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 DISTRICT COUNSEL, HOUSTON DISTRICT
CC:MSR:HOU
Attn: Janet Balboni

FROM: Associate Chief Counsel, CC:PSI

SUBJECT: Capital Loss on Preferred Stock Sale

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

This Chief Counsel Advice responds to your memorandum dated March 7, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

LEGEND

PCorp =

SubA =

SubAl =

SubA2 =

SubB =

SubBl =

Corp1 =

Year1 =

Year2	=	
Year3	=	
Year4	=	
Year5	=	
Year6	=	
Year7	=	
Date1	=	
Date2	=	
Date3	=	
Date 4	=	
Date 5	=	
StateA	=	
City 1	=	
Employee A	=	
Company A	=	
#a	=	
#b	=	
$a	=	
$b	=	
$c	=	
$d	=	
$e	=	
$f	=	
$g	=	

$h	=
$i	=
$j	=
$k	=
$l	=
$m	=
$n	=
$o	=
$p	=
$q	=
$r	=
$s	=
%a	=
%b	=
%c	=
%d	=
%e	=
%f	=
%g	=

ISSUE

Whether the transactions lacked economic substance.

CONCLUSION

The transactions described below lack economic substance and should not be respected.

FACTS

PCorp is a City 1 based company and the common parent of a controlled group of corporations that files its Federal income tax return (Form 1120L) on a consolidated basis.

SubA is a wholly-owned subsidiary of PCorp. SubA was formed Date3, and began its trade or business on Date4. SubA's services can be categorized into three business lines: cash and physical, risk management, and finance.

SubA has two wholly-owned subsidiaries, SubA1, and SubA2. SubA1 had been an inactive corporation.

SubB is another wholly-owned subsidiary of PCorp. SubB has a wholly-owned subsidiary, SubB1.

SubA, SubA1, SubA2, SubB, and SubB1 all were included in the PCorp group consolidated return for the taxable year Year1.

In Date 5, PCorp. announced that it would sell shares of Corp. 1, from which it would recognize gain.

During Year1, SubA held fixed-price risk management liabilities under swaps, options, swaptions, and forward contracts in excess of $a, as well as credit reserves in excess of $b. On Date1, members of the taxpayer's consolidated group engaged in the following transactions.

1. PCorp, SubA, SubA2, and SubB1 executed an Assignment of Accounts Receivable wherein PCorp transferred to SubA an account receivable from SubA2 in the amount of $c, and an account receivable from SubB1 in the amount of $d, for a total amount of $e.

2. SubA increased its account payable to PCorp in the amount of $e.

3. SubA2 and SubB1 each agreed to convert the transferred receivables into promissory notes to SubA. SubA2 executed a promissory note in favor of SubA in the amount of $c, and SubB1 executed a promissory note in favor of SubA in the amount of $d (collectively the "Promissory Notes").

4. SubA and SubA1 entered into a Subscription Agreement wherein SubA1 agreed to enter into a Master Swap Agreement in order to "transfer," as between SubA and SubA1 only, (1) the economic liability of certain liabilities of SubA under swap, option, swaption and forward contracts (the "Swap Liabilities"), which totaled $f, and (2) the economic risk of certain credit reserves of SubA that were characterized as liabilities (the "Credit Reserves"), which totaled $g. The Swap Liabilities and the Credit Reserves are collectively referred to herein as the "Liabilities." The Liabilities totaled

$h. SubA and SubA1 also entered into a Liability Management Agreement and a Services Agreement.

5. SubA1 filed a restated Certificate of Incorporation with the StateA Secretary of State and redefined the purpose, or nature of the business, of the corporation to be: (1) the management of certain liabilities pursuant to a Liability Management Agreement between SubA1 and SubA; (2) to undertake obligations under a Master Swap Agreement and a Service Agreement with SubA; and (3) any other lawful business or activity, provided such other business purposes are approved in writing by SubA in its sole discretion. Under the restated articles, the board of directors for SubA1 authorized the issuance of #a shares of voting preferred stock, each without a par value.

6. SubA transferred to SubA1 the Promissory Notes totaling $e in return for (i) the "assumption" of the Liabilities totaling $h, (ii) #b shares of SubA1 voting preferred stock, and (iii) $i. The face amount of the Promissory Notes exceeded the total amount of the Liabilities by $j.

Certain of the contracts creating the Swap Liabilities (the "Swap Contracts") required consent to assignment. Consequently, pursuant to a Subscription Agreement, SubA and SubA1 entered into a Master Swap Agreement and transactions on the same terms as the Swap Liabilities in order to transfer, as between SubA and SubA1 only, the economic liability of the Swap Liabilities without breaching any of the Swap Contracts. In order to transfer the economic risk of the Credit Reserves, the Master Swap Agreement and transactions granted SubA an option to receive payments from SubA1 if there was a payment default by third parties under the contracts under which the Credit Reserves arose.

In connection with the transfer of the Swap Liabilities, SubA and SubA1 entered into an additional transaction on terms that would hedge SubA1 against any increases in the Swap Liabilities as a result of changes in market conditions (the "SubA1 Hedge Transactions"). The liability of SubA1 with respect to the Credit Reserves was capped at the amount of the Credit Reserves.

Pursuant to the Liability Management Agreement, SubA1 agreed to be responsible for managing the Swap Liabilities and the Credit Reserves in an effort to reduce them. SubA1 had the right, subject to approval by SubA, to enter into any subcontract with any third party to perform its obligations under the Liability Management Agreement. The Liability Management Agreement provided that SubA would retain the right to manage the Liabilities as long as some benefit resulting from its management inured to SubA's benefit. Also the Liability Management Agreement specifically provides that SubA1 shall have no authority to and shall not restructure, cashout, enter into any agreements or carry out any other activities that directly or indirectly relate to Swap Liabilities, except on terms set forth in a Restructuring Approval Notice. Thus, before engaging in any swap restructuring, SubA1 was required to submit the proposed terms to SubA in writing, and SubA would then evaluate whether the restructuring would be a net benefit to SubA. Any derivative contracts entered into pursuant to a swap restructuring were to be carried out by SubA, as well as any other activities that, in SubA's view, were more appropriate for it to carry out. Similarly, before engaging in any credit restructuring, SubA1 was required to submit the proposed terms to SubA in writing, and SubA would then evaluate whether the restructuring would be a net benefit to SubA, and SubA would carry out any activities that, in its view, were more appropriate for SubA to carry out. Of the contracts comprising the Swap Liabilities, %a were due to mature in Year2, %b in Year3, %c in Year4, %d in Year5, and %e in each of the years Year6 and Year7.

Pursuant to the Liability Management Agreement, SubA agreed to pay SubA1 an annual base fee of $k as compensation for its services. Pursuant to the Services Agreement, SubA agreed to provide or cause to be provided to SubA1 certain corporate and staff services. In consideration therefore, SubA1 agreed to reimburse SubA or the applicable SubA affiliate for (i) $l a month ($m annually) for administrative and general expenditures, (ii) the actual cost of any item purchased for SubA1 by SubA, and (iii) outsourced charges. SubA1 could not terminate the contract to provide the following services: tax matters, registration and transfer of SubA1 securities, SEC filings; investor relations; insurance audit, financial and legal services.

To assist SubA1 in performing its obligations under the Master Swap Agreement and Liability Management Agreement, on Date1, PCorp and SubA1 entered into a Revolving Credit Agreement whereby PCorp agreed to make one or more advances to SubA1 in an aggregate amount not to exceed at any time $n. Pursuant to the Revolving Credit Agreement, SubA1 could use advances only for the purpose of enabling it (i) to perform its obligations under the Master Swap Agreement, the Liability Management Agreement, and the Services Agreement, (ii) to pay salaries of the employees of SubA1 and (iii) to pay dividends to the holders of the SubA1 preferred stock.

On Date2, SubA sold its #b shares of SubA1 voting preferred stock to three employees of SubA1 for a total sales price of $j. The three employees had been transferred to SubA1 from SubA, but continued to perform duties for SubA. One of these employees, Employee A, had been with Company A until Year1, where his major client was SubA.

On the Schedule D, Capital Gains and Losses, for SubA attached to the PCorp group return for Year1, SubA reported a basis in the #b shares in the amount of $o, and a loss on the sale of the #b shares in the amount of $p.

The taxpayer claims that it engaged in the transactions to add value to the company by restructuring the contracts comprising the Swap Liabilities. According to the taxpayer, any value from the contracts would be long-term, and it transferred them to a separate entity to demonstrate management's long-term commitment to the project. The taxpayer claims that it offered employees the opportunity to purchase equity in the new entity as an incentive to focus their efforts on the transferred contracts. Those employees estimated that they devoted less than %f of their time to restructuring the contracts after the transaction, and that the majority of their time was spent on performing their regular duties at SubA.

The taxpayer explained that the accounts receivable from SubA2 and SubB1 were converted into Promissory Notes payable to SubA1 in order to provide SubA1 with sufficient assets to cover the liabilities being transferred.

LAW AND ANALYSIS

You have asked whether these transactions should be respected for federal tax purposes. For the reasons discussed below, we agree with your conclusion that the transactions lack economic substance.

1. Economic Substance

A. In General

To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits, which were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. United States v. Wexler, 31 F.3d 117, 122, 124 (3d Cir. 1994); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), aff'g 44 T.C. 284 (1965); Weller v. Commissioner, 31 T.C. 33 (1958), aff'd, 270 F.2d 294 (3d Cir. 1959); Saba Partnership v. Commissioner, T.C. Memo. 1999-359; ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3d Cir. 1998). Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). This determination turns on whether the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. Cherin v. Commissioner, 89 T.C. 986, 993-94 (1987); ACM Partnership, supra. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. Yosha, supra; ACM Partnership, supra.

When a transaction lacks economic substance, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction. A transaction that is entered into primarily to reduce taxes and that has no economic or commercial objective to support it is without effect for federal income tax purposes. Frank Lyon Co v. United States, 435 U.S. 561 (1978); Rice's

Toyota World Inc. v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985) aff'g in part 81 T.C. 184 (1983).

This approach hinges on all of the facts and circumstances surrounding the transactions. No single factor will be determinative. Whether a court will respect the taxpayer's characterization of the transaction depends upon whether there is a bona fide transaction with economic substance, compelled or encouraged by business or regulatory realities, imbued with tax-independent considerations, and not shaped primarily by tax avoidance features that have meaningless labels attached. See Frank Lyon, 435 U.S. 561 (1978); ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000); Casebeer v. Commissioner 909 F.2nd 1360 (9th Cir. 1990); Rice's Toyota World,, 752 F.2nd 89 (4th Cir. 1985); Compaq v. Commissioner, 113 T.C. 363 (1999); Winn-Dixie v. Commissioner, 113 T.C. 254 (1999); UPS of Am. v. Commissioner, T.C. Memo. 1999-268; ACM Partnership, T.C. Memo. 1997-115. A transaction need not be a "promotion" to lack economic substance.

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership, 157 F. 3rd at 247; Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer, 909 F. 2nd 1360, 1363 (9th Cir. 1990); Rice's Toyota World, 81 T.C. 184 (1983). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3rd at 247; Casebeer, 909 F. 2nd at 1363.

To satisfy the business purpose inquiry, the transaction must be "rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and ... economic situation." Compaq Computer, supra, at 224, quoting ACM Partnership, T.C. Memo. 1997-115, 73 T.C.M. (CCH) 2189, 2217, affd. in relevant part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999); see Kirchman, supra, at 1490-1491. PCorp has stated that its business purpose was to add value through restructuring contracts. Further, PCorp claims that the transfer of the liabilities to SubA1 and the sale of the stock to the employees was done to incent the employees to work long term and focus on the contracts transferred. However, the employee's purchase of the stock, triggered the loss claimed by PCorp. Moreover, %a of these contracts matured within one year and were not long term. Also, after the transfer, the employees spent only %f of their time on these contracts. Additionally, the identity of the management remained largely the same and management decisions were still carried out by SubA. These factors lead to the conclusion that there was no business purpose to these transactions.

To satisfy the objective economic inquiry, the transaction must appreciably affect the taxpayer's beneficial interest, absent tax benefits. Knetsch v. United States, 364 U.S. 361, 366 (1960); ACM Partnership, 157 F.3d at 248. Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. Knetsch v. United States, 364 U.S. 361 (1960).[1] Modest or inconsequential profits relative to substantial tax benefits are insufficient to imbue an otherwise questionable transaction with economic substance. ACM Partnership, 157 F.3d at 258; Sheldon v. Commissioner, 94 T.C. 738, 767-768 (1990); Saba Partnership v. Commissioner, T.C. Memo. 1999-359, 78 T.C.M. (CCH) 684, 721-722. In conducting this economic review, it is appropriate to focus on the taxpayer's calculations at the outset of the transaction. ACM Partnership, 157 F.3d at 257. There is no evidence that SubA1 conducted any profitability analysis that would establish an objective economic purpose.

While the profit potential or economic risk, relative to the expected tax benefit, necessary to meet the objective economic substance test has not been quantified, a reasonable prospect or possibility for profit is required. See Horn, 968 F.2d at 1237-38 n. 10, 13; Rice's Toyota World, Inc., 81 T.C. at 202. Nominal or de minimis profit potential does not imbue a transaction with economic substance. Knetsch v. United States, 364 U.S. 361 (1960); Hines v. United States, 912 F.2d 736 (4th Cir. 1990), rev'g 89-9 USTC (CCH) ¶ 9523 (E.D.N.C. 1989); Krumhorn v. Commissioner, 103 T.C. 29, 55 (1994); Sheldon v. Commissioner, 94 T.C. 738, 767-68 (1990); Estate of Thomas v. Commissioner, 84 T.C. 412, 438 (1985).

With respect to allowing an artificial loss, the Tax Court in ACM Partnership stated:

> We do not suggest that a taxpayer refrain from using the tax laws to the taxpayer's advantage. In this case, however, the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. A taxpayer is not entitled to recognize a phantom loss from a transaction that lacks economic substance.

ACM Partnership v. Commissioner, T.C. Memo. 1997-115. The opinion demonstrates that the Tax Court will disregard a series of otherwise legitimate transactions, where the Service is able to show that the facts, when viewed as a whole, have no economic substance.

It appears from the facts presented that this series of transactions lacked economic substance.

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[1] In Knetsch, the taxpayer repeatedly borrowed against increases in the cash value of a bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

CASE DEVELOPMENT

[redacted]

7. [redacted]

[redacted]

ASSOCIATE CHIEF COUNSEL
PASSTHROUGHS & SPECIAL INDUSTRIES
By: DAVID R. HAGLUND
SENIOR TECHNICIAN REVIEWER, BRANCH 1
OFFICE OF THE ASSOCIATE CHIEF COUNSEL
(PASSTHROUGHS & SPECIAL INDUSTRIES)