Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200610019**

Release Date: 3/10/2006

CC:INTL:B04:TDBeem
POSTU-164495-04

[Third Party Communication:
Date of Communication: <Month> DD, YYYY]

UILC: 367.30-00

date: November 23, 2005

to:

(Large & Mid-Size Business)

from: Thomas D. Beem
Senior Technical Reviewer, Branch 4
(International)

subject: Request for Advice Concerning Parent Co Rebuttal

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

US Sub	=	
Parent Co	=	
Treaty	=	
Articles	=	
Certificate A	=	
Certificate B	=	
Country A	=	
Country A Political Subdivision	=	

Country B	=	
Country B Entity	=	
Country D Entity	=	
Country G Entity	=	
Number J	=	
Number K	=	
Number L	=	
Number N	=	
Number O	=	
Number P	=	
Official N	=	
State R	=	
State R Law	=	
Transaction	=	
Type T	=	
Type U	=	
Type V	=	
Type W	=	
Year 8	=	
Date 12	=	
Date 13	=	
Date 14	=	
Date 15	=	
Date 17	=	
Date 23	=	
Month A	=	
Month B	=	
$aa	=	
$bb	=	
$cc	=	
$dd	=	
$ee	=	
$hh	=	
$jj	=	
$kk	=	
$ll	=	

$uu	=	
$vv	=	
$ww	=	
$xx	=	
$yy	=	
$zz	=	
$aaa	=	

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

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I. Introduction

Parent Co and its includible subsidiaries (collectively, "Parent Co Group") protested certain proposed adjustments in its Protest and requested a conference with Appeals. This memorandum responds to your request for advice regarding the application of the provisions of Subchapter C of the Internal Revenue Code ("IRC")[1] to the transaction described in the Technical Advice Memorandum that was previously provided to you by Branch 1 of this office and to certain issues raised in Parent Co's Protest. The facts upon which this memorandum is based are the facts contained in the TAM that Branch 1 of our office previously issued to you. For that reason, a full recitation of the facts is not set out again here.

[1] All section references in this memorandum are to the IRC unless otherwise indicated.

A key difference between the positions of the Service and Parent Co in this matter is the valuation of the intangible property rights ("IP") that Parent Co transferred to Country B Entity via US Sub. Parent Co took the position in its return that the value of the IP was $cc. Parent Co continues to maintain that this is the correct valuation in its Protest. The Service, on the other hand, has determined that the correct valuation of the IP was $uu. The difference between the Service's valuation and Parent Co's valuation (referred to in the 30-day letter as the "Excess Value") is $vv. We express no opinion on what is the correct valuation of the IP. This memorandum will discuss the results under each valuation, as that is important to understanding the subchapter C consequences of the IP transfer.

Another difference between the positions of the Service and Parent Co is whether the Treaty exempts US Sub from the payment of U.S. tax. The advice previously issued to you from Branch 1 of our office discussed the application of the Treaty, concluding that Parent Co is not entitled to the benefits it claimed under the Treaty for this transaction. Thus, the tax consequences described in this memorandum assume that the Treaty does not apply.

The Service and Parent Co have asserted quite different valuations for the IP that Parent Co transferred. Even if we assume that Parent Co's valuation is correct, certain issues (in addition to the application of the Treaty) regarding the proper tax treatment of the transaction are in dispute. This memorandum first addresses these issues. As part of this discussion, we provide a brief summary of the transaction and a description of issues that are not in dispute. Then, assuming that Parent Co's valuation is incorrect, this memorandum determines the tax treatment of Country B Entity's acquisition of the Excess Value IP.

II. Analysis of the Transaction Assuming Parent Co's Valuation is Correct

A. Summary of the Transaction

Parent Co is a domestic corporation and the common parent of an affiliated group of corporations that file a consolidated return. At the outset of the transaction described below, Parent Co owned all of the common stock of US Sub, a State R corporation, and all of the common stock of Country B Entity, a Country B limited company that is treated as a corporation for U.S. tax purposes.

Step 1: The Domestic IP Transfer: On Date 12, Year 8, Parent Co transferred the IP to US Sub in exchange for Number J shares of US Sub Type T stock valued at $cc.[2] Parent

[2] Parent Co notes in its Protest that Type T stock is <u>not</u> non-qualified preferred stock as described in § 351(g). This issue is not in dispute.

Co owned all of the equity interests in US Sub immediately after this exchange. The Service does not contest Parent Co's position that this exchange qualifies under § 351.[3] As a result, Parent Co does not recognize any gain on its transfer of the IP to US Sub. § 351(a). Because Parent Co's basis in the IP was $aa, Parent Co's basis in the US Sub Type T stock it received in exchange therefore is $aa. § 358. US Sub's basis in the IP is also $aa. § 362(a). It appears that Parent Co agrees with this analysis of Step 1.

Step 2: The Continuance: On Date 15, Year 8, US Sub was granted Articles in Country A Political Subdivision and US Sub filed a Certificate A with the State R Official N, which permitted it to retain its State R corporate charter.[4] Because it retained its State R charter, US Sub remained a domestic corporation and a member of the consolidated group. § 7701(a)(4) and Treas. Reg. § 301.7701-2(b). The Transaction is treated as a reorganization under § 368(a)(1)(F). For federal income tax purposes, US Sub does not recognize gain or loss on the deemed transfer of the IP, the IP retains a basis of $aa, and there is no change in Parent Co's basis in its US Sub stock. Parent Co also appears to agree with this result.

Step 3: The § 367(d) IP Transfer: On Date 17, Year 8, US Sub transferred the IP to Country B Entity in exchange for Number K shares of Country B Entity Type U stock and Number L shares of Country B Entity Type V stock. Both series were priced at $ww per share. Thus, US Sub received aggregate consideration valued at $$cc ($dd of Country B Entity Series C stock and $ee of Country B Entity Series D stock). Parent Co takes the position that the exchange in this step is one described in § 351 and that the Type V stock is non-qualified preferred stock as described in § 351(g). The Service does not question Parent Co's position that this is an exchange described in § 351.[5]

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[3] It is not entirely clear that all substantial rights in the IP were transferred to US Sub. For the purposes of this analysis, we assume all substantial rights were transferred since that is apparently not an issue in this case.

[4] Under the State R Law in effect at the time of this transaction, US Sub had to file either a Certificate A or a Certificate B after the Transaction. Filing the former allows the company to keep its status as a State R corporation while the filing of the latter would have terminated its status as a State R corporation. Thus, US Sub had to elect under State R law whether it would keep its State R charter.

[5] Under Treas. Reg. § 1.1502-34, US Sub is considered to own all of the stock of Country B Entity held by any member of the consolidated group for purposes of testing whether the exchange qualifies under § 351. Thus, for the purposes of determining whether US Sub satisfied the control requirement of § 351(c), US Sub is treated as though it owned all of the common stock of Country B Entity that was actually owned by Parent Co. We understand that Country D Entity, which held the Type T and Type W shares of Country B Entity, made a contribution to Country B Entity in exchange for additional Type W shares as part of the overall transaction. If so, then Country D Entity was also a transferor in the § 351 exchange, with the result that the transferors met the requirement in § 368(c) that the transferors hold at least 80 percent of the shares of each class of non-voting stock. *See*. Rev. Rul. 59-259.

Furthermore, because US Sub was a U.S. person that transferred intangible property to a foreign corporation in an exchange described in § 351, the exchange was subject to § 367(d). Under § 367(d), the transferor must take into income annual payments based upon use, productivity, or disposition of the intangible. Parent Co and the Service agree that the exchange in this step is subject to § 367(d). However, the Service and Parent Co apparently disagree on the treatment of the $ee of other property received in the exchange. Parent Co asserts that § 351(b) applies to that part of the exchange, while the Service asserts that § 367(d) applies. This issue is discussed in detail in Part II(B)(2) of this memorandum.

Step 4: The "Borrowing": In Month A, Year 8, Country B Entity lent to Parent Co $hh and received in exchange from Parent Co a note for that amount (the "Parent Co Note").

Step 5: The Redemption of the Series D Stock: In Month B, Year 8, US Sub requested that Country B Entity redeem all of its outstanding Series D stock for the stated liquidation preference of $ee. Country B Entity paid US Sub $ll cash, the Parent Co Note with a face amount of $hh plus accrued and unpaid interest of $jj, and issued its own note (the "Country B Entity Note") for $kk. The actual redemption took place on Date 23, Year 8. The Service and Parent Co disagree on the effect of the issuance and redemption of the Type V Stock. This issue is discussed in detail in Part II(B)(1) of this memorandum.

Step 6: US Sub's Transfer of the Redemption Proceeds to Parent Co: The Protest acknowledges that US Sub transferred the redemption proceeds, including the Parent Co Note, to Parent Co but does not provide the date of such transfer.[6] Thus, Parent Co's debt to Country B Entity was extinguished.

B. Disputed Issues

1. Treatment of the Issuance and Redemption of the Type V Stock.

One issue in dispute is whether to respect Country B Entity' Date 17, Year 8 issuance of the Type V Preferred stock to US Sub for federal income tax purposes. Upon its issuance, the Type V stock was immediately redeemable at US Sub's option. As noted above, approximately Number N months after its issuance, US Sub asked to have the Type V stock redeemed for its liquidation preference of $ee.

The Service stepped the issuance and redemption together, with the result that US Sub is treated as though it contributed the IP to Country B Entity in direct exchange for

[6] Protest at p. 47.

the cash and notes described in Step 5. Although the treatment of the Type V stock does not change the dollar amount of the Service's proposed adjustments Parent Co vigorously contested the Service's characterization. On page 89 of the Protest, Parent Co acknowledges that the federal tax result is the same (i.e., a gain of $ee, assuming such gain is not excluded from U.S. tax pursuant to the Treaty). Given that fact, and Parent Co's assertion that as a resident of Country A under the Treaty US Sub would not expect to obtain any federal tax benefit on redemption of the Type V stock, the question arises why Parent Co objected so strenuously to the Service's application of the step transaction doctrine.

If the issuance and redemption are respected as separate steps as Parent Co suggests, we expect Parent Co to claim such significant U.S. tax benefits as positive basis adjustments and foreign tax credits. Certain of these benefits would be the result of Parent Co's misapplication of § 351(b) (See discussion in Appendix).

We conclude that the redemption of the Type V stock was a step in the larger transaction. Parent Co argues that the Government cannot ignore the issuance of the Type V stock on the basis of step transaction principles if "the second step [the redemption] was not contemplated at the time of the initial step [the issuance], and if the first step has economic substance and a business purpose."[7]

We anticipate that Parent Co will argue that the Parent Co Note was a valid negotiable instrument and had economic substance. "Indebtedness" has been defined an "an unconditional and legally enforceable obligation for the payment of money." *Autenreith v. Commissioner,* 115 F. 2d 856, 858 (3d Cir. 1940), affg. 41 B.T.A. 319 (1940). Further, we anticipate Parent Co may contend that Country B Entity, or later, US Sub, could have required payments on the Parent Co Note, and Parent Co was exposed to economic risk. However, in fact, the Parent Co Note was quickly extinguished.

In this case, there was a circular movement of the Parent Co Note among related parties. Parent Co was in total control of Country B Entity and US Sub, and it is our understanding that Parent Co never made a payment of principal or interest on the Parent Co Note. In its Protest, Parent Co acknowledged that the Parent Co Note, along with the Country B Entity Note and $ll were distributed from US Sub to Parent Co. Thus, the Parent Co Note went full circle. The Type V Preferred stock documents were written to facilitate the circular progress of the Parent Co Note. The transaction was structured so that US Sub, the holder of the Type V stock, could require the redemption of such stock at any time. Only months after receipt of the Type V stock, US Sub

[7] Protest at p. 89.

exercised this right. Once the Parent Co Note was in US Sub's hands, it was distributed back to Parent Co,[8] presumably as an inter-company dividend.

In its Protest, Parent Co states that the I.E.'s Report concludes that US Sub did not receive any economic benefit from the Type V shares "other than the tax advantages it hoped to receive upon its redemption" but that such advantages were not listed. Such tax benefits were not listed in the RAR as they do not change the adjustments as set forth in the Report. Given Parent Co's assertion that § 351(b) applies to the exchange, we expect that Parent Co will claim certain positive basis adjustments. These are more fully described in the appendix at the end of this memorandum. In addition, we expect Parent Co may also claim its group is entitled to foreign tax credits. We disagree with Parent Co's application of § 351(b) and we do not respect the issuance and redemption of the Type V stock.

We view the benefits that the Parent Co would claim as a result of respecting the issuance and redemption of the Type V as inappropriate in the circumstances of this case. Through complex and detailed planning, Parent Co sought to reap at least $xx of positive basis adjustments and have the Parent Co consolidated group garner significant foreign tax credits without paying a penny of the U.S. taxes on income generally associated with such basis adjustments and tax credits. We do not conclude that this complex transaction was the unintended result of happenstance. It was not happenstance that the Type V stock was issued as non-qualified preferred stock (subject to the application of § 351(g)) and was immediately redeemable.

Instead, we agree with the Service that the issuance and redemption of the Type V Preferred stock must be disregarded. Moreover, if, as Parent Co stated in its Protest, US Sub forwarded the Parent Co Note, along with the Country B Entity Note and $ll, to Parent Co, then the issuance and reacquisition of the Parent Co Note (along with the purported $jj of accrued interest) should be disregarded, as well.

If the Parent Co Note and accrued interest is disregarded, Parent Co would be treated as receiving a distribution (rather than a loan) of $hh from Country B Entity. To the extent that US Sub is not viewed as receiving the Parent Co Note and the accumulated interest (in the aggregate, $yy) in exchange for the IP because the Parent Co Note and accrued interest are disregarded, we conclude that Country B Entity must be deemed to have issued additional common stock with a value of $yy. As explained below in our discussion of "Excess Value", US Sub would be deemed to have distributed the additional common stock to Parent Co, and such stock transfer would be

[8] Parent Co does not address the tax treatment of US Sub's distribution to Parent Co. Presumably, it was treated as an inter-company dividend. As discussed below, we expect that Parent Co inappropriately increased Parent Co's basis in US Sub under § 1.1502-32, and we presume that Parent Co takes the position that the inter-company dividend will merely reduce such basis.

subject to the application of Treas. Reg. § 1.367(d)-1T(e)(1). The $hh distributed from Country B Entity to Parent Co is treated as a payment (or prepayment, as applicable) of amounts due under Treas. Reg. § 1.367(d)-1T(e)(1) and this amount is properly included in Parent Co's gross income. We presume that the Service did not take this position in the RAR because the fact that US Sub distributed the Parent Co Note to Parent Co was first disclosed in Parent Co's Protest.

It is axiomatic that the substance of a transaction, rather than its form, governs the Federal income tax treatment of the transaction. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Gregory v. Helvering,* 293 U.S. 465 (1935). The question of the applicability of the substance over form doctrine and related judicial doctrines requires "a searching analysis of the facts to see whether the true substance of the transaction is different from its form or whether the form reflects what actually happened." *Harris v. Commissioner,* 61 T.C. 770, 783 (1974). One such judicially created doctrine is the step transaction doctrine.

Under the step transaction doctrine, a series of formally separate steps may be collapsed and treated as a single transaction if the steps are in substance integrated and focused toward a particular result. The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The purpose of the unnecessary steps is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged. *Smith v. Commissioner,* 78 T.C. 350, 389 (1982).

Courts have applied three alternative tests in deciding whether the step transaction doctrine should be invoked in a particular situation: the binding commitment test, the end result test, and the interdependence test.

The binding commitment test is the most limited of the three tests. It looks to whether, at the time the first step was entered into, there was a binding commitment to undertake the later transactions. This is the most rigorous test of the step transaction doctrine. *Commissioner v. Gordon,* 13 F.3d 577, 583 (2d Cir. 1994). Under the heading "Mandatory Redemption," the Resolution does state that "[t]he holder of [Type V] Shares may call for the redemption of [Type V] Shares *at any time.*" See p. 9 of the Resolution (emphasis added). Thus, there was a *contractual obligation* put in place, even prior to the issuance of the Type V shares, requiring Country B Entity to redeem the Type V shares if US Sub requested their redemption. The timing of the redemption was left to the discretion of US Sub (as controlled by Parent Co). Just because US Sub and Country B Entity, related parties controlled by Parent Co, did not specify the timing of the redemption in writing at the time of the issuance, they should not be able to avoid the application of the binding commitment test.

The interdependence test looks to whether the steps are so interdependent that the legal relations created by one step would have been fruitless without a completion of the later series of steps. See *Penrod v. Commissioner,* 88 T.C. 1415, 1428-1430 (1987). Steps are generally accorded independent significance if, standing alone, they were undertaken for valid and independent economic or business reasons. *Green v. United States,* 13 F.3d 577, 584 (2d Cir. 1994). Parent Co argues that each step of its transaction had separate economic significance, aside from federal tax savings.

However, the existence of economic substance or a valid non-tax business purpose in a given transaction does not preclude the application of the step transaction doctrine. Thus, as the Tenth Circuit Court of Appeals explained:

> Events such as the actual payment of money, legal transfer of property, adjustment of company books, and execution of a contract all produce economic effects and accompany almost any business dealing. Thus we do not rely on the occurrence of these events alone to determine whether the step transaction doctrine applies. Likewise, a taxpayer may proffer some non-tax business purpose for engaging in a series of transactional steps to accomplish a result he could have achieved by more direct means, but that business purpose by itself does not preclude application of the step transaction doctrine.

True v. United States, 190 F.3d 1165, 1177 (10th Cir. 1999) (footnote omitted). However, nothing we have seen indicates any economic substance to US Sub's acquisition of the Type V Preferred stock. US Sub did not receive any economic advantage from its purported ownership of the stock, other than what we expect were the intended tax advantages. The stock was nonvoting stock. US Sub did not receive any dividends on this stock.

Moreover, the transaction in which Parent Co "borrowed" cash from Country B Entity is part of a plan to maximize Parent Co's U.S. tax benefits. In repatriating income in the form of "borrowing," Parent Co sought to avoid the normal tax costs of repatriating income. Parent Co failed to make any payments on the note to Country B Entity so that interest payments accrued. Country B Entity's use of the Parent Co Note to redeem its Type V stock was part of an integrated plan carried out to obtain tax benefits.

Finally, the step transaction doctrine's end result test analyzes whether the formally separate steps merely constitute prearranged parts of a single transaction intended from the outset to reach a specific end result. This test relies on the parties' intent at the time the transaction is structured. The intent the courts focus on is not whether taxpayers intended to avoid taxes, but whether the parties intended from the outset to "to reach a

particular result by structuring a series of transactions in a certain way." Additionally, they focus on whether the intended result was actually achieved. *True* at 1175. Sophisticated tax planners and taxpayers sometimes avoid memorializing their intentions in writings so as to avoid the application of the step transaction doctrine. However, the steps of the plan should be clear evidence of the parties' intent. Here, the fact that the Type V Preferred stock was structured from the outset to be "born to die"and was redeemed shortly after its issuance is strong evidence that the parties intended that the Type V Preferred stock's existence would be transitory.

In a recent case the Tax Court case disregarded the issuance and redemption of preferred stock of a Canadian subsidiary of a U.S. Parent Co. *InterTAN v. Commissioner,* T.C. Memo 2004-1, *assessment of penalty aff'd*, 2004 U.S. App. LEXIS 25192 (5th Cir. 2004).[9] The court found that "[t]he disputed transaction resulted in no change or the economic position of either petitioner or [its subsidiary]," and that "[t]he purported issuance to petitioner of [the subsidiary]'s preferred stock was but one fleeting, transitory step in the disputed transaction that was undertaken so that [the subsidiary] could immediately redeem that stock, thereby enabling petitioner to claim that such redemption resulted in a dividend to it under sections 302 and 301." *Id.* at 40. The purported dividend, as here, would have made available tax credits otherwise unavailable to the taxpayer.[10] The court therefore found that "the disputed transaction, including the purported issuance to petitioner of [the subsidiary]'s stock and the purported redemption by [the subsidiary] of that stock, should be disregarded."

The timing of the *InterTAN* issuance and redemption may appear more egregious than the timing of the instant case because the issuance and redemption in *InterTAN* occurred on the same day. However, taxpayers should not be able to avoid the application of the step transaction doctrine by merely "waiting out" whatever they perceive to be the step transaction doctrine's clock, especially when the parties are related and are in control of events. The Country B Entity Type V stock had only a transitory existence. In the instant case, as in *InterTAN,* the preferred stock was issued in order to be redeemed so as to obtain certain U.S. federal tax results consequent on the redemption.

The three step transaction tests are not mutually exclusive and the requirements of more than one test may be met in one transaction. Further, the circumstances of a transaction need only satisfy one of the tests for the step transaction to operate. *Associated Wholesale Grocers, Inc. v. United States,* 927 F.2d 1517, 1527-1528 (10th Cir. 1991)

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[9] The taxpayer appealed only from the Tax Court's assessment of an accuracy-related penalty, not from the decision on the specific issue discussed here.

[10] In InterTAN, a simple dividend would have resulted in Canadian nonresident withholding tax.

(finding the end result test inappropriate but applying the step transaction doctrine using the interdependence test).

Courts have held that in order to collapse a transaction, the Government must have a logically plausible alternative explanation that accounts for all the results of the transaction. *Del Commercial Props. Inc. v. Commissioner*, 251 F.3d 210, 213. (D.C. Cir. 2001), *aff'g* T.C. Memo. 1999-411. The Government has provided two alternative explanations for the current transaction:

(1) The distribution and redemption of the Type V Preferred stock are ignored. The purported $hh loan from Country B Entity to Parent Co is treated as a distribution rather than a loan (and the Parent Co Note is ignored).[11] Country B Entity is treated as issuing $ll cash, the Country B Entity Note and common stock equal to the Excess Value of the IP to US Sub in exchange for the IP. US Sub is treated as distributed all such common stock to Parent Co.

(2) The distribution and redemption of the Type V Preferred stock are ignored. The Parent Co Note is given effect.[12] US Sub is treated as exchanging the IP for Type U stock, the two notes and $ll.

One possible objection to the plausibility of this explanation is that the Parent Co Note did not exist on Date 17, Year 8 (the date US Sub transferred the IP to Country B Entity). The Parent Co Note was not issued until several months later. Thus, Country B Entity could not have transferred the Parent Co Note to US Sub on Date 17. However, § 351 does not require the § 351 transfers between the transferor and transferee to take place on the same date. Moreover, taxpayers should not be able to insist that the Government account for every legal relationship and timing sequence created by the transacting parties in order for the Government to assert a step transaction or substance-over-form argument. The court in *Long Term Capital Holdings v. United States,* 330 F.Supp. 2d 122, 207 n. 94 (D. Conn. 2004), in position of penalty aff'd, 2005 U.S. app. Lexis 20988 (2d Cir. Sept. 27, 2005), reasonably concludes that where, as here, one or two parties have "absolute control over the ultimate result" step-transaction doctrine may be applied in circumstances where it would be inapplicable if the parties were acting independently. Otherwise, the court notes that taxpayers could always avoid application of the step transaction doctrine and obtain tax results unintended by Congress.

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[11] As noted above, Parent Co indicated in its Protest that US Sub distributed the Parent Co Note back to Parent Co so that the Parent Co Note was extinguished.

[12] The stipulated facts do not state that US Sub distributed the Parent Co Note to Parent Co. Thus, we include this characterization of the transaction because it is consistent with the limited facts in the stipulation.

2. The Application of Section 351(b) versus Section 367(d)

In Step 3 of the transaction, as described in part II(A) of this memorandum, US Sub transferred IP to Country B Entity in exchange for Country B Entity Type U stock of $dd and Country B Entity Type V stock of $ee. The exchange is described in § 351. The Country B Entity Type V Stock was non-qualified preferred stock under § 351(g), and is therefore "other property" ("boot") for purposes of § 351(b). The Service, in its proposed adjustment, did not respect the issuance and redemption of the Country B Entity Type V stock. Instead, US Sub was treated as receiving notes and cash that total $ee.[13] This would also be treated as boot for purposes of § 351(b). Thus, regardless of which position of the issuance and redemption of the Type V stock is adopted, there is $ee of boot in this exchange for purposes of applying § 351(b). Because US Sub's basis in the IP it transferred was $aa, under § 351(b) this would result in US Sub recognizing $ee of gain on the transfer.

US Sub, a domestic corporation, transferred the IP to Country B Entity in an exchange described in § 351. When a U.S. person transfers intangible property to a foreign corporation in an exchange described in § 351, it is treated as a sale by the U.S. person to the foreign corporation in exchange for annual payments over the useful life of the intangible that contingent on the use, productivity, or disposition of the intangible. Sections 367(d)(1) and (2). These payments must be recognized even if the foreign corporation does not actually pay them. Treas. Reg. § 1.367(d)-1T(a). Thus, US Sub must recognize deemed annual payments with respect to the *entire* amount of the IP it transferred, not just the amount of the IP that is equal to the value of the Type U stock.

Neither the Code nor the regulations provide a rule for coordinating §§ 351(b) and 367(d). In order to determine the correct amount and character of the proposed adjustment, therefore, it is important to know whether both sections apply to the entire exchange, or if one section takes precedence over the other.

If both sections apply to this transaction without regard to the other, the transferor is taxed twice with respect to the boot portion of the exchange. That occurs because § 351(b) requires the transferor to recognize the gain in the exchange up to the amount of boot received in the exchange and, at the same time, § 367(d) requires the transferor to include deemed annual payments with respect to the entire value of the intangible property transferred, including the part for which the transferor was already compensated by the boot payment. Thus, if both these sections apply to the transfer in

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[13] As stated above, if the Parent Co Note and accrued interest are not respected, US Sub would be treated as issuing $yy of additional shares of Country B Entity common stock rather than the Parent Co Note (including accrued interest payments).

this case, US Sub would recognize gain to the extent of the $ee of boot under § 351(b) and it must also take into income deemed annual payments with respect to the entire value of IP transferred (i.e. $cc using Parent Co's valuation).

We believe that Congress did not intend to tax the transfer of intangible property twice (to the extent that there is boot). In its explanation of § 367(d) in the Explanation of Provisions [of the Deficit Reduction Act of 1984] Approved by the Committee, the Senate Committee on Finance stated:

> [A] number of U.S. companies have adopted a practice of developing patents or similar intangibles at their facilities in the United States. When these intangibles appear to be ready for profitable exploitation, they are transferred to a manufacturing subsidiary incorporated in a low-tax jurisdiction (or a high-tax jurisdiction that offers a tax holiday for specified local manufacturing operations). By engaging in such a practice, the transferor U.S. companies hope to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with the development of the transferred intangible and, *by transferring the intangible to a foreign corporation at the point of profitability, to ensure the deferral of U.S. tax on the profits generated by the intangible*. By incorporating the transferee in a low-tax jurisdiction, the U.S. companies also avoid any significant foreign tax on such profits.

S. Prt. 98-169, 98th Cong. 2d Sess., vol. 1 at 361 (1984)(italics added). This history makes it clear that Congress was concerned that the U.S. person could effectively avoid paying any tax on the income received from the intangible. That indicates the goal was to ensure that the intangible was taxed once. The deemed sale provision in § 367(d) reflects that, too. In a § 351 exchange without boot, the rules of § 367(d) only tax the value of the intangible (as represented by the deemed annual payments) once. Further, the regulations clearly contemplate that the foreign corporation may make actual payments for the income recognized under § 367(d) without the transferor incurring additional tax. Treas. Reg. § 1.367(d)-1T(g)(1).

Therefore, because the simultaneous application of §§ 351(b) and 367(d) results in double tax (to the extent of boot), this interpretation does not provide a proper result. Parent Co apparently does not dispute this conclusion. Instead, Parent Co contends that US Sub recognized[14] $ee of gain first under § 351(b) (whether or not the Treaty applies),

[14] If a transfer by US Sub is subject to a recognition provision of the Code, US Sub has a "recognition" event whether or not the Treaty applies. If, as Parent Co argues, the Treaty applies, US Sub recognizes gain, but is exempt from paying the U.S. federal income tax that would otherwise result from such recognition. As explained more fully in the Appendix, certain positive basis adjustments go hand in hand with recognition under § 351(b), rather than the actual payment of tax. Thus, Parent Co seeks to maximize the number of recognition events in the transaction. A Parent Co not claiming treaty protection would not likely claim the application of § 351(b) because such basis adjustments would have a cost.

and that US Sub is subject to § 367(d) treatment only for that portion of the IP transferred to Country B Entity in exchange for the Country B Entity Type U stock (i.e., $dd of the value of the IP). Thus, Parent Co avoids the double tax problem caused by the simultaneous application of §§ 351(b) and 367(d) by asserting an ordering rule that applies § 351(b) first.

By contrast, the Service takes the position that the entire IP value is subject to § 367(d) and that § 351(b) does not apply at all. Thus, US Sub would be required to take into income a payment that represents what it would have received if it had sold the IP for annual contingent payments based on productivity, use, or disposition of the IP. To the extent that the $ee of boot Parent Co received (whether it was non-qualified preferred stock or notes and cash) exceeded the § 367(d) annual payment in the year of the transfer, that excess is an advance payment on future § 367(d) annual payments. Under general tax principles, the advance payment is recognized in the year it is received. Thus, the effect of this treatment is that US Sub recognizes $ee of ordinary income in the year of the transfer under § 367(d).[15]

Note that Parent Co's treatment actually results in a larger income adjustment for the year of the exchange than the Service's treatment. Under Parent Co's approach, US Sub recognizes $ee of § 351(b) gain *plus* a § 367(d) payment on the remaining $dd value of IP that would be subject to § 367(d).

The following sections discuss in detail why § 367(d) governs the treatment of this exchange and why § 351(b) does not apply.

a. Section 367(d) takes precedence over § 351(b)

The double inclusion of § 351(b) gain is avoided by treating the entire transaction as subject only to § 367(d). This approach is suggested by the legislative history to § 367(d). Prior to the Deficit Reduction Act of 1984, U.S. persons who transferred assets (including intangible property) to a foreign corporation in a § 351 exchange were required to obtain a ruling from the Service that the transfer did not have as one of its principal purposes the avoidance of federal income tax. Congress repealed the ruling requirement in the Deficit Reduction Act of 1984 because the changes made to § 367 in that Act made it unnecessary. Of this change, Congress stated: "Taxpayers may now proceed with exchanges involving outbound transfers without advance or post-transaction IRS clearance. The exchanges will be tax free *or will involve the payment of an*

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[15] Given the useful life of nearly Number P years computed by the Service, the § 367(d) payment for the year of the transfer would be less than the boot received, and thus the remaining boot amount is treated as a pre-payment of future years payments. That results in US Sub recognizing income in the entire amount of the boot received.

appropriate toll charge, in accordance with the substantive rules set forth in section 367, as amended by the bill." S. Prt. 98-169, Deficit Reduction Act of 1984, Explanation of Provisions, Senate Finance Committee, 4/2/1984, pg. 369 (italics added). That indicates that Congress wanted § 367 to determine the taxable effect of these exchanges.

An examination of the structure of § 367 supports the conclusion that § 367(d) is meant to override § 351(b). Section 367(a) provides that, "if in connection with any exchange described in section 332, 351, 354, 355, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation." Because the transferor must be a corporation in order to get the benefit of non-recognition in the listed exchanges, § 367(a) has the effect of requiring the transferor to recognize the gain in the assets transferred. However, no loss may be recognized under § 367. Treas. Reg. § 1.367(a)-1T(b)(3)(ii). Because the foreign corporation is not a corporation for the purpose of determining gain on the transfer, § 367(a) clearly overrides § 351(b). The character and source of the gain is determined as if the property had been disposed of in a taxable exchange with the transferee foreign corporation. Treas. Reg. § 1.367(a)-1T(b)(4)(A). This generally results in the § 367(a) gain on the intangible transfer being treated as domestic source capital gain. Section 351(b) provides similar treatment of the exchange. The practical difference, then, between § 367(a) and § 351(b) is that the former taxes all of the gain and is not limited to the amount of any money and the fair market value of any property received in the exchange as in § 351(b).

Section 367(a)(3)(A) provides that the general rule in § 367(a) will not apply to property transferred for use in an active trade or business outside the United States. § 367(a)(3)(A). Intangible property, however, does not qualify for this exception. § 367(a)(3)(B)(iv). Thus, under § 367(a), all transfers of intangible property by a U.S. person to a foreign corporation result in recognition of gain. If the goal were simply to tax the gain on the intangible like a regular sale, this provision is all that would be required—§ 367(d) would not be needed.

Section 367(d)(1) provides that § 367(a) does not apply to transfers of intangibles and that the rules of § 367(d) apply instead. As discussed earlier, § 367(d) requires the transferor to treat the exchange as a sale contingent on the productivity, use, or disposition of the intangible. The payments are treated as ordinary income and are sourced in the same manner as royalty payments, which generally results in treating them as foreign source income.[16] The approach taken in § 367(d) therefore resembles a

[16] When § 367(d) was enacted, it required that the payments be sourced in the U.S. However, in 1997 the Congress removed that requirement and instead provided that the income from sales of intangibles that are contingent on productivity, use, or disposition is sourced in the same manner as a royalty. See § 865(d).

license arrangement.[17] Thus, it is clear that Congress wanted the transfers of intangibles to a foreign corporation in a § 351 or § 361 exchange to receive different treatment than a transfer in a regular sale. In particular, it is apparent that these transfers were meant to result in ordinary income to Parent Co, not capital gain.

In the case of a corporate transferor, the main effect of treating the § 367(d) payment as ordinary income instead of capital gain is that the income cannot be offset by a capital loss. However, if the transferor is an individual, the ordinary income treatment means the transferor does not get the benefit of the lower capital gains rates in § 1(h). This is important because Congress was concerned about persons taking deductions against ordinary income under provisions like § 174 for developing the intangible and then transferring the intangible offshore to defer the income from using or licensing the intangible. If an individual transferor could deduct the cost of developing the intangible against ordinary income that is taxed at a rate of 39.6 percent and then transfer it to a foreign corporation that he controls and get taxed at a maximum rate of 15 percent, that would provide a Parent Co with some of the same advantage that Congress intended to eliminate when it enacted § 367(d). Thus, § 367(d) should control the entire exchange in order to carry out the evident intent of Congress in enacting this provision.

Once the simultaneous application of §§ 351(b) and 367(d) is rejected, these two sections are conflicting provisions because they provide different tax effects for the same exchange. Therefore, it is useful to consider principles of statutory construction that are used to resolve these kinds of statutory conflicts. "When two statutes are in conflict, that statute which addresses the matter at issue in specific terms controls over a statute which addresses the issue in general terms, unless Congress has manifested a contrary aim." *Greene v. United States,* 79 F3d 1348 (2d Cir. 1996). In this instance, § 367(d) is the more specific statute, as it applies only to transfers of intangibles to foreign corporations in a transaction described in § 351 (or § 361), whereas § 351(b) can apply with respect to the transfer of any property (real property, tangible personal property, and intangible property) to any foreign or domestic corporation.

Finally, we note that the regulations provide that the foreign corporation may make actual payments to the U.S. transferor with respect to the deemed payments the U.S. transferor must recognize as income. The payment that the foreign corporation makes in that first year, whether made on the date of the IP transfer, or at a later time, is not treated as "boot" in the § 351 transfer, but instead is treated as a § 367(d) payment. So, another way of reaching the conclusion that § 367(d) controls the outcome in these exchanges is simply by characterizing any payment received from the transferee with

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[17] Indeed, the House version of § 367(d) had provided that the income would be treated as if the property had been transferred to the foreign corporation in an exclusive licensing agreement.

respect to the transfer of the intangible as a § 367(d) payment and not as "money or other property" in a § 351 exchange.

b. Section 367(b) cannot take precedence over § 367(d)

The other possible approach is to apply § 351(b) first, as Parent Co contends. In this case, that would mean treating the $ee of boot as § 351(b) gain in the year of the transfer and then § 367(d) applies only to the extent of the Type U stock received in the exchange. That results in two different treatments for the income US Sub recognizes from the exchange. Assuming the IP is a capital asset, US Sub would recognize capital gain income under the sale of exchange treatment of § 351(b). It also would be U.S. source income because US Sub is a resident of the U.S. under § 865(g) and generally sales of intangible property that are not contingent on productivity, use, disposition of the property are sourced where the seller resides. § 865(d)(1).

The § 367(d) annual payments, on the other hand, are ordinary income. § 367(d)(2)(C). In this case, the payments are likely to be foreign source income. Payments under § 367(d) are sourced in the same manner as a royalty. Section 865(d)(1)(B). Royalties received from the use of the intangible outside the U.S. are generally foreign source income. § 864(a)(4). Thus, the approach of applying § 351(b) first results in this case in US Sub recognizing two very different types of income on the same transfer: domestic source capital gain with respect to gain from the boot and foreign source ordinary income with respect to the remaining value of the IP. There is nothing in the Code to suggest that Congress intended this bifurcated result. Indeed, in general the income from a given exchange is all of the same source and character except where Congress has explicitly provided otherwise, as in various depreciation recapture provisions.

Furthermore, giving § 351(b) precedence over § 367(d) presents another difficulty. Section 367(d) payments must be commensurate with income. Section 351(b) gain does not have a commensurate with income requirement. As a result, this bifurcation would complicate efforts to compute what amount to attribute to the § 367(d) payments if some adjustment is necessary under the commensurate with income standard.

As discussed above, both the Congressional intent behind § 367(d) and the rules of statutory construction demonstrate that § 367(d) must take precedence over § 351(b). Congress intended for income from intangible property transferred to a foreign corporation to be ordinary income. Treating the exchange under § 351(b) permits some of the income from the IP to be taxed as a capital gain rather than ordinary income, defeating that intent.

Thus, for all the foregoing reasons, we conclude that § 367(d), not § 351(b), will determine the tax consequences where a U.S. person transfers intangible property to a

foreign corporation in a exchange described in § 351 and boot is received in the exchange.

III. Analysis of Country B Entity's Acquisition of the Excess Value

Not only do Parent Co and the Service disagree on the fair market value of the IP at the time Country B Entity acquired it, but they disagree as to the proper characterization of the transaction. To the extent the value of the IP was in excess of $cc, we refer to this amount as the "Excess Value." As this memorandum explains in Part III,(A), the Excess Value must be reflected in Parent Co's equity ownership of Country B Entity common shares. There are various ways Parent Co could have acquired this Excess Value. Parent Co takes issue at the Service's characterization. Three alternative explanations of Parent Co's acquisition of such Excess Value are explained below. All of the alternatives result in the same current adjustment.

A. Why the Excess Value is attributed to the Country B Entity common shares.

When due regard is given to the terms of the various documents executed by Parent Co, US Sub and Country B Entity in this case, it is clear that the Excess Value must be reflected in the common stock that Parent Co holds in Country B Entity, and not, as Parent Co contends, in the Type U stock that US Sub holds in Country B Entity.

In order to understand the Service's analysis of Country B Entity's acquisition of the Excess Value IP, it is important to first understand the economic result of the transaction following the form that Parent Co used (i.e, a transfer of IP from Parent Co to US Sub followed by a transfer of IP from US Sub to Country B Entity), as explained above. The contribution of the IP by Parent Co to US Sub in exchange for US Sub Type T stock resulted in US Sub holding IP valued at $uu.[18] Parent Co owned all of the stock interests in US Sub both before and after the exchange, so the value of its investment in US Sub was increased by $uu. The subsequent Transaction of US Sub to Country A Political Subdivision did not change this result.

When US Sub contributed the IP to Country B Entity, value was shifted to Parent Co's Country B Entity common shares. US Sub transferred IP worth $uu to Country B Entity for Country B Entity Type U stock valued by Parent Co at $dd and Type V stock valued by Parent Co at $ee. Thus, US Sub transferred property worth $uu in return for total consideration of just $cc. As explained further below, because US Sub's aggregate preferred stock interests in Country B Entity were fixed at a value of $cc, the Excess

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[18] Although this memorandum does not comment on the value of the IP, we use the Service's valuation for this discussion. To extent the value of the IP exceeds Parent Co's valuation, our analysis would be the same.

Value amount must have enhanced the value of some other class of Country B Entity stock. The only class of Country B Entity stock that was not fixed in value at the time of the IP contribution was the Country B Entity common stock. Therefore, only the value of the Country B Entity common stock could have been enhanced by the Excess value.

Parent Co argues that the Excess Value should be attributed to the Country B Entity Type U shares.[19] However, based upon the terms of Parent Co's documents which specify the terms of the Type U stock, that is not possible. The Resolution provides the specific number of Type U stock to be issued in exchange for the IP and specifies that the original issue price is $ww per share. Further, the Resolution requires Country B Entity to redeem the Type U shares in three annual installments starting on the 21st anniversary of the original issue date. The Resolution provides that the redemption price for each share is the original issue price of $ww (as adjusted for share dividends, combinations, splits, recapitalizations, etc., plus declared and unpaid dividends with respect to the Type U shares). Thus, upon the redemption of the Type U stock, US Sub would receive $ww per share, for a total of $dd (as adjusted). Thus, as the value of each share of the Type U Stock was fixed at $ww, and the total number of shares was fixed, the Excess Value cannot be attributed to the Type U stock.

Between the issue date and the redemptions starting in the 21st year, at US Sub's option, the Type U stock may be converted to common shares. The formula for conversion, when properly reduced, is: C = $ww/$F x S.

- C is the number of Country B Entity common shares to be received from the conversion.
- The $ww figure is the original price of the Type U stock at issuance.
- F is the fair market value of the Country B Entity common on the date that the Type U stock is issued.
- S is the number of Type U shares to be converted.

The following example shows how the formula works:

> Two companies, X and Y, decide to form a new corporation, Z. X contributes property with a fair market value of $200,000 and gets back 200 shares of preferred stock with an issue price of $1,000 per share and with the same rights

[19] It is clear that no other Country B Entity preferred stock interests were enhanced by the Excess Value. The Type T and Type W shares were non-voting shares, were not convertible to common shares, and had fixed liquidation values of $zz and $ll per share respectively. The Type V shares were also non-voting shares, were not convertible to common, and were redeemable at any time for the issue price plus accrued but unpaid dividends. Furthermore, Country B Entity did redeem the Type V stock Number N months later for property totaling the issue price of $ee.

as those of the Country B Entity Type U stock described above. Y contributes $400,000 cash and receives in exchange 400 shares of common stock issued at $1,000 per share. A few days after this transaction, X decides to convert the 200 shares of preferred stock it owns to common stock. Applying the formula above, X will receive: $1,000/$1,000 x 200 = 200 shares of common stock. Because each share of common is worth $1,000, after the conversion X holds common stock worth $200,000, the same as the issue price of the preferred shares X gave up.

Suppose, however, that the above facts remain the same except that the fair market value of the property that X contributed to Z was actually worth $600,000. As in the original facts, X still only receives 200 shares of preferred stock with an issue price of $1,000 a share (for a total of $200,000). The "Excess Value" in this example is $400,000. X requires Z to redeem all of its preferred shares. Immediately prior to the redemption, Z is worth $1 million (i.e., $600,000 + $400,000). X's preferred stock will still be redeemed for just $1,000 per share (plus declared but unpaid dividends). Presuming there are not any declared but unpaid dividends, X will receive $200,000 in exchange for its preferred shares (and Z's worth will then be reduced by $200,000 to $800,000). Y, the only remaining shareholder of Z, will hold Z common shares worth the entire $800,000. Thus, the entire $400,000 of Excess Value is reflected in Y's common stock ownership of Z. Each share of Z's common stock is worth $2000.

If instead of redeeming its preferred Z stock, X converts its preferred Z stock into common shares, the formula (C = $1,000/$F x S) determines how many shares of common stock X will receive. Thus, X receives 100 shares of Z common stock as follows:

Number of common Z shares received by X = $1,000/$2,000 x 200 = 100.

Thus, X receives 100 shares of common stock, each worth $2,000, for a total of $200,000 worth of stock, exactly the value of the preferred stock it gave up. This formula, by pricing the amount of common shares to be received in relation to a fixed value of $1,000 for the preferred is designed to give X for each share of preferred stock converted the number of common shares that, at issuance, would have been worth the $1,000 stated value of the preferred share. So, if all 200 shares of preferred are converted, the formula will always give X the number of common shares that together would have been worth $200,000 on the date the preferred stock was issued. Thus, regardless the amount of property X contributed to Z, the formula will always give X the same value of common stock as the *stated* value of the preferred stock it held, i.e. $200,000. The value of the property X contributed to Z that exceeds $200,000 therefore benefits the common shares that Y holds in Z. On the other hand, if the property X contributed was

> worth less than $200,000, it is the value of the common shares that take the loss, to Y's detriment.
>
> X will not enjoy the "upside" benefit of common stock ownership until after the conversion. Unlike common stock, however, until X converts the preferred stock, X is protected against decreases in common stock price because, upon redeeming the preferred shares, X will be able to recover its original $1000 per share investment.
>
> Thus, clearly the preferred stock X received is only worth $200,000, and any excess value that X contributed to Z must benefit the common shares —the common shares are the only shares that do not have a fixed value.

US Sub received Number K shares of Country B Entity Type U stock that was priced at $ww per share at issuance, for a total of $dd of preferred stock. As demonstrated above, if US Sub had promptly converted its Country B Entity Type U shares to Country B Entity common, the conversion formula would have given US Sub $dd worth of Country B Entity stock. On the other hand, if US Sub holds the stock until it is redeemed starting in the 21st year, it will receive $dd (plus declared but unpaid dividends.) The Excess Value of the IP, therefore, does not increase the value of the Country B Entity Series C stock as Parent Co contends, but rather it can only increase the value of the Country B Entity common shares, all of which are held by Parent Co. Thus, even though in form US Sub contributed the Excess Value to Country B Entity, the result is that Parent Co's common stock in Country B Entity reflects the Excess Value. Parent Co's proposal that the Excess Value be attributed to US Sub's Type U stock is not consistent with the terms of its own documents. Parent Co cannot now disavow its own documents.

B. Tax treatment of Country B Entity's Acquisition of Excess Value

Even though, in form, Parent Co contributed the IP (including the Excess Value) to US Sub, and US Sub, in turn, contributed it to Country B Entity, the result is that all of the Excess Value is reflected in Parent Co's common stock ownership of Country B Entity. There is a shift of value from US Sub to Parent Co. The transfer of value must be accounted for in the federal tax treatment of the transaction. Parent Co does not acknowledge this shift in value in its Protest and thus, did not provide an explanation of its tax treatment. As discussed, the Excess Value cannot merely be attributed to the Country B Entity Type U stock and the value shift cannot simply be ignored.

In its notice of proposed assessment, the Service offered two tax explanations to account for Country B Entity's acquisition of the Excess Value. Although Parent Co contends that both explanations are unwarranted attempts to disregard Parent Co's form, this is simply not the case. As set forth below, this explanation is what the

applicable tax law governing the transaction demands, taking into account how the Parent Co structured the transaction.

There are two § 351 exchanges in the transaction: the transfer of the IP from Parent Co to US Sub, followed almost immediately by a second transfer of the IP from US Sub to Country B Entity. Although § 351 does not specifically require that each transferor participating in a § 351 transaction receive stock of the transferee proportional in value to the value of the property transferred, § 351 does require that the transaction be given tax effect in accordance with its true nature.[20] Example 1 of Treas. Reg. § 1.351-1(b)(2) illustrates this point.[21] In Example 1, a Father and Son, each a transferor, are treated as having received stock of the transferee corporation equal in value to the property the transferor transferred, and then Father is treated as gifting shares of the transferee corporation to Son, or uses such shares to pay Son for services Son rendered to Father. Deemed steps are required to explain the economic shift in value from the Father to Son. Similarly, in the case of Parent Co's transaction, deemed steps are needed to explain the shift in value from US Sub to Parent Co.

In accordance with these rules, the Service offered two explanations for the shift in value in its notice, the "indirect transfer" and the "direct transfer." We note that both of these explanations yield the same adjustment; they are just two different ways to reach the same outcome. The two approaches and the tax effects of each are detailed below.

1. Indirect Transfer

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[20] Treas. Reg. § 1.351-1(b)(1) provides that "where property is transferred to a corporation by two or more persons in exchange for stock or securities . . . it is not required that the stock and securities received by each be substantially in proportion to his interest in the property immediately prior to the transfer. However, where stock or securities received are in disproportion to such interest, the entire transaction will be given tax effect in accordance with its true nature, and in appropriate cases the transaction may be treated as if stock and securities had first been received in proportion and then some of such stock and securities had been used to make gifts (§ 2501 and following), to pay compensation (§ 61(a)(1)), or to satisfy obligations of the transferor of any kind."

[21] In Example 1, Father and Son organize a corporation with 100 shares of common stock. Father transfers property worth $8000 in exchange for 20 shares of stock and Son transfers property worth $2000 in exchange for 80 shares of stock. Father and Son did not end up with interests in the transferee corporation proportionate with their respective contributions. Although the transaction is still one described in § 351, additional Code provisions must be applied to tax the transaction appropriately. If it is determined that Son ended up with the added value because Father made a gift to son, such gift would be subject to tax under § 2501 *et seq.* If it is determined that Son had rendered services to the Father (such services having no relation to the assets transferred or to the business of the transferee corporation), and the disproportionate value received by Son is attributable to compensation paid by Father to Son, Son will be taxed on the fair market value of the 60 shares of stock received as compensation for services rendered, and Father will realize gain or loss upon the difference between the basis to him of the 60 shares and their fair market value at the time of the exchange.

We start with a detailed explanation of the indirect transfer because it more closely tracks the form of Parent Co's transaction:

Step 1: Parent Co contributed the IP to US Sub in a § 351 exchange. Parent Co's pre-contribution basis in the IP was $aa. Parent Co received in exchange US Sub Type T with a value of $cc and deemed additional shares of US Sub common stock worth the Excess Value.[22] Alternatively, rather than the deemed issuance of US Sub common stock, the Excess Value may be added to the value of Parent Co's existing US Sub common shares.[23] Each method of accounting for the Excess Value provides the same result. [24] In each case, following the transfer:

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[22] We note that with regard to Step 1, Parent Co proposes that the Excess Value "can be accounted for by repricing the [US Sub Type T] Stock," a method that Parent Co alleges (without explanation) is "consistent with Section 482 principles." We note, however, that the terms of the US Sub Type T shares fix the value of the stock at $ww a share and thus the shares are not easily revalued. Parent Co confirmed this valuation during the examination, stating that the Type T Stock had a "fair market value at the time of the contribution of $cc." Response to Document Request number I.E. 0062, August 11, 2003. Further, Parent Co described the US Sub Type T stock as follows: "[Parent Co] held [Number O] shares of [US Sub] common stock issued at [$aaa] per share. The [Type T] shares [US Sub] issued were issued at [$ww] per share. The Type T shares were, at the option of the holder, convertible to common stock at a prescribed rate. The purpose of the reverse stock split was to increase the value of each share of common stock to [$ww] so that the conversion ratio of Type T shares to common shares would be 1:1." Response to Document Request number I.E. 0061, August 11, 2003. In addition, the chart presented in the August 11, 2003 Response to Document Request number I.E. 0065 states that US Sub issued Number J Preferred shares Parent Co on Date 14, Year 8 for an "Amount Paid" of "$cc." Because the value of the Type T shares are, by their terms, fixed in value, the Excess Value must increase the value of the US Sub common shares. Thus, Exam deemed Parent Co to receive additional shares of US Sub common stock to account for the Excess Value.

[23] We mention this alternative because Parent Co has stated that it is not necessary that US Sub issue additional shares of common stock to account for the Excess Value. As Parent Co was the sole owner of US Sub at the time of the transfer, Parent Co asserts that it would be a "meaningless gesture" for US Sub to issue additional shares of stock to Parent Co. Instead, Parent Co argues that, if there was extra value in the IP, that excess could be added to Parent Co's existing US Sub common shares. We conclude that adding value to the existing common shares or deeming the issuance of additional shares results in the same adjustment to Parent Co. Although we do not find a reason for Parent Co's argument, we address both methods for the sake of completeness.

[24] Prior to Parent Co's IP transfer to US Sub, Parent Co owned all of the common stock of US Sub. When Parent Co transferred the IP to US Sub, Parent Co had a $aa basis in the IP. When US Sub issued Type T stock with a fair market value of $cc to Parent Co in exchange therefore, Parent Co's basis in such stock was $aa. To the extent US Sub is deemed to have issued additional common shares to Parent Co in exchange for the Excess Value, the basis of such Excess value common shares is $aa and their fair market value is equal to Excess Value. To the extent that such an issuance of additional shares is construed as a "meaningless gesture" because Parent Co owns 100 percent of US Sub's common stock, the IP contribution would increase the basis in Parent Co's existing US Sub common shares by $aa and would increase their fair market value by an amount equal to the Excess Value.

- Parent Co owns US Sub Type T stock
  - Fair Market Value = $cc
  - Basis = $aa (§ 358)
- Parent Co owns 100 percent of the US Sub common stock
  - Fair Market Value = Prior Value + Excess Value
  - Basis = Prior Basis + $aa (§ 358)
- US Sub holds IP worth $uu
- US Sub's basis in the IP is $aa (§ 362(a))

We note that Parent Co's "meaningless gesture" argument does not change this outcome and merely distracts from the real issues in this case.

Step 2: On Date 14, Year 8, US Sub conducted Transaction into Country A Political Subdivision in a transaction described in § 368(a)(1)(F). For U.S. federal income tax purposes, US Sub is deemed to transfer the IP to US Sub in exchange for (deemed) US Sub stock. US Sub recognizes no gain or loss on such deemed transfer. Section 361(a). US Sub's basis in the IP is $aa. Section 362(a). US Sub has no gain or loss on the deemed issuance of its stock in exchange for the IP. Section 1032(a). Parent Co's basis in its US Sub stock is the same as its basis in its US Sub stock immediately preceding the § 368(a)(1)(F) reorganization. US Sub remains a domestic corporation.

Step 3: On Date 17, Year 8, US Sub contributes the IP to Country B Entity in exchange for Country B Entity Class C Preferred stock, Type V Preferred stock and Country B Entity common stock. The issuance of the Country B Entity Type V Preferred stock is, however, collapsed with the redemption (see discussion above). The Service treats US Sub as receiving in the exchange Country B Entity Type U shares in the amount of $dd; notes and cash of $ee; and deemed Country B Entity common stock of Excess Value.[25]

Section § 367(d) applies to the entire exchange. US Sub must recognize deemed annual payments based on productivity, use, or disposition of the IP. Section 367(d)(2). This income is ordinary income. It is sourced in the same manner as a royalty. § 865(d). US Sub's deemed Excess Value Country B Entity common stock has a basis of $aa and a fair market value equal to that of the Excess Value. Pursuant to the § 367(d) regulations, Country B Entity has a $aa basis in the IP. The notes and cash totaling $ee are treated as payment against the § 367(d) income and are not subject to § 351(b). To the extent that this amount exceeds the § 367(d) payment for the year, it is treated as an advance

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[25] To the extent that the Parent Co Note (including accrued interest) is not respected, proper adjustments must be made.

payment on the future § 367(d) income and is included in income in the year it is received.

Step 4: US Sub is treated as immediately distributing the Country B Entity deemed common stock to Parent Co. The tax results are the same whether this distribution is treated as a dividend distribution or as a distribution in redemption of stock.[26]

Result: Parent Co is treated as receiving the Country B Entity common stock from US Sub and the rules of Regs. § 1.367(d)-1T(e)(1) apply.[27] As a result, the portion of the § 367(d) annual payments that US Sub was required to take into income are now included in the income of Parent Co.[28]

If instead, Parent Co is treated as directly transferring the Excess Value IP to Country B Entity in exchange for Country B Entity common stock (as described in the direct transfer discussion below), § 367(d) applies and Parent Co will still take into

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[26] A dividend distribution from one member of a consolidated group to another member is treated as an intercompany transaction. Treas. Reg. § 1.1502-13(b)(1)(D). An intercompany distribution is not included in the gross income of the distributee member to the extent there is a corresponding negative adjustment reflected under Treas. Reg. § 1.1502-32 in the distributee's basis in the stock of the distributing member. Treas. Reg. § 1.1502-13(f)(2)(ii). The distributee does not include a distribution in gross income under § 301(c)(3) even if the distribution is in excess of the distributee's basis in of the stock of the distributor if the distribution results in an excess loss account under Treas. Reg. § 1.1502-32(a) that is treated as negative basis under Treas. Reg. § 1.1502-19. *Id.* If US Sub is treated as redeeming Parent Co's Excess Value US Sub common stock, the result would be the same.

[27] Treas. Reg. § 1.367(d)-1T(e)(1) states that if a U.S. person transfers intangible property that is subject to § 367(d) and the rules of this section to a foreign corporation in an exchange described in § 351… and, within the useful life of the transferred intangible property, that U.S. transferor subsequently transfers the stock of the transferee foreign corporation to U.S. persons that are related to the transferor within the meaning of paragraph (h) of this section, then the following rules apply:

(i) Each such related U.S. person shall be treated as having received (with the stock of the transferee foreign corporation) a right to receive a proportionate share of the contingent annual payments that would otherwise be deemed to be received the U.S. transferor under paragraph (c) of this section.

(ii) Each related U.S. person shall, over the useful life of the property, annually include in gross income a proportionate share of the amount that would have been included in the income of the U.S. transferor pursuant to paragraph (c) of this section. Such amounts shall be treated as ordinary income from sources within the United States.

(iii) [provides formula]

(iv) [applies to subsequent transfers]

[28] To the extent that the Parent Co Note is disregarded, Country B Entity would be treated as making a § 367(d) payment (equal in value to the purported loan) to Parent Co.

income the deemed annual payments attributable to the Excess Value. In each case, Parent Co's tax resulting from the outbound IP transfer is the same.[29]

Parent Co concedes that if Parent Co is treated as owning Country B Entity stock to which § 1.367(d)-1T(e)(1) applies, it is taxed under § 367(d) as if it had received a share of the royalties.[30] However, Parent Co protests this result, arguing that Exam did not provide any authorities to support its arguments. Parent Co states that the Government cannot deem an issuance (and redemption) of stock without statutory authority and cannot rely on judicial doctrines such as economic sham or step transaction to create fictitious steps.

As discussed above, the Service responds that § 367(c)(2) is absolutely clear that "any transfer of property to a foreign corporation [in a § 351 transaction] … shall be treated as an exchange of such property **for stock of the foreign corporation equal in value to the fair market value of the property transferred**." (Emphasis added.) The Government's position is in strict conformance with this provision[31] and is fully consistent with Treas. Reg. § 1.351-1(b)(1) and (b)(2) Example 1.

2. Direct Transfer

The direct transfer alternative described below yields the same adjustment amount as the indirect transfer described in the preceding section. It achieves that result by using fewer steps, however, and thus the Service asserted it as its primary position.

Step 1: Parent Co transferred the IP in two parts: Parent Co transferred $cc of the value of the IP value to US Sub in exchange for $cc of US Sub Type T stock; Parent Co transferred Excess Value IP directly to Country B Entity in exchange for deemed additional common shares of Country B Entity stock.[32]

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[29] Note that the § 367(d) income that Parent Co recognizes on the Excess Value portion of the IP would not be protected by Parent Co's treaty argument.

[30] See p. 84 of Parent Co's Protest.

[31] While Parent Co cites *Esmark v. Commissioner*, 90 T.C. 171, 196 (1988), *aff'd mem.*, 886 F.2d 1318 (7th Cir. 1989), to argue steps cannot be created, we find it puzzling that Parent Co omits any mention of § 367(c)(2) and the § 351 regulations. In its Protest, Parent Co does not acknowledge these provisions at all, much less rebut their import.

[32] To the extent that the Parent Co Note is disregarded, Country B Entity would be treated as transferring its common stock and cash (equal in value to the purported loan) to Parent Co in this exchange. The cash would be treated as a § 367(d) payment (and, if appropriate, a prepayment).

Step 2. US Sub conducted Transaction to Country A Political Subdivision. See Step 2 of the indirect transfer discussion.

Step 3. US Sub transfers the IP to Country B Entity in exchange for (1) $dd of Country B Entity Type U Stock and (2) notes and cash in the amount of $ee. [33]

If Parent Co is treated as making a direct transfer, then Parent Co takes into account the § 367(d) income attributable to the Excess Value. Similarly, if Parent Co is treated as making an indirect transfer, as discussed above, Treas. Reg. § 1.367(d)-1T(e)(1) applies and Parent Co is still taxed on the § 367(d) amount related to the Excess Value. Thus, either way, Parent Co ends up recognizing the § 367(d) amount related to the Excess Value, tracking the economic benefit it received from the shift of the Excess Value from US Sub to Parent Co. [34] Therefore, even if the Treaty applied, it would not shield Parent Co from paying tax with respect to § 367(d) income it recognizes related to the Excess Value.

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[33] To the extent that the Parent Co Note is disregarded, such value would be attributed to Parent Co's Country B Entity common stock. Proper adjustments must be made to reflect this change.

[34] We note that if the Treaty does not apply, although the direct transfer approach results in the same current adjustment as the indirect transfer, the direct transfer avoids certain potential future gain recognition by US Sub. If US Sub is treated as distributing the deemed Country B Entity common stock to Parent Co as a dividend or in redemption, US Sub would have deferred gain equal to the difference between its basis in the Country B Entity common stock (i.e., $aa) and the fair market value of such stock. See Treas. Reg. § 1.1502-13 (f)(7), Exs. 1 and 4. Such gain would be recognized upon the occurrence of certain events (e.g., the deconsolidation of the group or a transfer of such Excess Value Country B Entity common stock outside the group). As explained in the 30 day notice, Exam determined that the "direct transfer" was the preferable approach. However, we stress that it is not necessary to determine which of the three alternatives (e.g., direct transfer, dividend or redemption) applies in order to compute the current tax adjustment, because all three alternatives result in the same current adjustment. Parent Co's criticism of Exam's use of the direct transfer approach is a diversion from the real issues of the case because it does not impact the resulting adjustment.

Appendix

This appendix describes the basis effects and other benefits we anticipate Parent Co will claim if the issuance of the Type V stock and the subsequent redemption are respected. The adjustments described below are based on Parent Co's application of § 351(b) (and the accompanying basis adjustments). As noted in part II(B)(2) of this memorandum, we do not agree with Parent Co's application of § 351(b).

ISSUANCE OF TYPE V STOCK (4/1/Year 8): Parent Co asserts that the Type V stock is nonqualified preferred stock ("NQPS"). Section 351(g)(1) states that in the case of a person who transfers property to a corporation and receives nonqualified preferred stock –

> (A) [§ 351(a)] shall not apply to such transferor, and
> (B) if (and only if) the transferor receives stock other than nonqualified preferred stock –
> > (i) [§ 351(b)] shall apply to such transferor; and
> > (ii) such nonqualified preferred stock shall be treated as other property for purposes of applying subsection (b).

Parent Co takes the position that US Sub recognizes gain on receipt of the NQPS under § 351(b). Parent Co also claims such gain is exempt from U.S. tax under the Treaty. We assume Parent Co wants § 351(b) to apply because gain recognition under § 351(b) gives rise to certain positive basis adjustments. Given Parent Co's position that § 351(b) applies to the issuance of the Type V stock, the Government expects Parent Co will claim:

US Sub's basis in its Country B Entity Type V NQPS (as "other property") increases from $aa to $ee under the application of § 358(a)(2).[35]

Country B Entity's basis in the IP is increased from $aa to $ee million under the application of § 362(a).[36]

Parent Co's basis in its US Sub stock is increased by $ee under § 1.1502-32.[37]

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[35] Section 358(a)(2) states that the basis of any other property (except money) received by the Parent Co shall be its fair market value. The Type V stock is treated as "other property" under § 351(g).

[36] Section 362(a) states that if property was acquired … by a corporation—

> (1) in connection with a transaction to which § 351 applies …, or
> (2) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain **recognized** to the transferor on such transfer. [Emphasis added.]

Parent Co takes the position that US Sub is a member of its consolidated group but US Sub's taxable income under § 351(b) is not subject to tax in the US. Therefore, we expect Parent Co to take the position that the value of the Type V stock is not to be included as consolidated taxable income.

Similarly, Parent Co claims US Sub's taxable income under § 367(d) is not subject to tax in the US. Therefore, we expect Parent Co to take the position that the value of the Type V stock is not to be included as consolidated taxable income.

Section 1.1502-32(b)(3)(ii)(A) defines "tax-exempt income" as S's income and gain which is taken into account but permanently excluded from its gross income under applicable law, and which increases, directly or indirectly, the basis of its assets (or an equivalent amount).

We expect Parent Co to take the position that US Sub's income recognition of $ee under § 351(b) is "tax-exempt income" within the meaning of § 1.1502-32(b)(3)(ii)(A). Accordingly, we expect Parent Co to take the position that it is entitled to a positive basis adjustment of $ee in its US Sub stock.

In summary, we expect Parent Co to claim that **the issuance** of the Type V NQPS gives rise to:

- a positive basis adjustment of $ee under § 358(a)(2);
- a positive basis adjustment of $ee under § 362; and
- a positive basis adjustment of $ee under § 1.1502-32

for a total of $xx in positive basis adjustments and the payment of no US tax.

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[37] Section 1.1502-32(b)(2) states that P's basis in S's stock is increased by positive adjustments and decreased by negative adjustments under this paragraph (b)(2). The amount of the adjustment, determined as of the time of the adjustment, is the net amount of S's --

(i) Taxable income or loss;
(ii) Tax-exempt income;
(iii) Noncapital, nondeductible expenses; and
(iv) Distributions with respect to S's stock.

Section 1.1502-32(b)(3)(i) defines "taxable income or loss" as consolidated taxable income (or loss) determined by including only S's items of income, gain, deduction, and loss taken into account in determining consolidated taxable income (or loss), treating S's deductions and losses as taken into account to the extent they are absorbed by S or any other member.

REDEMPTION OF TYPE V STOCK: Country B Entity redeems all of US Sub's Type V stock for an aggregate payment of $ee. See § 302. Although the NQPS qualified as "other property" under § 351(g) and is not treated as stock upon its issuance by Country B Entity in the § 351 transaction, the NQPS is considered stock for the purposes of its tax treatment on redemption. Under § 302(d), to the extent that Country B Entity had earnings and profits (E&P), US Sub is subject to dividend treatment (§ 301). To the extent that the redemption is respected, US Sub would have a recognition event on receipt of the § 301 dividend. To the extent that the distribution exceeds Country B Entity's E&P, the consideration is be treated as a return of capital. Here again, Parent Co claims that US Sub is exempt from US taxation under the Treaty. However, Parent Co claims that the dividend results in the Parent Co consolidated group's receipt of foreign tax credits. See § 902(a).

As explained above, we expect that Parent Co will take the position that US Sub had a basis of $ee in the Type V stock. Assuming that Parent Co claims the entire distribution was a dividend to US Sub rather than a return of capital, US Sub will claim it may shift its $ee basis in its Type V stock to its Type U stock.

Moreover, as discussed above, we expect Parent Co to take the position that US Sub's dividend income is "tax-exempt" income, and as such, Parent Co is entitled to make a positive basis adjustment in its US Sub stock of another $ee under Treas. Reg. §1.1502-32.

In summary, we expect Parent Co to claim that the redemption of the Type V stock gives rise to

- a positive basis adjustment of $ee to Parent Co's stock in US Sub under § 1.1502-32;
- foreign tax credits under § 902(a);
- a positive basis adjustment of $ee to US Sub's Class C Country B Entity stock (shifted from the Type V stock);
- no US tax.