
$$ff	=
$$gg	=
$$hh	=
$$ii	=
$$kk	=
$$mm	=
$$nn	=
$$oo	=
$$pp	=

$$qq	=
$$rr	=
$$ss	=
a%	=
b%	=
c%	=
d%	=
e%	=
f%	=
g%	=
h%	=
j%	=
k%	=
m%	=
n%	=
p%	=
q%	=
r%	=
s%	=
t%	=
u%	=
v%	=
w%	=
X%	=
StateA	=
StateB	=

StateC	=	
CountryZ	=	

ISSUES

1. Whether § 384 applies to bar CorpA, from offsetting the gain it recognized on the transfer of the Series B CorpG Preferred Stock (the “CorpG Stock”) to CorpK (the “CorpG gain”) against pre-merger net operating losses (“NOLs”)?

2. Whether the transfer of cash, stock and other assets to CorpA, in exchange for its stock qualified for nonrecognition under § 351(a)?

3. Whether the CorpG gain may be reallocated to CorpC under § 482?

CONCLUSIONS

1. No. Based on the available information, § 384 does not apply.

2. Yes. The exchange qualifies for nonrecognition under § 351.

3. Yes. The gain on the CorpG Stock may be reallocated under § 482 to CorpC.

FACTS

This matter involves the ultimate outbound transfer of the appreciated CorpG Stock owned by CorpC in order to recognize its built-in gain under the shelter of net operating losses of CorpB which were due to expire shortly after the transfer.

1. The Inversion of CorpB under a Holding Company.

In Year1, CorpB, a StateB corporation,[1] with approximately $qq of net operating loss carryovers, of which $pp were due to expire on Date17, formed a wholly owned subsidiary CorpA, a StateA corporation. CorpA in turn formed CorpJ, a wholly

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[1] CorpC, a StateA corporation, was the principal shareholder of CorpB. According to information provided by the Financial Products Specialist assigned to the case, CorpC owned f% of the Common Stock of CorpB on Date1, and v% on Date5. On Date7, CorpC bought #c shares of Class A Common Stock of CorpB from X, attaining x% ownership of CorpB in order to permit consolidation for financial reporting purposes. On Date10, CorpC owned a% of CorpB Common Stock.

owned StateA subsidiary. On Date14, CorpJ merged with and into CorpB, the surviving corporation. In the reorganization, each outstanding share of Common Stock (other than stock of the dissenters) and Class A Common Stock of CorpB was converted into Common Stock of CorpA ("the Inversion").[2] As a result of the Inversion, CorpB became a wholly owned subsidiary of CorpA, and the former shareholders of CorpB became shareholders of CorpA

2. The Exchange Agreement.

On Date14, two publicly-held corporations, CorpC and CorpE, commonly owned in part, directly (or through their wholly owned subsidiaries) transferred cash or assets in exchange for stock of CorpA as described below.

The Parties.

CorpC is a StateA corporation with principal executive offices in , and had outstanding #e shares of Common Stock, $aa par value (#m votes) per share, and #f shares of Class A Common Preference Stock, $bb par value (#bb vote) per share, as of Date6. CorpC owned all the stock of CorpD, a StateC corporation.

CorpE, a StateA corporation, as of Date11, had issued and outstanding #r shares of Common Stock, and #s shares of Serial Preferred Stock. CorpE was the sole shareholder of CorpF, a StateA corporation.

CorpA is the holding company created in the Inversion described above, which occurred on Date14, before the Exchange. In the Inversion, CorpA became the sole shareholder of CorpB.

X was the Chairman of the Board of CorpE, CorpC, CorpA, and CorpB. He is a principal shareholder of CorpC, owning approximately d% of CorpC's Common Stock, and e% of its Class A Common Preference Stock, (together with options covering an additional g% of such Common Stock). S - 4, p. #n.[3] He also

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[2] As of the record date, Date12, CorpB had #a total shares entitled to vote (#bb vote per share), of which #h were Common and the balance were Class A Common Stock. Form S-4 Prospectus of CorpA dated Date13 ("S - 4"), p. #k.

[3] See CorpC's Form 13-D, filed Date7A, indicating X beneficially owned approximately w% of CorpC's outstanding stock (inclusive of optioned stock and stock held by a general partnership).

beneficially owned h% of the CorpE Common Stock and all of CorpE's Serial Preferred Stock as of Date4 (according to SEC filings).

Prior to consummation of the Exchange, CorpC legally owned all of CorpE's Serial Preferred Stock, and approximately j% of CorpB, which owned #t shares, or k% of the Common Stock of CorpE. CorpC also held a warrant to purchase #u or (approximately n%) of the Common Stock of CorpE for $cc per share as of Date14. (Id.).

The Exchange

Pursuant to the terms of the Exchange Agreement, the following exchanges occurred on Date14, after the Inversion.

- CorpE (or CorpF) contributed cash in the amount of $dd to CorpA in exchange for #p shares of CorpA Series A Voting Cumulative Convertible Preferred Stock (the "Series A Preferred Stock") and an option to transfer all or substantially all of its assets to CorpA for CorpA Common Stock (the "Asset Put Option").[4]

- CorpC contributed assets, valued for purposes of this transaction at $ee, in exchange for #o shares of CorpA Common Stock and #q shares of CorpA Series B Voting Cumulative Convertible Preferred Stock. The assets transferred by CorpC (or CorpD) consisted of (i) #v shares of the Series B Preferred Stock of CorpG,[5] (ii) CorpC's p% membership interest in CorpH,

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[4] The Asset Put Option gives CorpE the right to require CorpA to acquire, for shares of CorpA Common Stock, substantially all of CorpE's assets and assume related liabilities. In exchange for up to $mm in aggregate appraised value of such assets, CorpA is obligated to deliver to CorpE the number of shares of CorpA Common Stock determined by dividing the value of CorpE's assets by $ss per share. The closing price of such stock was $rr per share at Date19. If the appraised value of CorpE's assets is in excess of $mm, CorpA is obligated to pay for the excess by issuing Common Stock at the then fair market value, up to a maximum of $nn of assets. CorpE Form 10-K filed Date20, p.#n.

[5] The CorpG Stock was acquired by CorpC upon conversion of CorpG Common Stock held by it, effective Date3A, according to Form 10 - Q of CorpG at p. #w, n. #w, filed Date8. The CorpG Stock was subject to redemption under an Option Agreement with the issuer (CorpG) for $hh per share. Upon exercise, CorpC would have received $oo. Such gross proceeds would have been subject to income taxes which, assuming an effective combined federal and state tax rate of u%, would have resulted in net

> and (iii) #s shares of CorpE's Preferred Stock. The CorpG Stock was transferred by CorpD to CorpA according to the Exchange Agreement, and redeemed in Date18 for $hh per share.

Upon consummation of the Exchange, CorpC and CorpE, as joint transferors under the Exchange Agreement, held in the aggregate approximately q% of the voting power of CorpA, with CorpC's holdings representing b% of the voting power, and c% of the value of CorpA (according to the Financial Products Specialist),[6] and CorpE's holdings representing approximately s% of such voting power.

Also in accordance with the Exchange Agreement, CorpA exchanged the Preferred Stock of CorpE received from CorpC for an equal number of shares of CorpE's Series B t% Cumulative Voting Convertible Preferred Stock, which has a lower accrual rate and except on a change in control, is not convertible into CorpE Common Stock during the #bb year period commencing on the fifteenth day following the filing date of CorpE's Form 10-K for Year1, and was described in CorpE's Form 10-Q, filed Date15, as substantially identical to the terms of the Preferred Stock exchanged therefor. After the Exchange closed, CorpA owned m% of the voting power possessed by the Common Stock and Serial Preferred Stock of CorpE. (Form 10-Q CorpE for quarter ended Date11, at Note #i ("Subsequent Event"), filed Date15.) CorpF's charter required that the stock of CorpA owned by it (which was received in the Exchange) could only be voted upon the direction of independent continuing directors of CorpF. The purpose of the restrictions was to protect CorpF from domination by CorpA, the m% corporate shareholder of its parent, CorpE.[7]

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proceeds to CorpC of $ff. In addition, upon exercise by CorpG of the option to redeem, the $ii option payment CorpG made to CorpC in a prior year would have become taxable to CorpC. Such tax liability, assuming the same rates, would have amounted to $kk according to Form 10 - Q of CorpC for the quarter ended Date2, filed Date3, at p. #y.

[6] CorpC owned #b shares of CorpA including #c shares it purchased from X, on Date7 (at an agreed value of $gg per share in exchange for #d shares of Common Stock of CorpC). Form 10-K (Date17), n. #j, page #l.

[7] See CorpA's Form S-4, the Prospectus dated Date13, pps. #z. "The foregoing provisions are intended to ensure that, . . . CorpF will not be considered to be dominated or controlled by [CorpA] with respect to the voting of [CorpA] . . . stock, and thus will retain the right to vote the Convertible Preferred Stock received by it in the Stock Transactions."

On or about Date16, #aa days prior to the expiration of $pp in net operating loss carryovers of CorpB, mentioned above, the CorpG Stock was transferred to CorpK, a wholly owned CountryZ subsidiary of CorpB. The taxpayer reported gain on this outbound transfer under section 367(a)(1) and offset the gain against CorpB's NOLs. The CorpG Stock was redeemed in Date18 for $hh per share.

LAW AND ANALYSIS

Overview of the Inversion and Exchange.

CorpA, the newly created holding company, acquired the stock of CorpB and the assets (such as the CorpG Stock) transferred to it (or to its subsidiaries) in the Exchange in integrated transfers on even date. Thus, CorpA's acquisition of the stock of CorpB may be viewed separately either as a reverse triangular merger (under § 368(a)(2)(E)), or as overlapping transfers of CorpB shares to a controlled corporation (CorpA) under § 351. As discussed under issue 2, this stock acquisition may also be viewed as an integrated part of a "double winged" stock and asset acquisition under § 351. Our discussions and conclusions under issues 1 and 3 below apply under either of these constructs.

Issue 1. § 384.

This issue concerns whether the built-in gain on the CorpG Stock may be offset and sheltered by the net operating losses of CorpB, which would otherwise have expired, or whether section 384 bars this offset.

Section 384(a) provides:

> If a corporation acquires directly (or through 1 or more other corporations) control of another corporation, or the assets of a corporation are acquired by another corporation in a reorganization described in subparagraph (A), (C), or (D) of section 368(a)(1), and either of such corporations is a gain corporation, income for any recognition period taxable year (to the extent attributable to recognized built-in gains) shall not be offset by any preacquisition loss (other than a preacquisition loss of the gain corporation).

Section 384 operates to segregate and "quarantine" a built-in gain of either corporation, where one corporation acquires control of another corporation, directly or indirectly, or acquires the assets of another corporation in a reorganization described in subparagraph (A), (C), or (D) of § 368 (a)(1). The asset reorganization rule does not apply to the instant case because CorpC did not transfer any of its operating assets to CorpA.

The Stock Acquisition Rule of § 384(a)(1)(A) applies to acquisitions of control of the stock of an unrelated corporation. For purposes of § 384, “control” means ownership of stock meeting the requirements of § 1504(a)(2). § 384(c)(5). Neither § 384 nor § 1504(a)(2) provides constructive ownership rules for determining control.

Under § 1504(a)(2), control is achieved when the stock owned (A) possesses at least 80 percent of the total voting power and (B) has a value of at least 80 percent of the total value of the stock of the corporation. Voting power ordinarily means the power to elect directors. See Rev. Rul. 69-126, 1969-1 C.B. 218; Hermes Consolidated, Inc. v. United States, 14 Cl. Ct. 398 (1988). But see Alumax, Inc. v. Commissioner, 109 T.C. 133 (1997), aff’d, 165 F.3d 822 (11th Cir. 1999) (other terms and agreements cut into parent’s voting “power” and lowered it below the 80 percent line).

Neither CorpC nor CorpE directly owned stock of CorpA possessing the requisite 80 percent of vote or value. Thus, neither CorpC nor CorpE acquired control of CorpA within the meaning of § 384 (c)(5) as a result of the Exchange. Furthermore, CorpC did not directly own stock of CorpE possessing 80 percent of the vote and value of CorpE. Consequently, § 384 does not apply.

In order for § 384 to apply, the acquisition of control must occur at a time when either the acquiring or acquired corporation is a gain corporation. The Stock Acquisition Rule applies to direct acquisitions of control as well as to acquisitions of control through one or more other corporations. Even though control may be acquired indirectly through one or more other corporations, § 384 does not expressly provide rules for constructive ownership through one or more other corporations. In the absence of such rules, the most likely situation where a corporation could acquire control through one or more other corporations for purposes of § 384 would be where the corporation owned stock in the other corporations satisfying the 80 percent vote and value tests of § 1504 (a)(2).

In this case, CorpC cannot be found to have acquired control of CorpA under § 384 unless its stock ownership of CorpA is either aggregated with that of CorpE’s (an unaffiliated corporation) thereby exceeding the 80 percent vote and value tests of § 1504(a)(2), or increasing the vote and value of the CorpA stock held by CorpC under another theory. We do not believe such aggregation or increase is warranted under the facts and circumstances that are presented.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We have assumed that the conclusions of the Financial Products Specialist as to vote and value of the stock ownership of CorpA by CorpC, which were each found to fall below 80 percent as set forth above), are correct. If further factual development indicates that CorpC's ownership of CorpA stock meets the 80 percent tests of § 1504(a)(2), then, obviously, § 384 could apply. Similarly, if CorpC owned stock in CorpE satisfying the 80 percent tests of § 1504(a)(2), we believe that CorpE's stock ownership in CorpA could be aggregated with CorpC's stock to satisfy the 80 percent tests.

We note that section 384(b) does not apply to this case, because these corporations were not members of a controlled group as defined therein, for five years preceding the Inversion. See note 1, supra (stating the historical stock ownership of CorpB by CorpC was below 50 percent during the five years before the Inversion).

Although you did not request an analysis of § 269 to this case, we further note that § 269 (a)(1) does not apply due to CorpC's attainment of x% stock ownership of CorpB on Date7, in order to consolidate for financial accounting purposes. For that reason, we do not believe a court would treat the acquisition on Date7, as being integrated with the merger and Exchange on Date14, for purposes of acquiring control under § 269(a)(1).

Based on the available information, however, we note that § 269 (a)(2) may apply to deny CorpA the benefit of the offsetting the gain on the CorpG Stock against its expiring NOLs. Section 269 (a)(2) applies if a corporation acquires, directly or indirectly, property of another corporation, the basis of which in the hands of the acquirer is determined by reference to the basis in the hands of the transferor, and the transferor corporation was not controlled directly or indirectly, immediately before such acquisition by the acquiring corporation or its shareholders, and if the principal purpose of such acquisition was to evade or avoid Federal income tax by securing the benefit of a deduction, credit, or other allowance which it would not otherwise enjoy.

Control is determined by legal or beneficial stock ownership of at least 50 percent vote or value without attribution. (Neither §§ 318 nor 267 constructive stock ownership rules apply). See Rev. Rul. 70-638, 1970-2 C.B. 71. This common control exception is unique to asset acquisitions and has no counterpart within the corporate stock acquisition rules (under § 269). Brick Milling Co. v. Commissioner, T.C. Memo. 1963-305, 22 T.C.M. (CCH) 1603. Compare Southland Corp. v. Campbell, 358 F.2d 333 (5th Cir. 1966).

In the instant case, CorpA acquired the CorpG Stock from CorpC in a § 351 transaction, and therefore CorpA's basis in the CorpG Stock was determined by reference to CorpC's basis. Accordingly, § 269(a)(2) may apply unless CorpA (as the acquirer) <u>or its shareholders</u> controlled, directly or indirectly, CorpC (the transferor) immediately before the transfer of the CorpG Stock.[8] In addition, of course, the application of § 269(a)(2) would require a showing that the principal purpose of CorpA's acquisition of the CorpG Stock was the evasion or avoidance of tax by securing the benefit of offsetting the gain on the CorpG Stock against CorpB's expiring NOLs.

[redacted][9][redacted]

Issue 2. § 351.

In general, gain or loss is not recognized if property is transferred to a corporation solely in exchange for its common stock and/or preferred stock[10] and if the transferor or transferors control the corporation immediately after the exchange. § 351. CorpB, CorpA, CorpC, CorpD, CorpE, and CorpF, (the "Parties") entered into the written Exchange Agreement (dated as of Date9), to transfer property to CorpA in exchange for its stock, in transactions intended to qualify for

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[8] In Example 3 of Treas. Reg. § 1.269-6, the parent corporation transfers profitable assets to a newly-acquired loss subsidiary. The common control exception is deemed not to apply since the parent transferor is not controlled by the subsidiary-transferee or its stockholders.

[9] [redacted]

[10] Nonqualified preferred stock under § 351(g) did not apply to the Exchange because that provision was not adopted until 1997. <u>See</u> Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1014(a), 111 Stat. 788, 919 (effective for transactions after June 8, 1997).

nonrecognition under § 351. If the transaction failed to qualify under § 351, however, CorpC's transfer of the CorpG Stock would be taxable, resulting in recognition of gains by CorpC.

The regulations indicate that multiple transferors are considered as a group if their rights have been defined by agreement and if the agreement is executed with expedition consistent with orderly procedure. Treas. Reg. § 1.351-1(a)(1). In this case, the exchanges were consummated on Date14 pursuant to the Exchange Agreement. Therefore, the transferors can be regarded as a single control group. If the transferors (CorpC and CorpE), as a group, were in control of CorpA immediately after the transfers, each member of the group who receives only stock of the transferee corporation qualifies for nonrecognition treatment, even though no transferor alone has the requisite control.

Control as used in § 351, is defined in § 368(c). Under that section, the term means:

> [T]he ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of [i.e., nonvoting] stock of the corporation.[11]

The determination of control is made based on the number, not the value, of the transferee corporation's shares.

The Exchange

Upon consummation of the Exchange, CorpC and CorpE, as joint transferors under the Exchange Agreement, in the aggregate, owned stock of CorpA possessing approximately q% of the voting power of CorpA, with CorpC's holdings representing r% of the voting power of CorpA and CorpE's holdings representing approximately s% of such voting power. No nonvoting stock of CorpA was then issued and

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[11] Section 368(c) does not use any rules of attribution in its definition of "control." Therefore, in order to be included in the transferor group with respect to which control is determined, actual, not constructive, stock ownership is required. <u>See</u>, <u>e.g.</u>, Rev. Rul 56-613, 1956-2 C.B. 212, where the control test was failed by a parent that acquired all of one class of target's stock in an attempted "B" reorganization, when its wholly owned subsidiary owned all of the target's other class of stock. Although the Service recognized that all of the stock of the target was owned, directly or indirectly, by the parent corporation, it determined that the parent failed to obtain control.

outstanding. Based upon the foregoing, CorpC and CorpE together possessed control of CorpA immediately after closing of the Exchange Agreement on Date14.

The charter restrictions imposed on CorpF in respect of its ability to vote the stock of CorpA received in the Exchange, "except upon the direction of independent continuing directors" of CorpF, raises the issue of whether such stock was excluded from the calculation of control under § 368(c). The CorpA stock owned by CorpF, which could only be voted by its independent directors, was "stock entitled to vote" under § 368(c) for the reasons stated below.

- CorpF, the corporate shareholder-transferor remained fully able to vote the CorpA stock.
- The restrictions merely limit the pool from which the directors of CorpF may be selected in order to vote the CorpA stock. They do not affect the voting entitlement (or the ability to exercise it), or the other rights intrinsic to the stock. (They are temporary but were in effect at the Exchange).
- Often minority shareholders may prefer that a majority shareholder select its directors from a pool of independent candidates, rather than from more closely related persons. In general, the courts have been willing to countenance such limitations as not preventing voting power.[12]

In our view, limiting the pool from which a shareholder could select directors would not be a meaningful limitation on a shareholder's voting power so long as the pool of individuals eligible to become a director does not become so small as to materially impede the voting right of the shareholder. The reason that a mere limitation on the pool of eligible individuals should not be viewed as overriding a

[12] In Hermes Consolidated, Inc. v. United States,14 Ct. Cl. 398 (1988), a controlling shareholder acquiesced to the request of a minority shareholder to elect an independent director as one of the controlling shareholder's two directors. The minority shareholder thus elected one director of its choosing while the majority shareholder selected one director of its choosing and one independent director. The Court of Claims ruled that the minority shareholder was not deemed to have 50 percent or more of the corporation's voting power even though the majority shareholder agreed to select one independent director. 14 Ct. Cl. at 406. The court does not state whether the majority shareholder who agreed to elect an independent director was still treated as having more than 50 percent voting power. However, that outcome seems inevitable by implication. Given that Hermes had only two shareholders, any finding by the court that the minority shareholder had less than 50 percent of the corporation's voting power would necessarily mean that the majority shareholder had more than 50 percent.

shareholder’s right to elect directors is that, if an elected director in fact does not act in accord with the wishes of the electing shareholder, the shareholder would then be free not to re-elect that director.

Based upon the foregoing reasoning, we do not believe the restrictions in question affect CorpF’s stock in CorpA for purposes of determining control under §§ 351 and 368(c). Therefore, because CorpC and CorpE together were in control of CorpA immediately after the Exchange, their transfers to CorpA in exchange for CorpA stock qualified for nonrecognition under § 351.

Integrated Transaction

As previously noted, both the Inversion and Exchange occurred on the same date and arguably may be treated as an integrated transaction. Accordingly, while the Inversion took the form of a merger of CorpJ into CorpB, in a transaction qualifying under § 368(a)(1)(A) and (a)(2)(E), it was substantively the same as if the shareholders of CorpB transferred their CorpB stock to CorpA in exchange for CorpA stock. If integrated with the contemporaneous transfers to CorpA from CorpC and CorpE described in the Exchange transaction, the Inversion became part of a larger exchange transaction in which the CorpB shareholders, along with CorpC and CorpE, transferred property to CorpA in exchange for CorpA stock.

Immediately after the integrated Inversion-Exchange transaction, the former shareholders of CorpB, CorpC and CorpE, in the aggregate, owned all of the outstanding stock of CorpA. Accordingly, they were in control of CorpA within the meaning of § 368(c), and the integrated transaction would qualify for nonrecognition under § 351.

Issue 3. § 482.

Section 482 provides in relevant part:

> In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may . . . distribute, apportion, or allocate gross income . . . 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.

Section 1.482-1(f)(1)(iii) of the Income Tax Regulations provides in pertinent part:

> If necessary to prevent the avoidance of taxes or to clearly reflect income, the [Service] . . . may make an allocation under section 482 with respect to transactions that otherwise qualify for nonrecognition of gain or loss under applicable provisions of the Internal Revenue Code (such as section 351 . . .).

These regulations allow the Service to make § 482 allocations "with respect to transactions that otherwise qualify for nonrecognition of gain or loss" whenever "necessary to prevent the avoidance of taxes or to clearly reflect income," and they illustrate this principle with an example based on National Securities v. Commissioner, 137 F.2d 600 (3d Cir. 1943). Treas. Reg. § 1.482-1(f)(1)(iii). In a few cases involving § 351 transfers of land with growing crops, expenses incurred by the transferor before the transfer have been reallocated under § 482 to the transferee in order to match the deductions for the expenses with the transferee's income on selling the harvested crops. Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); Central Cuba Sugar Co. v. Commissioner, 198 F 2d 214 (2d Cir. 1952).

The courts have recognized that in appropriate circumstances, income and deductions may be reallocated under § 482 even if the inter-company transaction was covered by a nonrecognition rule. We concur with the proposed § 482 adjustment that would allocate to CorpC the gain recognized on the outbound transfer of the CorpG Stock to CorpK. In doing so, we rely on Treas. Reg. § 1.482-1(f)(1)(iii) and Foster v. Commissioner, 80 T.C. 34 (1983), aff'd in pertinent part, 756 F.2d 1430 (9th Cir. 1985), cert. denied, 474 U.S. 1053 (1986) (holding that § 482 reallocation of income was appropriate where sole purpose of § 351 transactions was tax avoidance). Accord, National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943) (upholding a § 482 reallocation of a loss from a sale of stock previously transferred in a nonrecognition transaction back to the transferor to clearly reflect income) and progeny;[13] see also Eli Lilly & Co. v.

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[13]See, e.g., Dolese v. Commissioner, 811 F.2d 543 (10th Cir. 1987) (§ 482 reallocation permitted in connection with non recognition distribution of partnership property to partners under § 731); Stewart v. Commissioner, 714 F.2d 977, 992 (9th Cir. 1983) (reallocating gain following § 351 transaction because § 351 does not shield a transferor of appreciated property from gain recognition if the taxpayer "cashes in" on that gain indirectly); Rooney v. United States, 305 F.2d 681 (9th Cir. 1962) (reallocating expenses to clearly reflect income where expenses and income arising from planted crops were mismatched); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2nd Cir.), rev'g 16 T.C. 882 (1951), cert. denied, 344 U.S. 874 (1952) (facts and outcome similar to Rooney); Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, 7th ed., ¶ 3.17[3] (explaining that § 482 re-allocations do not violate the non recognition principles of § 351 because the reallocated gain or loss is triggered not

Commissioner, 84 T.C. 996, 1115-1116 (1985), aff'd in part and rev'd in part, 856 F.2d 855 (7th Cir. 1988). In Eli Lilly, the Tax Court suggested that § 482 re-allocations that overcome nonrecognition treatment may be appropriate in two situations – when a transaction is arranged "without a valid business purpose and solely in order to avoid taxes" and "where the incomes of related parties are not clearly reflected, even in the absence of tax avoidance motives."[14] See generally Treas. Reg. § 1.482-1(f)(1)(iii), and its predecessor Treas. Reg. § 1.482-1A(d)(5), discussed below.

In Foster, a family partnership of a father and three sons acquired a large tract of land and developed nine neighborhoods. In October 1962, after the first neighborhood was developed but before any sales to builders, the partnership transferred an undivided one-quarter interest in acreage in the first neighborhood to each of four newly formed corporations owned by one of the Fosters. These transfers were designed to qualify under § 351. In 1966, after another neighborhood was developed, to a lesser extent than the first, the property was transferred to a separate family corporation that had large NOL carryforwards. This transfer was a contribution to capital designed to qualify under § 118. In each of these transfers, the Service invoked § 482 to tax the income on ultimate sale to the transferor to the extent that it had economically accrued on the date of the exchanges.

The Tax Court sustained the application of § 482, as interpreted in the regulations, to nonrecognition transactions based on "a solid line of cases," citing and reviewing prominently National Securities, Rooney, and Central Cuba, with a "but see" reference to Ruddick Corp. v. United States, 643 F.2d 747 (Cl. Ct. 1981), on remand, 3 Cl. Ct. 61 (1983), aff'd without opinion, 732 F.2d 168 (Fed. Cir. 1984). 80 T.C. at 151. Further, the court upheld the validity of former Treas. Reg. § 1.482-

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by the non recognition exchange but, rather, by a "lack of business purpose . . . (manifesting a purpose to evade taxes), or because the [transaction] does not clearly reflect income, or both.").

[14] While in Eli Lilly only transfer pricing adjustments were ultimately upheld by the Seventh Circuit, and adjustments that would have effectively involved section 482 overriding section 351 treatment were rejected, the case is materially distinguishable from this case and the National Securities, Rooney, and Central Cuba progeny, because the transferee of the income-producing assets in Eli Lilly did not dispose of those assets subsequently triggering recognition as occurred here and the other cases.

1(d)(5)[15] and expressly held that the statutory and regulatory provisions "may be applied to a taxable disposition of property previously acquired in a nonrecognition transaction." Id. at 151-159. Finally, the court concluded that the transfers of the properties from the partnership to the corporations were for tax avoidance purposes and sustained the reallocation to the partnership of the income from the sale of the lots. Id. at 177, 184. On appeal, the Ninth Circuit affirmed the Tax Court's holdings on the application of § 482. 756 F.2d at 1432-1436.

The determination of the existence of the requisite tax avoidance motive, where a purported business purpose may also be present, is ultimately a factual inquiry. See, e.g., Ruddick. In the instant case, we concur that substantial tax avoidance motives prompted the initial and outbound transfers of the highly appreciated CorpG Stock, especially since the transactions occurred at the end of Year1 just in time to offset the appreciated value in the CorpG Stock against CorpB's soon-to-expire NOL carryovers. It is abundantly clear that the initial transfer to CorpA by CorpC through CorpD, its wholly owned subsidiary, set the stage for a disposition of the transferred CorpG Stock on favorable tax terms not available to CorpC (or CorpD). The expiry date for CorpB's NOLs and the announced intention to redeem the CorpG Stock highlight the tax avoidance motives for the initial and outbound transfers. Moreover, the outbound transfer accelerated the gain so that it could be offset against the expiring NOLs even though it may also have provided some additional capital through the foreign transferee's borrowing against the CorpG Stock.

It should be emphasized that neither § 482 nor Reg. § 1.482-1(f)(1)(iii) limit the ability to override nonrecognition treatment under § 482 to situations in which no business purpose exists. Notably, the National Securities court expressly relied on a clear reflection of income analysis and did not reach the tax avoidance issue. Conversely, the Tax Court in Foster followed a tax avoidance analysis and did not address the clear reflection of income question.

It is further noted that CorpC and CorpA (or CorpB) triggered recognition with respect to the CorpG Stock, not by a sale of the property as often occurs in the National Securities line of cases, but through an outbound transfer that triggered gain recognition under § 367(a).[16] That is, by structuring the outbound transfer of

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[15] Former Treas. Reg. § 1.482-1(d)(5), now designated § 1.482-1A(d)(5), is the predecessor of current Treas. Reg. § 1.482-1(f)(1)(iii).

[16] The transfer(s) of the CorpG Stock by CorpA, through CorpB (or by CorpB) to CorpK otherwise would have qualified as constructive exchanges under § 351 because each transferee was wholly owned by the transferor of the CorpG Stock. See Rev. Rul.

the CorpG Stock as they did, CorpC, CorpD, CorpA, and CorpB made certain that the transfer would trigger gain recognition as if the stock had been sold. Thus, the § 367(a) outbound transfer in the instant case had the same effect as the taxable dispositions in the cited authorities and should be similarly treated for purposes of the § 482 analysis in this case.

In conclusion, we believe the available facts show that the outbound transfer triggered the gain primarily to absorb the otherwise expiring net operating loss carryovers of CorpB. Accordingly, the reallocation of gain to CorpC, the parent of CorpD (the transferor of the CorpG Stock to CorpA or CorpB), should be sustained.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

64-155, 1964-1 C.B. 138; Lessinger v. Commissioner, 85 T.C. 824 (1985) (reviewed), rev'd, 872 F.2d 519 (2d Cir. 1989), distinguishing Abegg v. Commissioner, 50 T.C. 145 (1968), aff"d on other grounds, 429 F.2d 1209 (2d Cir. 1970), cert. denied, 400 U.S. 1008 (1971). Because CorpA (or CorpB) owned 50 percent of the value (and a 48% voting interest) of CorpG (the target corporation) when CorpA (or CorpB) contributed the CorpG Stock to CorpK (CorpA was a 5 percent target shareholder), and CorpA owned 100 percent of CorpK immediately after CorpA transferred the CorpG Stock to CorpK, the CorpG Stock transfer did not satisfy the requirements for nonrecognition under Temp. Treas. Reg. § 1.367(a)-3T(c) and, thus, was subject to § 367(a). Accordingly, CorpA was required to recognize gain pursuant to § 367(a) on its transfer of the CorpG Stock to CorpK.

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Please call if you have any further questions.

Jasper L. Cummings
Associate Chief Counsel (Corporate)
Gerald B. Fleming
Senior Technician Reviewer
Branch 2

cc: