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Internal Revenue Service National Office Field Service Advice

MEMORANDUM FOR DISTRICT COUNSEL,
CC
Attn:

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

SUBJECT: **Substance over Form Characterization of a Transaction**

This Field Service Advice responds to your memorandum dated July 28, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

P =
S =
PB =
B =
b =
date c =
date d =
date e =
date f =
date g =
x amount =

ISSUE

Whether S's alleged "sales" of the Distributed Assets to P are, in substance, dividend distributions to P.

CONCLUSION

S's alleged "sales" of the Distributed Assets to P are, in substance, dividend distributions to P.

FACTS

Background

This case involves a transaction in which P may attempt to effectively claim the losses on the sales of the Distributed Assets twice: once in selling the S stock (since P's stock basis in S would NOT be reduced by the losses on the sales of the Distributed Assets) and a second time in later selling the Distributed Assets (since section 267 provided that when P sold S outside the group, P increased its basis in the Distributed Assets by the amount of the losses that S recognized on S's sale of the Distributed Assets to P).

Facts --In General

P, the parent corporation of a consolidated group, wholly-owned a subsidiary, S. PB, a corporation unrelated to P, wanted to acquire S, but objected to purchasing certain unwanted assets held by S and its subsidiaries ("Distributed Assets"). S was engaged in the b business, and certain state regulatory rules required S to maintain certain surplus balances. These state regulatory rules, which restricted S's ability to make distributions, precluded S from making an outright distribution of the Distributed Assets to P.

P, PB and B reached an agreement on date f for P to sell to B (a subsidiary of PB) its stock in S -- without the Distributed Assets -- with economic effect as of date e.[1] This stock purchase agreement between P, PB and B contemplated that S and its subsidiaries (hereinafter referred to as just "S") were to "sell" the Distributed Assets before Date c, and P was to sell B its stock in S on Date d. While the agreement actually provided that P was to <u>either</u> sell the Distributed Assets <u>or</u> transfer the Distributed Assets, not only did state regulatory rules restrict S's ability to distribute the Distributed Assets (as previously indicated), but the sales agreement to sell the S stock also provided that S could not distribute amounts that S received in "selling" the Distributed Assets to P. The sales agreement also required S to have the permission of PB to pay a distribution, and indicated that S could not make a distribution to the extent it could lower S's Bests' ratings.

P, PB, and B structured the deal by agreeing to a "Base Purchase Price" for the S stock. This Base Purchase Price reflected the value of the S stock without the Distributed Assets. P, PB, and B then agreed to further increase this base purchase price by amounts arising from S's "sale" (rather than

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[1] We express no opinion on any tax consequences of the sale involving Code sections under the jurisdiction of CC:INTL.

distribution) of the Distributed Assets ("Excess Purchase Price" or "Excess Purchase Price Amount"). In form, S was to "sell" these Distributed Assets to P, and consequently, S was to hold the "cash proceeds" from these "sales" of the Distributed Assets which were to then factor into the amount of the Excess Purchase Price that B would pay to S. Or, in other words, B would "pay" an Excess Purchase Price to essentially "purchase" the "cash proceeds" that S received from P in "selling" the Distributed Assets to P. B also agreed to pay P interest on these cash proceeds held by S.

The parties structured the deal so that the overall economic effect of the deal was that the Distributed Assets were distributed to the Seller as of date e, and B purchased P's stock in S for the Base Purchase Price as of date e. Although S was to "sell" the Distributed Assets, S and B essentially planned the transaction to effect the same economic result as one in which S instead distributed the Distributed Assets. The P group acknowledged this in a proxy statement, stating the transaction has "approximately the same economic effect" as a transfer of the Distributed Assets "without the payment of any consideration," followed by a sale of the stock in S for the "Base Purchase Price."

Although in the transaction S was to "sell" the Distributed Assets to P, P did not have sufficient cash to "purchase" the Distributed Assets. Consequently, P negotiated short-term loans on date g to make the purchases. According to the credit agreement for these loans, P received the loans on the condition that P use the loan proceeds solely to acquire the Distributed Assets (or to refinance certain Distributed Assets purchased) and to repay these loans on the date on which S was sold to B. The credit agreement also required S to retain liquid assets equal to the outstanding debt balance. P could have issued notes to S to "purchase" the Distributed Assets, but P would have had to pay off these notes when P sold the S stock to B, by offsetting the amount of the notes against the amount of the sales "proceeds" (<u>i.e.</u>, with the result that B would pay less than the full amount of the "sales proceeds.")

Between date f and date d, S "sold" Distributed Assets having a value of x to P. The "sales" of the Distributed Assets would not have occurred but for the agreement for the sale of P's stock in S to B. P also requested permission from the state to resell the Distributed Assets to S in the event the sale to B was not consummated.

You conclude that S, in substance, distributed the Distributed Assets from S to P. We agree with this conclusion.

<u>LAW & ANALYSIS</u>

Where the substance of a transaction does not coincide with the form chosen by the parties, the transaction should be taxed in accordance with its substance. Gregory v. Helvering, 293 U.S. 465 (1935). The substance over form inquiry involves determining whether the labels of a transaction match the economic substance of the transaction as a whole. J.E.Seagram v. Commissioner, 104 T.C. 75 (1995). The meaning of a transaction may be more than its separate parts and the transaction must be viewed in light of the setting they occur and collectively create. Gregory v. Commissioner, 69 F.2d 809 (2d Cir. 1934); aff'd 293 U.C. 465 (1935). A transaction can be recharacterized where the form of the transaction does not match its substance and does not reflect the real rights and obligations of the parties. See Estate of Schneider v. Commissioner, 88 T.C. 906 (1988).

The form of the transaction in the instant case is a sale by S to P of the Distributed Assets for cash, and a sale by P of its stock in S, which held the cash received from P on S's sale of the Distributed Assets. However, the transaction's form does not match its substance. In substance, S distributed the Distributed Assets to P; B acquired the S stock for the Base Purchase Price; and B contributed cash to S in an amount equal to Excess Purchase Price.

In substance, PB or B, or both (depending on the extent to which the cash originated in either party) procured the bank debt. B then provided funds to P to repay the debt for it. B also paid interest to P to reimburse P for the use of the funds. In essence, P was essentially used as a conduit of PB or B, or both, to first take out the debt and to then repay that debt.

P did not bear the obligations -- nor obtain the rights -- with respect to the debt. The credit agreement required P to use the debt proceeds to "purchase" the Distributed Assets and to immediately repay the debt amounts from the "sales proceeds" received from B. In addition, S was required to hold liquid assets equal to the debt balance. Further, B "reimbursed" P for the interest amounts on S's holding of the debt proceeds.

Moreover, given its transitory nature, the bank debt was arguably illusory. Additionally, even from the creditor's perspective, the bank arguably did not bear a creditor's risk on the debt because debt proceed amounts were essentially wired to first flow out to P and to later come back from P. Specifically, P paid the debt proceed amounts to S, which was then required to hold the debt proceed amounts until P transferred them from its control to B's control, at which time B was required to simultaneously pay amounts to P for indirectly "purchasing" these debt proceed amounts, and P, in turn, was required to then immediately pay off the bank debt from these amounts received from B.

However, irrespective of whether this transitory debt should not be respected and should therefore be treated as nonexistent, or should instead be treated as debt of PB or B (or both) for which P acted as a conduit, P brought no cash to the transaction. In substance, P did not obtain the debt proceeds, and P paid no consideration to S for S's transfer of the Distributed Assets to it. In substance, S distributed the Distributed Assets to P. See Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981); Estate of Durkin v. Commissioner, 99 T.C. 561 (1992). In addition, B paid to P only the Base Purchase Price for the S stock. The Excess Purchase Price Amount that B purportedly paid to P was, in substance, an amount that B contributed to S.

This characterization of the transaction is logical. If this transaction were instead viewed as if the amount of the Excess Purchase Price ended up in S by some route other than a capital contribution by B, the transaction might instead be viewed as if B transferred cash to P for P to purchase the Distributed Assets, and then P sold S to B. This latter characterization is not only illogical, but also begs the question of why B transferred cash to P in the first place. Additionally, under this scenario, B would essentially be viewed as having transferred cash over to P to just turn around and buy back this cash when P sold its S stock to B. This latter characterization must fail in favor of the logical characterization that the Excess Purchase Price Amount ended up in S as a capital contribution by B of that cash (whether that cash first originated in PB or originated in B).[2]

TSN Liquidating Corporation, Inc. v. United States, 624 F.2d 1328 (5th Cir. 1980), affirming 77-2 USTC ¶ 9741 (N.D. Tex. 1977), supports respecting the substance of this transaction as one in which S distributed the Distributed Assets to P and B contributed cash to S. TSN Liquidating is a case that concerns the substance of a transaction, in particular the substance of a distribution on stock. The transaction in that case involved, in form, a pre-sale distribution of securities from a corporation to be sold and then a buyer capital contribution to that corporation of a different kind of securities. The TSN Liquidating court found that the substance of that transaction coincided with its form.

[2] To the extent the cash originated in PB, PB first contributed the cash to B, which then contributed the cash to S.

In TSN Liquidating, Community Life Insurance Company ("Community"), a financial company, was sold to Union Mutual Life Insurance Company ("Union Mutual"). As a major part of its investment portfolio, Community held very speculative securities. Union Mutual did not want to own these speculative securities. In fact, it viewed such ownership as inappropriate for an insurance company. However, state regulators warned Union Mutual that it would not allow the sale if there was any significant corporate contraction in assets of Community. Under the final plan of sale, Community distributed the securities to its shareholder ("TSN") shortly before the sale. Union Mutual purchased Community for a price which excluded the amount of the distribution and immediately replaced the value of the speculative securities with investment grade securities of the same value.

The government argued that the distribution to TSN actually represented part of the acquisition proceeds, citing Waterman Steamship v. Commissioner, 430 F.2d 1185 (5th Cir. 1970), cert. denied, 401 U.S. 939 (1971).[\3] The Court rejected the government's argument. The Court held that the distributed assets were speculative high risk securities which Union Mutual clearly had not negotiated to purchase. Thus, it was improper to view these assets as acquisition assets; rather they were distributed directly from the target corporation. Moreover, even though the securities which Union Mutual reinfused were of the same value as the assets distributed, they were different assets "in kind," and, appropriately, these securities were viewed as a capital contribution. The Court in TSN Liquidating distinguished the Waterman situation, where the Target shareholder received cash while the taxpayer paid cash as well.

TSN Liquidating defines the substance of a distribution on stock. Its rationale supports respecting S's distribution of the Distributed Assets as a distribution and B's contribution of cash to S as a capital contribution. The TSN Liquidating court found that the substance of the transaction was a pre-sale distribution of assets of the corporation, coupled with a capital contribution by the purchaser to the corporation. The court found the pre-sale securities distributed were different in kind than the securities contributed by the purchaser.

[\3]In Waterman Steamship, P negotiated to buy T for $3,500,000. A corporate shareholder, X, held the stock of T with a basis of $700,000. X and T filed consolidated returns. P and X renegotiated the deal such that T paid dividends to X in the amount of $2,800,000, payable in 30 days. X agreed to sell all of the stock of T for $700,000. T borrowed the money from P and paid off the dividends the same day as the sale.

In the instant case, the Distributed Assets that S distributed to P were also different in kind from the cash that B infused into S. As a result, TSN Liquidating supports respecting the substance of this transaction as one in which S distributed Distributed Assets to P, and B contributed cash to S. This is not the form of the transaction, but it is the substance of the transaction. The court should respect the substance of the transaction and treat B as having bought S for only the Base Purchase Price and having made a cash capital contribution to S in an amount equal to the Excess Purchase Price.

The instant case is not unlike various other substance over form cases involving conduits such as Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517 (10th Cir. 1991), aff'g 720 F. Supp. 887 (D. Kan. 1989) and West Coast Marketing Corp. v. Commissioner, 46 T.C. 32 (1966).

In Associated Wholesale Grocers, the court recharacterized the following two transactions as a complete liquidation of the Target corporation into its Parent: 1.) the purported merger of the Target corporation into a second corporation (where, but for the court's recharacterization, the Parent of the Target corporation would have recognized the loss inherent in the Parent's stock in the Target corporation)\[4], followed by 2.) the second corporation's immediate transfer back, by sale, of most of the assets that the second corporation just acquired in the merger transaction to the Parent of the Target corporation. In that case, Parent owned 99.97% of Target, and transferred back to the second corporation the consideration that the second corporation paid for those assets in the merger transaction.

The Tenth Circuit held that, in substance, the transaction constituted a complete liquidation of the Target corporation. The court, which viewed the merger and sale transactions as planned by the parties in an attempt to permit the Parent of the Target corporation to recognize the tax loss inherent in the Parent's stock in the Target corporation, was mindful that if the Target corporation had liquidated and transferred its assets directly to the Parent, the transaction would have constituted a section 332 transaction that would have precluded any recognition of the loss. The Court, in recharacterizing the transaction as a complete liquidation, disregarded the

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\[4] The Tenth Circuit inconsistently suggests that the loss at issue was a loss on the Target corporation's assets, rather than a loss on the Parent's stock in the Target corporation. See e.g., 927 F.2d. at 1519, 1520. However, it appears that the loss at issue was a loss on the Parent's stock in the Target corporation. See 927 F.2d. at 1518 n. 1, 1519; 720 F. Supp. 887. However, this is not totally clear from reading the case.

circuitous routing of the Target corporation's assets to the second corporation in the merger transaction and then back to the Parent in the sale transaction.

A second case that looks to the substance, rather than the form, of a transaction is West Coast Marketing. In West Coast Marketing, the court held that a transaction was, in substance, an exchange of an interest in land for stock in the corporation that acquired the land ("acquiring corporation"), and ignored the intermediate steps structured by the parties to avoid having the petitioner recognize gain on the interest in the land. The petitioner would have had to recognize gain had the interest in the land been transferred directly to the acquiring corporation in exchange for acquiring corporation stock. To avoid this gain, the interest in the land was first contributed to a newly formed corporation in a purported nonrecognition transaction and then the stock in this newly formed corporation was transferred to the acquiring corporation in exchange for acquiring corporation stock in a purported tax-free reorganization; finally, the newly formed corporation was dissolved. The court viewed the newly formed corporation as a conduit that the parties used to pass the title in the interest in the land from the petitioner to the acquiring corporation in a taxable transaction.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

We believe litigation hazards exist in pursuing the substance over form argument in this case. The case would have provided a better substance over form argument if state regulatory rules had not required S to maintain certain surplus levels.

We also note that S, as well as its subsidiaries (i.e., not solely P), "sold" Distributed Assets to P. As a result, to the extent P's subsidiaries sold Distributed Assets, P's subsidiaries would have to be treated as having made distributions of the Distributed Assets up to S before S, in turn, made the distributions of the Distributed Assets to P.

An issue also exists concerning whether a court could recharacterize some or all of S's "sales" of the Distributed Assets as redemptions (rather than distributions). However, we believe a court would be more likely to recharacterize the "sales" as distributions, rather than redemptions. See Estate of Durkin v. Commissioner, 99 T.C. 561, 570 (1992). Note that the tax consequences of the transaction are different under a redemption recast. For example, if all of the Distributed Assets are treated as distributed in redemption of S stock, P would recognize a loss on its S stock to the extent redeemed since the redemption would receive sale or exchange treatment under section 302(b)(3). In determining that loss, a portion of P's basis in its S stock would be allocated to the portion of P's stock treated as sold or exchanged in that redemption. P would also recognize loss on the sale to B of its remaining S stock (that was not redeemed). In determining that loss, P's basis in the portion of its S stock sold would only include that portion of P's basis in its S stock not allocated to the portion of P's S stock redeemed. In contrast with the distribution recharacterization, P's S stock sold to B would not be reduced by 100% of the distribution, which, as you properly indicated in your request for advice, would be the case if S is instead viewed as having distributed the Distributed Assets as a dividend (assuming S has sufficient earnings and profits). Nevertheless, in recharacterizing S's transfer of the Distributed Assets to P as a redemption of S stock, P would also take a fair market value basis in the Distributed Assets received in the redemption transaction, and thus, could not attempt to effectively claim a second loss on any later sale of the Distributed Assets.

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

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by: ____________________________
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