DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR Associate Area Counsel

FROM: Associate Chief Counsel (CORP) CC:CORP:1

SUBJECT: Field Service Advice - Foreign Currency Transaction

This Chief Counsel Advice responds to your memorandum dated <none specified>. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This Chief Counsel Advice should not be cited as precedent.

LEGEND

P Group =

P =

Year 1 =

Year 2 =

Year 3 =

Date 1 =

Date 2 =

Date 3	=
Date 4	=
$a	=
$b	=
$c	=
$d	=
$e	=
units	=
<u>f</u> units	=
$g	=
<u>h</u> units	=
$j	=
$k	=
<u>m</u> units	=
<u>n</u> units	=
$o	=
$p	=
Individual	=
Country X	=
RelatedCo	=
Sub1	=
Sub2	=

FSub =

Employee =

Business R =

ISSUES

What theories can the Internal Revenue Service pursue to disallow a loss created through a series of transactions among related parties that include (1) the formation of a new foreign company, (2) the issuance of offsetting short-term intercompany notes, (3) the transfer by the foreign company (in a § 351 transaction) of a nominal amount of foreign currency in exchange for stock of a domestic transferee corporation and the purported assumption by the transferee corporation of the foreign corporation's liability under one of the intercompany notes, and (4) the disposition of the foreign currency, for which an inflated basis is claimed as a result of step 3, at a substantial loss.

CONCLUSIONS

The Service can pursue the following theories: (1) that all of the intercompany loan transactions can be disregarded as factual shams; (2) that the domestic transferee corporation did not assume the foreign corporation's liability under the intercompany note; (3) that the domestic transferee corporation's assumption of the foreign corporation's note was a constructive dividend; (4) that § 465 may disallow the loss; (5) that § 269 may disallow the loss; (6) that § 482 may require the reallocation of the loss to the foreign corporation; and (7) that Treas. Reg. § 1.988-1(a)(11) may limit the loss.

FACTS

The taxpayer is the P Group, which is an affiliated group of corporations that files a consolidated return for federal income tax purposes. P is the parent of the P Group. The P Group filed a consolidated return for Year 1 and Year 2. This FSA addresses a claimed loss of $a resulting from the disposition of foreign currency with a basis in excess of its fair market value.

Background

During the relevant time frame, Individual and his family controlled, either directly or indirectly, all the entities that were involved in the transactions described below. Individual indirectly owned 100 percent of P and directly owned 60 percent of RelatedCo. P owned 100 percent of Sub1 and Sub2, which are U.S. corporations that join in the filing of the P Group's consolidated return. In addition, Individual was also the President of P, Sub1, Sub2, and FSub, a newly formed corporation described below. Consequently, Individual is the principal indirect beneficiary of the tax benefits generated by this transaction.

Formation of Foreign Company and Creation of Notes

On Date 1, FSub was incorporated as a Country X corporation. On Date 2, P loaned $b to Employee, an employee of RelatedCo, in exchange for a promissory note (the “Employee Note”). Employee then contributed the $b to FSub in exchange for 50 percent of the stock of FSub. P also contributed $b in exchange for the remaining 50 percent of the stock of FSub. The Employee Note provided for a single balloon payment of all outstanding principle and interest due in Year 3. The Employee Note also provided that all payments of principle and interest thereon could only be made through the transfer of Employee’s shares in FSub to P. The Employee Note was nonrecourse as to Employee and P held actual possession of the stock certificates as security for the loan. Therefore, P’s only option in the event of default was to take possession of Employee’s FSub shares. Thus, P effectively controlled 100 percent of the FSub stock. According to P, FSub was created in order to take advantage of Business R opportunities in Country X. There are no facts indicating that FSub has ever conducted any business activities other than the transactions described below.

On Date 2, Sub1 purportedly loaned $c to RelatedCo, which was evidenced by a written promissory note (the “RelatedCo Note” or “RelatedCo Loan”). The RelatedCo Note provided for a single balloon payment of all outstanding principal and interest in the amount of $d that was due on Date 3.

On Date 2, RelatedCo purportedly loaned $e to FSub, which was evidenced by a written promissory note and security agreement (the “FSub Note” or “FSub Loan”). The FSub Note provided for a single balloon payment of all outstanding principal and interest in the amount of $d that was due on Date 3.[1]

On Date 2, FSub purportedly converted the $e it received from RelatedCo into Country X currency (“units”) for a total amount of f units and then loaned the f units to Sub1, which was evidenced by a written promissory note (the “Sub1 Note” or “Sub1 Loan”). (The RelatedCo Note/Loan, the FSub Note/Loan, and the Sub1 Note/Loan are hereinafter collectively referred to as the “Notes” or the “Loans.”) The Sub1 Note provided for a single balloon payment of all outstanding principal and interest that was due on Date 3. P claims that FSub entered into this loan

[1] Although the same amounts were due on Date 3 on both the RelatedCo and FSub Notes, the RelatedCo Note stated a slightly lower face amount and a slightly higher interest rate.

transaction because it believed that the Country X currency would increase in value relative to the United States dollar, and that FSub would earn a profit on its loan transactions when the Sub1 and RelatedCo Notes matured on Date 3.

In each purported lending transaction on Date 2, it appears that no money was actually transferred and that the purported loan proceeds were credited to the respective borrower through the use of offsetting book entries. It also appears that no collateral was provided to secure payment of any of the Loans. In addition, based on the documents we have reviewed to date, it is not clear whether or not any of the parties had sufficient cash or assets on hand to advance the loaned amounts, or the independent ability to repay their respective borrowings.

Section 351 Transaction

On or before Date 2, FSub converted the $b received from P and the $b received from Employee ($g combined) into h units of Country X currency. On Date 2, FSub contributed the h units to Sub2 in a purported transfer under § 351 and, in exchange, Sub2 assumed FSub's obligations under the FSub Note and issued Sub2 common stock to FSub (the "FSub Exchange"). Sub2's assumption of FSub's obligations under the FSub Note was made pursuant to a separate "Assignment and Assumption Agreement" dated Date 2 (the "Assumption Agreement"). The Assumption Agreement provides as follows: "Nothing herein shall release FSub from any of its own obligations under the loan agreement [with RelatedCo], and RelatedCo shall have the right to enforce the obligation under the loan agreement against Sub2, FSub, or both." Simultaneously, P contributed $j to Sub2 and in exchange received Sub2 common stock (P's transfer of cash for Sub2 stock, together with the FSub Exchange, is hereinafter referred to as the "Exchange"). After the Exchange, P owned approximately 99 percent of Sub2 and FSub owned approximately 1 percent of Sub2.

P claims that its business purpose for entering into the Exchange was that P and its related entities had a long history of engaging in Business R transactions. At the time of the transfer, P was in the process of investigating Business R opportunities in Country X and needed the h units of Country X currency contributed in the FSub Exchange for anticipated costs relating to investigating, structuring and undertaking Business R transactions in Country X.

FSub claims that its business purpose for entering into the FSub Exchange was that it gave FSub the opportunity to pursue a joint investment strategy with P through the joint ownership of Sub2, and to benefit from P's experience in Business R. FSub has also stated that it believed that converting its Country X currency into stock of Sub2 would allow FSub to earn a higher rate of return that it had earned on its other investments.

Discharge of Notes

On Date 4, RelatedCo purchased Sub1. As part of the purchase agreement, RelatedCo assumed Sub1's obligations under the Sub1 Note and, in exchange, Sub1 released RelatedCo from its obligations under the RelatedCo Note. On the same day, RelatedCo entered into a settlement agreement with FSub whereby RelatedCo agreed to release FSub from its obligations under the FSub Note in exchange for FSub releasing RelatedCo from the obligations it assumed under the Sub1 Note. In addition, FSub agreed to pay RelatedCo an additional $k because Country X currency had decreased in value (relative to the dollar) in the interim. Except as noted in the preceding sentence, it appears that no cash was transferred in these transactions, and that the cancellation of all of the Loans was effected through offsetting book entries.[2]

Dates 1, 2, 3, and 4 are all within a seven month period in Year 2. Later in Year 2, Sub2 paid a bank fee of m units and a consulting fee to Employee of n units using a portion of the h units contributed by FSub in the FSub Exchange.

The P Group's tax treatment of the transactions

The P Group treated the Exchange, including the FSub Exchange, as a § 351 transaction. The P Group claimed that, because the $e liability assumed by Sub2 in the FSub Exchange exceeded FSub's $g basis in the h units of Country X currency, FSub's realized gain was subject to § 357(c). FSub, however, is not subject to U.S. taxation on any gain recognized under § 357(c). The P Group claimed that, as a result of the § 357(c) gain, Sub2's basis in the h units of Country X currency under § 362(a)(1) was $e (an amount that is more than 1000 times greater than the fair market value of the h units).[3] The P Group therefore reported a loss of $a (hereinafter, the "Claimed Loss") when it subsequently paid the bank fee and consulting fee using a portion of the inflated-basis h units. Disregarding the basis increase resulting from the FSub Exchange, Sub2's actual economic loss on the disposition of the Country X currency was $o (hereinafter, the "Economic Loss"), which is a de minimis amount reflecting currency fluctuations between the time of the FSub Exchange and the time of the disposition. Accordingly, the

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[2] Since all of the purported Loans may have been issued and satisfied through offsetting book entries, the bona fides of the $k payment should be examined. For example, it is unclear whether this payment was actually made and, if so, whether the payment, in substance, was part of the purported lending transaction or some other transaction between FSub and RelatedCo (such as, e.g., a foreign currency derivative).

[3] The transactions described above occurred prior to the effective date of §§ 357(d) and 362(d).

amount of loss that the Service should seek to disallow is $p (hereinafter, the "Loss"), which equals the Claimed Loss of $a minus the $o Economic Loss.

LAW AND ANALYSIS

Following is a list of possible alternative theories for disallowing the Loss that the Service should consider in the development of this case.

Theory 1. The loan transactions can be disregarded as factual shams.

A loss is allowable as a deduction for federal income tax purposes only if it is bona fide and reflects actual economic consequences. Sham transactions are not recognized for federal income tax purposes and losses generated by such transactions are not allowed. See, e.g., Freytag v. Comm'r, 904 F.2d 1011, 1015 (5th Cir. 1990). The sham transaction doctrine originated with the Supreme Court decision in Gregory v. Helvering, 293 U.S. 465 (1935). In Gregory, the Court affirmed the Commissioner's denial of losses and expense deductions incurred in a corporate reorganization. Although the reorganization plan conformed to the terms of the statute, the Court nonetheless held that the reorganization was a "mere device" for the "consummation of a preconceived plan" and not a reorganization within the intent of the statute as it then existed. Gregory v. Helvering, 293 U.S. at 469.

The courts have recognized two types of sham transactions: shams in fact and shams in substance. ACM Partnership v. Comm'r 157 F.3d 231, 247 n.30 (3d Cir. 1998), citing Kirchman v. Comm'r, 862 F.2d 1492 (11th Cir. 1989). A "factual sham" is a transaction that never actually occurs. An "economic sham" is a transaction that actually occurs, but lacks economic substance. Lerman v. Comm'r, 939 F.2d 44, 49 n.6 (3d Cir. 1991). See also, Yosha v. Comm'r, 861 F.2d 494, 500 (7th Cir. 1988). "It is well settled that the mere fact that a note is given does not prove the existence of a loan if there was no indebtedness existing which the note evidenced." Leonard v. Comm'r, T.C. Memo. 1985-51, citing Elbert v. Comm'r, 45 B.T.A. 685 (1941) and Golsen v. Comm'r, 54 T.C. 742, 754 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971).

In the instant case, the Loans may be shams in fact and, therefore, disregarded for federal income tax purposes. If the purported Loans were in fact never made, then Sub2's alleged assumption of FSub's obligations under the FSub Note will be disregarded in determining Sub2's basis in the h units of Country X currency.

In addition, regardless of whether money was actually transferred, the form of the loan transactions supports a determination that they constitute shams in substance. The circular movement of the money shows that each party served only as a conduit in the circulation of loan proceeds back to Sub1. Over the course of a single day, Sub1 transferred funds to RelatedCo, which transferred the same funds to FSub, which purportedly converted the funds to Country X currency and then transferred the funds back to Sub1. Thus, rather than incurring a real expenditure, Sub1 merely transferred funds through a chain of related entities that ultimately returned the funds to Sub1. In light of this circular flow, and the relationship of the parties involved, there is some doubt as to whether a lending transaction actually occurred for tax purposes. See Leonard v. Comm'r, T.C. Memo 1985-51. The fact that no collateral was apparently provided for any of the Loans, that the borrowers may not have had the independent means to satisfy their obligations under the Loans, and that none of the borrowers may have been expected to satisfy the Loans out of their own funds also suggests that no lending transaction occurred for tax purposes. See, e.g., Roe v. Comm'r, 52 T.C.M. 778 (1968).

[redacted]

Theory 2. Sub2 did not assume the FSub Loan in the FSub Exchange.

Based on the facts submitted, it appears that the parties did not expect that Sub2 would pay off the FSub Note purportedly assumed in the FSub Exchange. First, it is not clear whether, at the time of the FSub Exchange, Sub2 had sufficient assets to pay off the FSub Note. Second, Sub2 was the only obligor on any of the Loans that did not hold a creditor interest in a corresponding loan with an offsetting amount, which further suggests that FSub, rather than Sub2, was expected to satisfy the FSub Note through the release of Sub1 from its offsetting obligation under the Sub1 Note. Third, as provided in the Assumption Agreement, FSub remained as a co-obligor on the FSub Note, and was thus at all times liable for the full amount of the debt. Fourth, Sub2 was never subsequently required to pay off any portion of the FSub Note. Instead, as indicated above, FSub effectively discharged the FSub Note by releasing RelatedCo (as successor to Sub1) from its obligations under the Sub1 Note. See Roe v. Comm'r, 52 T.C.M. 778, 797 (1968) ("[r]ecourse debt should not be taken into account where, taking economic realities into account, there is no reasonable likelihood that the taxpayer actually will have to pay the debt"). Finally, as discussed under Theory 1 above, the FSub Note may not constitute genuine indebtedness. If this is the case, then any assumption of such indebtedness would have no effect for tax purposes. Accordingly, for all the reasons above, the Service can argue that Sub2 did not assume any liability in the FSub Exchange, and thus can not claim any basis increase in the h units under §§ 357(c) or 362(a).

The facts above also support the argument that, because FSub's discharge of the FSub Note was contemplated at the time of the FSub Exchange, the assumption should be disregarded as transitory under the step transaction doctrine. See, e.g., Comm'r v. Clark, 489 U.S. 726, 738 (1989) (stating that "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction"). [redacted]

If, upon further development of the facts, it appears that the parties did intend for Sub2 to assume and pay some portion of the liability on the FSub Note, then Sub2's basis under § 362 in the h units should only be increased to the extent of the portion actually assumed. In appropriate cases, the courts have limited the portion of an assumed indebtedness that may be taken into account for federal income tax purposes. For example, where two or more persons are liable on the same indebtedness, or hold separate properties subject to the same indebtedness, the amount taken into account for federal income tax purposes by each person generally is based on all the facts and circumstances, including the economic realities of the situation and the parties' expectations as to how the liabilities will be paid. See Maher v. U.S., No. 16253-1 (W.D. Mo. 1969) (property was not in substance "subject to" liability where lender was not actually relying on property as collateral); Maher v. Comm'r, 469 F.2d 225 (8th Cir. 1972) (corporation's assumption of primary liability on shareholder's indebtedness becomes taxable dividend only as corporation makes payments as promised).[4] But cf., Owen v.

[4] For purposes of this memorandum, we presume that the Loans are recourse indebtedness. The determination of whether the Loans constitute recourse or nonrecourse indebtedness is a material fact in the development of this case. If a nonrecourse debt substantially exceeds the fair market value of acquired property it encumbers, the loan is deemed to lack economic substance and is not includible in basis. Estate of Franklin v. Comm'r, 64 T.C. 752, aff'd, 544 F.2d 1045 (9th Cir. 1975). See also, Odend'hal v. Comm'r, 748 F.2d 908 (4th Cir. 1984), aff'g and remanding 80 T.C. 588, cert. denied, 471 U.S. 1143; Rev. Rul. 77-110, 1977-1 C.B. 58; Rev. Rul. 78-

Comm'r, 881 F.2d 832 (9th Cir. 1989) (§ 357(c) applied to assumed liability where transferor remained as personal guarantor on such liability).

Theory 3. Sub2's assumption of the FSub Loan was a constructive dividend to the extent that FSub received excess value in the FSub Exchange.

If the facts ultimately indicate that Sub2 did assume (and intend to repay) some or all of the FSub Note at the time of the FSub Exchange, then, depending on the value of the Sub2 stock received by FSub and the amount of liability actually assumed by Sub2, FSub may have realized an amount in excess of the fair market value of the h units it contributed in the FSub Exchange. If so, then such excess amount would be treated as occurring outside of FSub's § 351 transaction with Sub2. See, e.g., Treas. Reg. § 1.301-1(l). To the extent that some or all of the liability on the FSub Note was assumed by Sub2 outside of the FSub Exchange, the most logical characterization of such assumption is as a distribution with respect to the Sub2 stock. Id. Accordingly, the portion of the liability assumed by Sub2 that occurs outside of the § 351 transaction would not be treated as assumed for purposes of §§ 357(c) or 362(a), and would not otherwise increase Sub2's basis in the Country X currency. [redacted]

Theory 4. Section 465 may disallow the Loss.

Even if Sub2 were able to establish that for tax purposes it assumed the full amount of FSub's obligations under the FSub Note, and that it is entitled to an $e basis in the h units under §§ 357(c) and 362(a), § 465 may disallow the Loss. Under § 465(a), the at risk provisions apply to Sub2 because it is owned indirectly, 100 percent prior to the transaction, and then 99 percent after the transaction, by Individual.

Although Sub2 claims to have increased its basis in the Country X currency by an amount that represented FSub's § 357(c) gain, that amount also represents a liability that Sub2 assumed as part of a transaction to acquire funds for use in its business. FSub indicated that it contributed the h units to Sub2 because "it gave FSub the opportunity to pursue a joint investment strategy with P through joint ownership of Sub2." Therefore, if FSub's characterization of the facts is respected, Sub2 would be in the trade or business for the production of income under § 465(c)(3)(A). Sub2 assumed the loan as part of a transaction to facilitate FSub becoming a part of the joint investment strategy. Since Sub2 stepped into the shoes of the borrower when it assumed the FSub Note, under § 465(b)(1)(B), Sub2 became the borrower of an amount with respect to the income producing activity.

29, 1978-1 C.B. 62.

Sub2 may nevertheless not be considered at risk with respect to such borrowing for such income-producing activity because, under § 465(b)(4), a taxpayer is not considered to be at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements or other similar arrangements.

Based on the facts discussed under Theories 1 and 2 above (e.g., the issuance of circular, short-term offsetting loans with no collateral, and the expectation that FSub, rather than Sub2, would repay the FSub Note), there appears to be an arrangement to protect Sub2 against loss (within the meaning of § 465(b)(4)) with respect to the amount of the FSub liability assumed in the FSub Exchange. Accordingly, the amount of liability assumed by Sub2 on the FSub Note may not be includible in Sub2's amount at risk with respect to the relevant income producing activities. Therefore, the Service can argue that any loss arising from such amount (i.e., arising from the reflection of this amount in Sub2's basis in the h units) may be disallowed under § 465.[5]

Theory 5. Section 269 may disallow the loss.

If a person acquires control of a corporation and the principle purpose of the acquisition is to evade or avoid Federal income tax by securing the benefit of a deduction, credit or other allowance that the person would not otherwise enjoy, then § 269 authorizes the Service to disallow such tax benefit. “Control” for these purposes means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

In this case, the formation of FSub constitutes the requisite acquisition of control under § 269(a), as the formation of a new corporation can constitute an acquisition of control for § 269(a)(1) purposes. See Treas. Reg. § 1.269-1(c); see also, Borge v. Comm’r, 405 F.2d 673 (2d Cir. 1968); Coastal Oil Storage Co. v. Comm’r, 242 F.2d 396 (4th Cir. 1957). The fact that P is the acquiring corporation and that the P Group (rather than FSub) claimed the tax benefits arising from the acquisition of FSub does not bar the application of § 269, as § 269 can be applied to deny tax benefits claimed by either an acquiring person or an acquired corporation. See, e.g., Treas. Reg. § 1.269-3(a); Coastal Oil Storage, 242 F.2d 396; and James Realty Co. v. U.S., 280 F.2d 394 (8th Cir. 1960). Similarly, the fact

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[5] The possible application of § 465(c)(7) to Sub2 should be considered when developing the § 465 argument. If Sub2 is a “qualified C corporation” within the meaning of § 465(c)(7), then § 465(a) would not disallow Sub2's losses from any of its “qualifying businesses.” We do not have sufficient facts on hand to determine whether Sub2 is a “qualified C corporation” that carries on a “qualified business.”

that the Loss resulted from the combined effects of several of the transactions described (i.e., the Loss did not arise solely from the formation of FSub) does not bar the application of § 269. See, e.g., Treas. Reg. § 1.269-3(a) (stating that, if the principal purpose test is met with respect to an acquisition giving rise to a tax benefit, then "it is immaterial by what method or by what conjunction of events the benefit is sought"); see also, J.T. Slocomb v. Comm'r, 334 F.2d 269 (2d Cir. 1964). Accordingly, the Service can apply § 269 to disallow the Loss if the principle purpose of forming FSub was tax avoidance.

If the purpose to evade or avoid Federal income taxes exceeds in importance any other purpose for an acquisition, then such purpose is the principle purpose for the acquisition. Treas. Reg. § 1.269-3(a)(2). Thus, in determining whether FSub was formed for the principal purpose of tax avoidance, the non-tax purposes for the transaction must be weighed against its tax-avoidance purposes. See also, Treas. Reg. § 1.269-2(b).[6]

The information submitted in this case suggests that the formation of FSub may have been undertaken for the principal purpose of evading or avoiding Federal income tax, since the tax benefit of the Loss may exceed in importance the non-tax purposes for the transaction. Representatives of P have stated that the business purpose for the formation of FSub was to take advantage of Business R opportunities in Country X. Representatives of P and FSub have also stated that the Exchange was entered into in part to pursue Business R in Country X, and that the h units contributed by FSub to Sub2 were needed to finance anticipated costs relating to these opportunities.[7] However, the P Group has not provided adequate substantiation for this business purpose. For instance, the information submitted does not contain any indication that Business R opportunities were actually

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[6] Treas. Reg. § 1.269-2(b) provides as follows: Under the Code, an amount otherwise constituting a deduction, credit, or other allowance becomes unavailable as such under certain circumstances. Characteristic of such circumstances are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate. The distortion may be evidenced, for example, by the fact that the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer, by the unreal nature of the transaction such as its sham character, or by the unreal or unreasonable relation which the deduction, credit, or other allowance bears to the transaction.

[7] The stated business purposes for the other transactions described in this FSA should also be considered in determining whether or not FSub was formed for the principle purpose of tax avoidance.

considered or pursued by FSub, P, or Sub2, or that such opportunities could reasonably be pursued with an investment of only h units. The primary expenditure that was paid out of the h units was a small consulting fee to Employee. We recommend that the Service develop the facts and circumstances relating to any possible business purposes for the transactions described above. Even if the parties involved eventually produce further evidence in support of the business purposes for the above transactions, the strength of the evidence and underlying business purposes must be weighed against the significant tax savings produced by the transaction. See Coastal Oil Storage, supra, at 396.

We also note that while tax years after Year 2 are not presently before us, to the extent that the Service establishes that Sub2 or the P Group claimed further losses from the inflated-basis Country X currency in later years, the Service can also apply § 269 to disallow those losses. See, e.g., Hall Paving Co. v. U.S., 74-1 U.S.T.C. (CCH) 9397 (D. Ga. 1974) (which held that operating losses of acquired companies that occurred in years after the acquisitions could not be deducted where the original transactions were motivated principally by a tax-avoidance purpose).

Theory 6. Section 482 may reallocate the loss.

Based on the facts provided, § 482 may apply to provide the Commissioner the authority to reallocate the loss from Sub2 to FSub if it can be shown that the parties acted in concert to shift the loss in question from FSub to Sub2.

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. [Emphasis Added.]

See also Treas. Reg. § 1.482-1(a)(2) ("The district director may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such case, the district director may allocate income, deductions . . . or any other item or element affecting taxable income (referred to as allocations).").

Thus, in order for § 482 to apply to a transaction, the transaction must be between two or more entities owned or controlled by the same interests. If it is determined that the parties to the transaction are members of a controlled group, the Service may make allocations among the members if the taxpayer has not reported its true taxable income. Because Individual has common majority ownership of P, Sub1, Sub2, and RelatedCo, the primary question under § 482 is whether FSub and these entities are controlled by the same interests. See Treas. Reg. § 1.482-1(i)(6) (a controlled group is defined as taxpayers controlled directly or indirectly by the same interests).

The § 482 regulations[8] define control as

> [including] any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted. Treas. Reg. § 1.482-1(i)(4).

Where the actions of two unrelated parties were undertaken with respect to a joint venture, the Tax Court found the unrelated parties to be in common control of a company owned 50 percent by each. B. Forman v. Comm'r, 453 F.2d 1144 (2nd Cir. 1972), rev'g in relevant part 54 T.C. 912 (1970), cert. denied, 407 U.S. 934 (1972), reh'g denied, 409 U.S. 899 (1972), nonacq., 1975-2 C.B. 3 (nonacquiescence relates to Tax Court opinion only, as the Second Circuit adopted an interpretation of control that is consistent with the 1968, 1993, and 1994 § 482 regulations). 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. Id. Accord Ach v. Comm'r, 42 T.C. 114 (1964), aff'd, 358 F.2d 342 (6th Cir. 1966), cert. denied, 385 U.S. 899 (1966); Grenada Indus. v. Comm'r, 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. Comm'r, 372 F.2d 415 (4th Cir. 1967), aff'g T.C. Memo. 1966-15, cert. denied, 389 U.S. 841 (1967). Neither the regulations nor case law require majority ownership by one person or entity over the parties to a transaction to establish control. Furthermore, the presence of an unrelated party is not an automatic bar to the application of § 482. See DHL Corp. v. Comm'r, 285 F.3d 1210, 1218 (9th Cir. 2002) ("Where a third party is indifferent to the terms of the transaction affecting the allocated items, its involvement does not interfere with the application of § 482."). See also, GAC Produce Co. v. Comm'r, 77 T.C.M. (CCH) 1890, 1904 (1999).

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[8] The applicable regulations are the current regulations, T.D. 8552, which were finalized in 1994.

In the present case, FSub was jointly owned in equal amounts by P and Employee. Notwithstanding Employee's putative 50 percent ownership interest in FSub, several factors demonstrate that Individual was, in reality, in control of FSub. For instance, Individual held the office of President of FSub. Additionally, Employee was an employee of RelatedCo, a company in which Individual owned 60 percent. Also, Employee's interest in FSub was used for payment and collateral in a nonrecourse loan owed to P, a 100 percent Individual controlled entity. Therefore, during all of the transactions presently in question, it was a foregone conclusion that Individual, or entities he controlled, would eventually own greater than 50 percent of FSub. Accordingly, the facts at hand support the application of § 482 because of Individual's joint, legal, and overlapping ownership of Sub2 and FSub.

In the alternative, the regulations provide that a "presumption of control arises if income or deductions have been arbitrarily shifted." Treas. Reg. § 1.482-1(i)(4). See Dallas Ceramic Co. v. Comm'r, 598 F.2d 1382, 1389 (5th Cir. 1979), rev'g 35 A.F.T.R.2d (RIA) ¶ 75-394 (N.D. Tex. 1974) (holding that based on Treas. Reg. § 1.482-1(a)(3) (1968) - - which contained language similar to Treas. Reg. § 1.482-1(i)(4) of the current regulation - - the Service properly argued that proof of income shifting between two corporations establishes a presumption of common control). Accord Hall v. Comm'r, 294 F.2d 82 (5th Cir. 1961), aff'g 32 T.C. 390 (1959), acq., 1959-2 C.B. 4 (referring to Reg. 111 § 29.45-1). The regulations also state that control may exist as a result of the actions of "two or more taxpayers acting in concert with a common goal or purpose." Treas. Reg. § 1.482-1(i)(4). Thus, under the regulations, joint, legal, or overlapping ownership is not required for unrelated corporations to come within the purview of § 482 if income or deduction shifting is present, or if there is a common goal to shift income or deductions. But see Lake Erie & Pittsburgh Railway Co. v. Comm'r, 5 T.C. 558 (1945), acq., 1945 C.B. 5, acq. withdrawn and substituted for nonacq., Rev. Rul. 65-142, 1965-1 C.B. 223.

Where the Service seeks to establish common control due to the presence of an artificial shifting of income and deductions, it is the Service's burden to prove the applicability of § 482 by establishing a shifting of income and deductions. Dallas Ceramic Tile Co., 598 F.2d at 1390. We believe this burden is met by the P Group and FSub acting in concert to intentionally create a noneconomic gain in FSub (which is not subject to U.S. taxation) and a corresponding noneconomic unrealized loss in Sub2 through the transfer of the Country X currency from FSub to Sub2 in the § 351 transaction. See Notice 95-53, 1995-2 C.B. 334 (stating that for purposes of § 482, the parties in a stripping transaction, as defined in the Notice, generally are "controlled . . . by the same interests" because they act in concert with the common goal of arbitrarily shifting income or deductions between the transferor and the transferee). Although this transaction may not technically fit into the definition of a stripping transaction, this transaction is similar to stripping transactions since the P Group claims that a § 351 transaction resulted in FSub realizing noneconomic income, and that FSub's recognition of gain directly resulted in Sub2's acquisition of an artificially inflated basis. Accordingly, a presumption of control arises since the loss on the Country X currency may be viewed to have been arbitrarily shifted. See Treas. Reg. § 1.482-1(i)(4).

A controlled group or controlled taxpayer is defined to mean the entities owned or controlled by the "same interests," and includes the taxpayer that owns or controls other taxpayers. Treas. Reg. §§ 1.482-1(i)(5), (6). Unlike the term "control," the phrase "same interests" is not defined in the § 482 regulations. Case law as well as the legislative history of § 482 provide guidance, however.

Section 482 was enacted to prevent the artificial shifting of income between controlled taxpayers to avoid Federal taxes, and thereby "milk" a taxable entity, i.e., by moving losses to a taxable entity. See, e.g., Brittingham v. Comm'r, 598 F.2d 1375, 1379 (5th Cir. 1979), citing, H. Rept. No.2, 70th Cong., 1st Sess. (1927), 1939-1 C.B. (Part 2) 384, 395; S. Rept. No. 960, 70th Cong., 1st Sess. (1928), 1939-1 C.B. (Part 2) 409, 426. See also, H. Rept. No. 350 and S. Rept. No. 275, 67th Cong., 1st Sess. (1921); Ach v. Comm'r, 42 T.C. 114, 125 (1964), aff'd, 358 F.2d 342 (6th Cir. 1966), cert. denied, 385 U.S. 899 (1966). In using the term "same interests," Congress intended to include more than "the same persons" or "the same individuals." Brittingham, 598 F.2d at 1379; South Texas Rice Warehouse Co. v. Comm'r, 366 F.2d 890, 894-5 (5th Cir. 1966), aff'g 43 T.C. 540 (1965), cert. denied, 386 U.S. 1016 (1967); Appeal of Rishell Phonograph Co., 2 B.T.A. 229, 233 (1925). See also, LXI-Part 6 Cong. Rec. 5827 (1921) (statement of Sen. King referring to the "same forces" controlling a number of corporations). Different persons with a common goal or purpose for artificially shifting income can constitute the "same interests" for the purposes of the statute. South Texas Rice Warehouse, 366 F.2d at 894-5. See also, Brittingham, 598 F.2d at 1378-9, citing Ach, 42 T.C. at 125-6 (the phrase, "same interests," should not be narrowly construed to frustrate the intent of § 482); Appeal of Rishell Phonograph Co., 2 B.T.A. at 233 ("If 'the same interests' was intended to mean only `the same persons,' it would have been easy for Congress, by using the latter term, to have avoided all ambiguity."). Accord Grenada Indus., supra, 17 T.C. 231.

Thus, it is not necessary that the same person or persons own or control each controlled business before § 482 can be applied, but there must be a common design for the shifting of income in order for different entities to constitute the "same interests." Indeed, this definition of same interest is identical to the definition of control (and the presumption relating thereto) in the regulations and case law. Thus, if there is a common design for shifting income or deductions, then the requirements for control and same interests will be met. See Hall v. Comm'r, supra, 32 T.C. at 409-10 (an arbitrary shifting of income coupled with the ability to direct the actions of an entity establishes control for the purposes of § 482 -- whether or not ownership exists).

For the reasons discussed above, we believe that P and FSub were controlled by the same interests as required for § 482's application. Alternatively, we believe the parties to the transaction acted pursuant to a common plan to shift a large amount of basis in the Country X currency to Sub2 through the § 351 transaction.

Once the Secretary has proven that the parties are controlled by the same interests, he “may distribute, apportion, or allocate . . . deductions . . . 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 such organizations, trades or businesses.” Section 482. Generally, the Commissioner’s determinations under § 482 must be sustained absent an abuse of discretion. G.D. Searle and Co. v. Comm’r, 88 T.C. 252, 358 (1988). The taxpayer must meet a heavier than normal burden of proof and demonstrate that the Commissioner’s determinations are arbitrary, capricious, or unreasonable in order for the courts to set aside the Commissioner’s determinations. Id.

Under Treas. Reg. § 1.482-1(f)(1)(iii)(A), the Commissioner has specific regulatory authority to allocate to the transferor, with respect to a nonrecognition transaction, the loss from a sale of property which had previously been transferred in a nonrecognition transaction to the extent the taxpayer’s basis upon receipt of the property exceeded the property’s fair market value. Courts have sustained the Commissioner’s reallocation in the context of § 351 transactions in order to clearly reflect income in cases when the income was recognized by one party and the expenses incurred in producing the income were deducted by another related party, even if there was no finding that tax avoidance was a principal motive of the taxpayer. See, e.g., Rooney v. U.S., 305 F.2d 681 (9th Cir. 1962); Central Cuba Sugar Co. v. Comm’r, 198 F.2d 214 (2d Cir. 1952). Section 482 has also been applied where the transfer of property in a § 351 transaction was found to have been made with a tax avoidance purpose. National Securities Corp. v. Comm’r, 137 F.2d 600 (3d Cir. 1943). However, by its terms, Treas. Reg. § 1.482-1(f)(1)(iii)(A) does not require that a tax avoidance motive be present. The regulation provides:

> [I]f necessary to prevent the avoidance of taxes or to clearly reflect income, the district director may make an allocation under § 482 with respect to transactions that otherwise qualify for nonrecognition of gain or loss under applicable provisions of the Internal Revenue Code (such as §§ 351 or 1031).

In addition, courts have sustained the Commissioner's reallocation of gain or loss on taxable dispositions to the transferor with respect to the previous nontaxable transfer of the property under §§ 351 or 311 (as then in effect), when the purpose of the transaction was tainted by tax avoidance motives, e.g., when the transferee was better able to use the loss, absorb the capital gain, or use the deduction for charitable contributions. Northwestern Nat'l Bank v. U.S., 556 F.2d 889 (8th Cir. 1977) (the Commissioner's reallocation of charitable contribution deduction to the wholly owned subsidiary was sustained when the subsidiary distributed the appreciated stock to the parent corporation, and the parent contributed the stock to a charitable organization, so that the parent corporation could make use of the charitable deduction); Nat'l Sec. Corp. v. Comm'r, 137 F.2d 600 (3d Cir. 1943) (sustaining the Commissioner's reallocation of capital loss to the parent corporation when the parent corporation contributed built in loss stock to its wholly owned subsidiary in a transaction tax free under the predecessor of current § 351, so that ten months later upon sale of the stock, the subsidiary could make use of the capital loss deduction); Ruddick Corp. v. U.S., 3 Cl. Ct. 61, 83-2 U.S.T.C. P 9480 (1983), on remand from 643 F.2d 168 (Ct. Cl. 1981), aff'd, 732 F.2d 168 (Fed. Cir. 1984) (the Commissioner's reallocation of capital gain to the subsidiary-transferor was sustained when a wholly owned subsidiary distributed appreciated stock to its parent in a tax free distribution under § 311 as then in effect so that the parent could offset the capital gain from the disposition of the stock with its net operating loss); Southern Bancorp. v. Comm'r, 67 T.C. 1022, 1027 (1977).

For the reasons discussed above under Theories 1, 2, and 5, the Service can argue that Sub2's principal purpose for engaging in the § 351 transaction was tax avoidance. Accordingly, based on Treas. Reg. § 1.482-1(f) and the above-mentioned cases, the Commissioner may be able to reallocate Sub2's loss on the Country X currency, to the extent it was unrealized when Sub2 acquired the Country X currency, to FSub.

Theory 7. Treas. Reg. § 1.988-1(a)(11) may limit the loss.

In the alternative to reallocating the loss from Sub2 to FSub under § 482, the Commissioner may apply Treas. Reg. § 1.988-1(a)(11) to limit the § 988 ordinary loss treatment claimed by Sub2 to that amount which reflects actual currency value fluctuations (i.e., the Economic Loss). Treas. Reg. § 1.988-1(a)(11) would exclude the remainder of the loss (i.e., the Loss) realized by Sub2 from § 988. This exclusion from § 988 would cause all of the Loss, which was not associated with actual currency fluctuations, to be treated as capital loss realized by Sub2.

Sections 985-989, which were enacted as part of the Tax Reform Act of 1986, set forth a comprehensive set of rules for the treatment of foreign currency transactions. Section 988(a)(1)(A) provides that foreign currency gain or loss attributable to a § 988 transaction is computed separately and treated as ordinary income or loss. Foreign currency gain on a § 988 transaction is generally defined as the gain on the transaction to the extent such gain does not exceed gain realized by reasons of changes in exchange rates on or after the booking date and before the payment date. Section 988(b)(1). Foreign currency loss is similarly defined in § 988(b)(2). In this manner, Congress intended that only gain or loss to the extent it is realized by reason of a change in exchange rates between the date the asset or liability is taken into account for tax purposes and the date it is paid or otherwise disposed of will be treated as foreign currency gain or loss. S. Rep. No. 313., 99th Cong., 2d Sess. 461 (1986). In addition, any gain or loss from the disposition of nonfunctional currency is treated as foreign currency gain or loss.

The legislative history of sections 985 - 989 suggests that Congress was concerned about tax motivated transactions. The Senate Finance Committee Report accompanying the Tax Reform Act of 1986 stated that one of the two reasons for the enactment of §§ 985 - 989 was that prior law provided opportunities for tax motivated transactions. S. Rep. No. 313., 99th Cong., 2d Sess. 450 (1986). Accordingly, in enacting §§ 985 - 989, Congress granted broad authority for the Service to promulgate regulations "as may be necessary or appropriate to carry out the purposes of [§§ 985 - 989] . . . ." Section 989(c). The legislative history to the TAMRA, in discussing the law prior to the enactment of TAMRA, stated that "[t]he Secretary has general authority to provide the regulations necessary or appropriate to carry out the purposes of new subpart J. For example, the Secretary may prescribe regulations appropriately recharacterizing transactions to harmonize the general realization and recognition provisions of the Code with the policies of § 988." H.R. Rep. No. 795, 100th Cong., 2d Sess. 296 (1988); S. Rep. No. 445, 100th Cong., 2d Sess. 311 (1988) (containing identical language).

In response to Congress's concern about tax motivated transactions, the Service, under the authority of § 989(c), promulgated Treas. Reg. § 1.988-1(a)(11). Treas. Reg. § 1.988-1(a)(11) states in part that the Commissioner may exclude a transaction or series of transactions which in form is a § 988 transaction from the provisions of § 988 if the substance of the transaction or series of transactions indicates that it is not properly considered a § 988 transaction.

We believe that the only loss that can be properly characterized by Sub2 as ordinary loss under § 988 is the Economic Loss. To the extent that the Loss is not disallowed or reallocated under Theories 1 through 6 above, the Loss should be excluded from § 988 under Treas. Reg. § 1.988-1(a)(11) and re-characterized as capital loss for Sub2. We note that this capital loss may be carried back and carried forward for use by Sub2. Therefore, application of Treas. Reg. § 1.988-1(a)(11) may not result in a disallowance of tax benefits to Sub2.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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Please call if you have any further questions.

By ______________________________
Senior Technical Reviewer, Branch 1

cc: