OFFICE OF
CHIEF COUNSEL

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

July 16, 1999

Number: **200135001**
Release Date: 8/31/2001
CC:DOM:FS:CORP/TL-N-876-99
UILC: 351.00-00; 482.06-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT: Transfer of Property

This Field Service Advice responds to your memorandum dated April 13, 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:

Parent =

Sub1 =

Sub2 =

REIT =

Individual =

Purchaser =

TrustX =

TrustY =

CorpZ =

Facilities =

Assets =

Customers =

State A =

Country X	=
Date1	=
Date2	=
Date3	=
MonthA	=
MonthB	=
MonthC	=
MonthD	=
Year1	=
Year2	=
Year3	=
$aa	=
$bb	=
$cc	=
$dd	=
$ee	=
$ff	=
#m	=
#n	=

ISSUES:

1. Whether Parent's transfer of built-in gain property and Individual's transfer of built-in loss property to Sub2, both transfers in exchange for stock of Sub2, constituted a valid transaction under I.R.C. § 351.

2. Whether Sub2 sufficiently substantiated the basis in the built-in loss assets received from Individual.

CONCLUSION:

1. The available facts suggest that there was no business purpose for the transfers to Sub2. Accordingly, those transfers would not qualify for nonrecognition under

I.R.C. § 351. Alternatively, even if the transfers were subject to I.R.C. § 351, there are potential arguments under the *Court Holding* doctrine and I.R.C. § 482 that would essentially tax Sub2's gain as if the transfers had occurred.

2. There are insufficient facts to establish Sub2's basis in the assets received from Individual.

Issue 1. Transfers to Sub2

FACTS:

Parent is engaged in developing and managing Facilities. Parent derives substantially all of its revenues from the management of Facilities for Customers in the United States and abroad. Sub1 and Sub2 are subsidiaries of Parent. Sub1 was acquired in MonthA Year3, and Sub2 was acquired in MonthB Year3.

In Year1 Parent formed REIT, a State A real estate investment trust, which completed an initial public offering on Date1. REIT was formed with the intention that it would qualify as a real estate investment trust within the meaning of I.R.C. § 856. The stated business strategy of REIT was to own, acquire and develop Facilities that meet its investment criteria, to expand the design capacity of its existing Facilities, and to lease all such Facilities under long-term leases.

Parent agreed to enter into transactions with REIT for the sale and leaseback of #n Facilities. In addition, Parent gave REIT an option to acquire other existing and future acquired Facilities, as well as the right of first refusal for REIT to provide financing for future Facilities developed by Parent.

Prior to the sale-leaseback transaction with REIT, Parent and Sub1 transferred the #n Facilities to Sub2 in exchange for the voting common stock of Sub2 on Date2. At the same time, Individual, a Country X resident, transferred interests in #m trusts to Sub2 in exchange for $aa cash and nonvoting preferred stock with a fair market value of $aa. The available information indicates that the #m trusts' only assets comprised preferred stock in corporations that purportedly owned leased Assets. Individual's basis in the trust interests was approximately $bb.

On Date1, Sub2 sold the Facilities received from Parent and Sub1 to REIT and recognized a gain of approximately $cc on the transaction. On the same date, REIT leased the Facilities to Parent under long-term, non-cancellable triple net leases that require Parent to pay all operating expenses, taxes, insurance and other costs. On Date3, Sub2 sold the trust interests received from Individual to Purchaser for $dd and recognized a loss of $ee on the sale.

LAW AND ANALYSIS

A. <u>Section 351</u>

I.R.C. § 351(a) provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in I.R.C. § 368(c)) of the corporation. Under Treas. Reg. § 1.351-1(a)(1) and I.R.C. § 368(c), the transferors are in control of the transferee corporation if, immediately after the transfer, they own 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 share of all other classes of stock of such corporation. The ownership interests of all transferors participating in a single transaction are aggregated to determine whether the control test is met.

If the transferor in a transaction subject to section 351 receives not only the transferee corporation's stock but also other property or money ("boot"), I.R.C. § 351(b) provides that the transferor shall recognize gain. The amount of gain recognized, however, is limited to the amount of money received plus the fair market value of other property received. Any loss to the transferor, however, is not recognized. In contrast, if I.R.C. § 351 does not apply, the transfer of property is a taxable exchange under I.R.C. § 1001.

Under I.R.C. § 362(a), a corporation's basis in property acquired in a transaction to which I.R.C. § 351 applies is the same as it would be in the hands of the transferor. As relevant in this case, the transferor's basis in the transferee corporation's stock is the same as its basis in the transferred property, decreased by the amount of money received.

In addition to the statutory requirements of section 351, courts have held that a transaction meeting the statutory elements of section 351 still does not qualify for nonrecognition if it lacks a non-tax, business purpose. *See Caruth v. United States*, 688 F. Supp. 1129, 1138-1141 (N.D. Tex. 1987), *aff'd on other issues*, 865 F.2d 644 (5th Cir. 1989); *Stewart v. Commissioner*, 714 F.2d 977, 992 (9th Cir. 1983). Opinions discussing other I.R.C. § 351 issues often point out that the taxpayer had a valid business purpose for the transaction in question. *See Hempt Bros., Inc. v. United States*, 490 F.2d 1172, 1178 (3d Cir. 1974), *cert. denied*, 419 U.S. 826 (1974).

A thorough judicial exploration of the business purpose doctrine of I.R.C. § 351 was undertaken in *Caruth v. United States*, 688 F. Supp. 1129, 1138-1141 (N.D. Tex. 1987), *aff'd on other issues*, 865 F.2d 644 (5th Cir. 1989). In *Caruth*, the taxpayer transferred stock in a closely held corporation to his wholly owned corporation four days before the closely held corporation declared a large dividend. The government argued that the dividend should be recognized by the taxpayer because his transfer of the closely held stock to his wholly owned corporation had no business purpose. The taxpayer argued that section 351 does not require a business purpose. The court's opinion traces the development of I.R.C. § 351 and concludes that this provision is tied very closely to the corporate reorganization provisions. 688 F.2d at 1138-1140, 1142-1146. On that basis, the court reasoned that the principles applicable to reorganizations are equally valid for transfers of property to a controlled corporation under I.R.C. § 351. Accordingly, the *Caruth* court held that the business purpose doctrine of *Gregory v. Helvering*, 293 U.S. 465 (1935), applies in the case of a transfer of property to a controlled corporation. The court further held that the taxpayer in that case established a business purpose for the transfer to his controlled corporation.[1/]

In *Stewart v. Commissioner*, T.C. Memo. 1982-209, 43 T.C.M. (CCH) 1119, *aff'd*, 714 F.2d 977 (9th Cir. 1983), the taxpayer made several transfers of appreciated securities to a corporation that he controlled, in exchange for the corporation's stock. In each such instance, the corporation sold the securities on the date of transfer and distributed all but 13 percent of the proceeds to the taxpayer or to businesses in which he held a substantial interest. On these facts, the Tax Court held that the taxpayer should be taxable on the gain from the sales of the appreciated securities because he had "not shown any valid business purpose, other than tax savings, for the formalistic 'transfer' of his stocks" in exchange for the corporation's stock. 43 T.C.M. at 1125. On appeal, the Ninth Circuit affirmed, finding no error in the Tax Court's determination that the corporation was merely a conduit for the sale of the appreciated securities and agreeing that the taxpayer was not entitled to the benefits of section 351. 714 F.2d at 992.

Similarly, in *Kluener v. Commissioner*, T.C. Memo. 1996-519, *aff'd*, 154 F.3d 630 (6th Cir. 1998), the taxpayer decided to sell his thoroughbred horses in order to raise funds to meet certain loan obligations. He first transferred the horses to his wholly owned corporation, which then sold the horses at auction. The corporation reported the sale of the horses on its tax return but offset its loss carryover against the entire gain. Rather than use the proceeds for its own purposes, the corporation held the funds in a separate account for several months and then distributed the entire amount to the taxpayer, who used the funds to make loan payments and loaned a portion back to the corporation. The Tax Court held that, in substance, the taxpayer sold the horses using the corporation as a conduit. On appeal, the

---

[1/] Although the *Caruth* court asserted that both sections 351 and 368 have been subject to the continuity of interest test, 688 F. Supp. at 1139-1140, the Service does not apply a continuity of interest or continuity of business enterprise requirement for transfers under section 351. *See* Rev. Rul. 84-71, 1984-1 C.B. 106 (no continuity of interest requirement for section 351 transaction), *revoking* Rev. Rul. 80-284, 1980-2 C.B. 117, and Rev. Rul. 80-285, 1980-2 C.B. 119. However, the control requirement will not be satisfied if the transferor has a binding contract to transfer the stock of the transferee corporation at the time it transfers the property to the corporation. *Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025, 1032-1034 (1976).

Sixth Circuit affirmed. In discussing section 351, the court of appeals summarized the application of the business purpose requirement by noting that a shareholder's transfer of property to his closely held corporation is not taxed "if the transfer occurred for a valid, non-tax business purposes" but that "the [Internal Revenue] Code will tax a shareholder who transfers property solely to avoid taxes." 154 F.3d at 634. In addition, the court identified the standards that courts use to determine whether there is a business purpose for a transfer:

> [C]ourts consistently look to several factors to evaluate the existence of a valid, non-tax business purpose. These factors include the following: whether the transfer fulfilled its stated purpose; the extent to which the transferor, rather than the transferee, benefitted from the transfer; the extent to which the transferee needed the property; the length of time between the transfer and subsequent events; the number of such transfers; the taxpayer's expertise in tax matters; and the transactions' form. Courts also examine any explicit indicators of a taxpayer's intent, such as documents or negotiations that confirm or belie the existence of a pre-arranged plan.

154 F.3d at 635.

In the instant case, the available facts strongly suggest that Parent's and Sub1's transfer of the Facilities to Sub2 and Individual's transfer of the built-in loss trust interests to Sub2 were for the purpose of avoiding tax on the gain from the sale of the Facilities to REIT. Sub2 sold the Facilities only #n days after it received them in a transaction that was arranged before the transfer occurred. The trust interests received from Individual had no relationship to the business of Parent, Sub1 or Sub2, and they were sold within the same tax year at a loss that more than offset the gain recognized on the sale of the Facilities to REIT.

Parent has offered three business purposes for the transfers to Sub2: (1) to save state and local taxes; (2) to set up a financing subsidiary; and (3) to obtain Individual's services for consulting on international leasing transactions. Although these putative purposes may appear valid on the surface, we have questions about each one. The available information does not permit us to determine whether any of these reasons would constitute a legitimate business purpose under section 351 in this case.

If the transfers to Sub2 lack a business purpose, the transfers would be treated as taxable sales under I.R.C. § 1001. Thus, Parent and Sub1 would recognize gain on the Facilities transferred to Sub2, and Individual would recognize any loss on the trust interests. The gain or loss would be equal to the difference between the fair market value of the Facilities and transferor's basis in those assets. Sub2 would take a cost basis in each of the assets received and would have no gain or loss on the subsequent disposition of the assets. As a result, the taxation of the built-in gains and built-in losses would occur at the transferors' levels rather than at Sub2's level, and there would accordingly be no offset of loss against gain.

B. _Court Holding_

The facts of this case raise issues similar to those in *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1943). In *Court Holding*, a corporation orally agreed to sell an apartment building, its sole asset, to an unrelated party. Before the agreement was reduced to writing, the corporation canceled the transaction upon learning that it would incur a substantial tax liability on gain from the sale of the building. The day after canceling the sale, the corporation declared a liquidating distribution of the building to the corporation's two shareholders, who then proceeded to sell the building to the same purchaser under substantially the same terms and conditions previously agreed to by the corporation. The shareholders recognized gain on their receipt of the building in the liquidation, but the corporation recognized no gain on the liquidating distribution pursuant to applicable regulations permitting a corporation to distribute appreciated property to its shareholders without recognition of any gain or loss. Because the shareholders took a stepped-up basis in the building, they had no gain or loss on the sale.

The Supreme Court agreed with the Tax Court that the corporation had not abandoned the sale negotiations, notwithstanding the declaration of the liquidating dividend and transfer of legal title of the building to the shareholders. Thus, the Supreme Court held that the executed sale was in substance a sale by the corporation and that the gain on the sale should be attributed to the corporation. 324 U.S. at 334. In reaching this result, the Court stated the following general principles:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. [footnote omitted] To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

324 U.S. at 334.

The Court subsequently clarified its *Court Holding* decision in *United States v. Cumberland Public Service Company*, 338 U.S. 451 (1950). The facts in *Cumberland* involve a closely held corporation engaged in the generation and distribution of electric power. The shareholders offered to sell the stock of the corporation to a local cooperative that distributed lower cost hydroelectric power generated by the Tennessee Valley Authority. The cooperative refused to buy the stock of the corporation but countered with an offer to buy the corporation's transmission and distribution equipment. The corporation rejected the offer because of the capital gains tax it would incur on the sale. The shareholders, however, offered to acquire the equipment from the corporation and then sell it to the cooperative. The cooperative accepted, and the corporation distributed the transmission and distribution equipment to the shareholders, sold its other assets, and dissolved. The shareholders then sold the equipment to the cooperative.

Giving deference to the trial court's finding that the sale in question was made by the shareholders rather than the corporation, the Court affirmed the lower court's holding that the sale was not attributable to the corporation even though the shareholders had structured the transaction to avoid payment of the corporate capital gains tax. 338 U.S. at 455. "Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes." 338 U.S. at 455.

The *Court Holding* decision supports applying substance over form in determining the identity of the seller for tax purposes. In *Cumberland*, the Court explained its holding in *Court Holding* as "an approval of the action of the Tax Court in looking beyond the papers executed by the corporation and shareholders in order to determine whether the sale there had actually been made by the corporation." 338 U.S. 454 n.3. The principle that emerges from the *Court Holding* and *Cumberland* decisions is that, no matter who the selling party is in form, the party negotiating the sale is treated as the seller for tax purposes.

In the instant case, the available information indicates that Parent negotiated an agreement to sell the Facilities to REIT before the Facilities were transferred to Sub2. Under the principles of *Court Holding* and *Cumberland* discussed above, Parent and Sub1 would be treated as the sellers of the Facilities, notwithstanding their use of Sub2 as a conduit to transfer title to REIT. As a result, Parent and Sub1 rather than Sub2 would recognize the gain on the sale of the Facilities.

B. <u>Section 482</u>

If the transfers to Sub2 are determined to satisfy the requirements of section 351, there may be an argument under I.R.C. § 482 that the gains recognized by Sub2 on the sale of the Facilities to REIT should be allocated to Parent and Sub1.

Section 482 provides the following:

> 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, deductions . . . between or among such organizations . . . 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.

The section 482 regulations define control "to include any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." Treas. Reg. § 1.482-1(i)(4). *See also Isse Koch & Company, Inc. v. Commissioner*, 1 B.T.A. 624, 627 (1925), *acq.,* 1925-1 C.B. 2 ("control not arising or flowing from legally enforceable means may be just as effective in evading taxation as if found on the most formal and readily enforceable legal instrument"). The regulations also state that "[i]t is the reality of control that is decisive," rather than a rigid focus on record ownership of the entities at issue. Treas. Reg. § 1.482-1(i)(4). *Accord Ach v. Commissioner*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert denied*, 385 U.S. 899 (1966); *Grenada Indus., Inc. v. Commissioner*, 17 T.C. 231 (1951), *aff'd*, 202 F.2d 873 (5th Cir. 1953), *cert. denied*, 346 U.S. 819 (1953), *acq. in part and nonacq. in part*, 1952-2 C.B. 2, 5; Rev. Rul. 65-142, 1965-1 C.B. 223, 224; *Charles Town, Inc. v. Commissioner*, 372 F.2d 415 (4th Cir. 1967), *aff'g,* T.C. Memo. 1966-015, *cert. denied*, 389 U.S. 841 (1967).

Thus, in order for I.R.C. § 482 to apply to a transaction, the transaction must be between two or more entities owned or controlled by the same interests. In the instant case, Parent and Sub1 together hold control of Sub2 inasmuch as they own all of Sub2's voting common stock.[2/] Accordingly, the control requirement is clearly satisfied.

Section 482 may apply in nonrecognition transactions to prevent the avoidance of taxes or clearly reflect income. For example, if section 482 is applicable, the Service may allocate income and deductions attributable to an entity's disposition of built-in-loss (and gain) property, which it acquired in a nonrecognition transaction, to the contributing shareholder (or partner). *See* Treas. Reg. § 1.482-1(f)(1)(iii) (1994); *National Securities Corp. v. Commissioner*, 137 F.2d 600 (3d Cir. 1943), *aff'g*, 46 B.T.A. 562 (1942), *cert. denied*, 320 U.S. 794 (1943)*; Ruddick Corp. v. United States*, 643 F.2d 747 (Cl. Ct. 1981), *on remand*, 3 Cl. Ct. 61, 65 (1983), *aff'd without opinion*, 732 F.2d 168 (Fed. Cir. 1984); *Northwestern Nat. Bank of Minneapolis v. United States*, 556 F.2d 889, 892 (8th Cir. 1977), *aff'g*, 37 A.F.T.R.2d ¶ 76-1400 (D. Minn. 1976); *Dolese v. Commissioner*, 811 F.2d 543

[2/] The preferred stock owned by Individual has no voting power.

(10th Cir. 1987), *aff'g*, 82 T.C. 830 (1984); *Foster v. Commissioner*, 80 T.C. 34, 160, 172-177 (1983), *aff'd in relevant part*, 756 F.2d 1430, 1433-1434 (9th Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986). *See also Eli Lily & Co. v. Commissioner,* 84 T.C. 996, 1119 (1985), *aff'd in part, rev'd in part*, 856 F.2d 855 (7th Cir. 1988) (restricting I.R.C. § 482's application to nonrecognition transactions in cases of tax avoidance).

As previously discussed, there appears to have been a tax-avoidance purpose underlying the transfers of the Facilities to Sub2, purported by Parent to qualify under I.R.C. § 351, in order to be able to offset the gain from the planned sale of the Facilities to REIT against the loss from sale of the trust interests contributed by Individual. Under the facts of this case, the gain recognized by Sub2 on the sale of the Facilities may be allocated to Parent and Sub1, the transferors in the section 351 transaction, thereby eliminating the offset of any loss attributable to the sale of the trust interests received from Individual.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:</u>

[redacted]

[redacted]

[redacted]

Issue 2. Sub2's Basis in Assets Received from Individual

FACTS

The available information concerning the trust interests that Individual transferred to Sub2 is sketchy. It appears that the trust interests are part of a complex leasing transaction involving multiple transfers. Individual held an interest in TrustY, which apparently purchased certain Assets from TrustX in MonthC Year2 and then leased the equipment back to TrustX. In MonthD Year2, TrustY transferred its interest in the Assets to CorpZ in exchange for #n shares of $ff par value preferred stock.

ANALYSIS

Tax Court has determined that similar sale-leaseback transactions lacked economic substance and should be disregarded. *See, e.g., Estate of Strober v. Commissioner*, T.C. Memo. 1992-350, 63 T.C.M. (CCH) 3158, 3160-3161. We cannot determine from the available information whether the transactions at issue here had economic substance or what basis Individual had in the trust interests transferred to Sub2. Accordingly, we recommend further development of the facts concerning the underlying transactions.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

If you have any further questions, please call 202-622-7930.

Deborah A. Butler
Assistant Chief Counsel (Field Service)
By: STEVEN J. HANKIN
Special Counsel (Corporate)
Field Service Division

cc: Assistant Regional Counsel (LC)