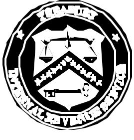

OFFICE OF
CHIEF COUNSEL

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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR REGIONAL COUNSEL

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE) CC:DOM:FS

SUBJECT: BASIS ALLOCATION/SUBSTANCE OVER FORM

This Field Service Advice responds to your memorandum dated March 26, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
Target = .
Target Sub =
Mirror X =
Mirror Y =
Taxpayer=s Expert =
Year 1 =
Year 2 =
Year 3 =
Date 1 =
Date 2 =
Date 3 =
a =
b =
c =

d =
e =
f =
g =
h =
i =

ISSUE(S):

Whether Taxpayer properly recognized a loss on the sale of the stock of its subsidiary Mirror X.

CONCLUSION(S):

Taxpayer did not realize a loss on the sale its Mirror X stock and therefore is not entitled to recognize the loss. The basis that Taxpayer used in determining a loss on the sale of the Mirror X stock resulted from non-arm=s-length transaction between related parties and does not reflect economic reality.

FACTS:

The facts are not fully developed, but as outlined in previous correspondence with this office the facts are as follows. During the period Year 1 through Year 2, Target, the common parent of a consolidated group, made loans to its subsidiary Target Sub in an amount totaling approximately $a.

In Year 2, in anticipation of an acquisition of Target, Taxpayer formed b mirror subsidiaries, which then formed an acquisition subsidiary. Mirror X contributed $c to the acquisition subsidiary and received in exchange d% of the acquisition subsidiary stock.

On Date 1, the Taxpayer group purchased all the outstanding stock of Target. The exact form of the acquisition is unclear, but following the transaction, the b mirror subsidiaries owned directly all the stock of Target in the same proportion as they had owned the stock of the acquisition subsidiary. On Date 2, Target liquidated and distributed its assets among the mirror subsidiaries. The stock of Target Sub was distributed to Mirror X. The receivables representing the $a debt owed by Target Sub to Target were distributed to Mirror Y, along with other assets of Target.

Taxpayer claims that immediately after the distribution, Taxpayer had a $c basis in its Mirror X stock, and that Mirror X had a net asset value (apparently disregarding Target Sub=s $a intercompany debt) of approximately $e.

On Date 3, i.e. approximately 18 months after Date 2, in anticipation of a sale of its Mirror X stock, Taxpayer began a series a transactions that Taxpayer describes as follows. Taxpayer contributed approximately $a to Mirror X and Mirror X contributed that amount to Target Sub. Target Sub then repaid its $a million indebtedness to Mirror Y. Mirror Y then loaned $a million to Taxpayer. As a result of the capital contribution, Taxpayer=s claimed basis in its Mirror X stock was increased by $a.

Taxpayer then, in Year 3, sold its Mirror X stock for approximately $f, resulting in a claimed capital loss of approximately $g. (At the time of the sale Taxpayer claimed a basis in the Mirror Y stock of approximately $h.)

LAW AND ANALYSIS

The basis used by Taxpayer in determining the loss on the sale of Mirror X resulted from an allocation of basis among the Mirror subsidiaries that did not reflect economic realities.

An example will illustrate the importance of an accurate basis allocation in a mirror-transaction acquisition. Suppose a holding corporation (AHolding@) has no assets other than the stock of two subsidiaries, S1, whose stock has a value of $40 and S2, whose stock has a value of $60. Prior to a planned acquisition of Holding, an unrelated corporation, Acquiring, sets up two subsidiaries, M1 and M2. Acquiring funds M1 with $60 and M2 with $40. M1 and M2 contribute those funds to a newly formed acquisition subsidiary in exchange for 60% and 40% of the acquisition subsidiary stock, respectively. Holding and the acquisition subsidiary then merge, with Holding surviving. The former shareholders of Holding receive $100 in exchange for their stock. Holding then liquidates, distributing the stock of S1 to M1 and the stock of S2 to M2. Acquiring then sells the stock of M1 to an unrelated third party for its fair market value of $40. If the form of the series of transactions is respected, Acquiring would recognize a loss of $20 on the sale of the M1 stock. But the purported loss results from the fact that the initial funding of M1 and M2, and therefore Acquiring=s basis in the two corporations, was not reflected in the value received by the two mirror subsidiaries in the liquidation of Holding. The form therefore should not be respected and the purported loss should not be allowed.

The transaction at issue here does not substantively differ from that outlined above. The economic reality of the transaction at issue is obscured by the fact that Target Sub was insolvent, and by the fact that Target Sub=s insolvency stemmed at least in part from an intercompany debt.

Reduced to its essentials, the series of transaction at issue here is as follows: Taxpayer funded Mirror X with $c. Taxpayer sold Mirror X for $f, that is, for $i more than $c. Additionally, Mirror Y loaned $a, the ultimate source of which was Taxpayer, to Taxpayer. The series of transactions in which Taxpayer engaged prior to the disposition of Mirror X

should not be allowed to obscure the fact that the Taxpayer group suffered no economic loss on the sale of Mirror X, and indeed may have realized an economic gain of approximately $i (ignoring any possible proper adjustments to Taxpayer=s basis in its Mirror X between the time of the acquisition of Target and the time of the disposition of Mirror X).

The failure of the series of transactions to reflect economic reality stems in the first instance, as in the example above, from the mismatch between the capitalization of Mirror X and the value of what Mirror X received in the liquidation of Target. This mismatch will become even clearer if one imagines that Mirror X, instead of being a wholly-owned subsidiary of Taxpayer, had had minority third-party shareholders. Suppose, that is, that third parties had contributed money to Mirror X in exchange for stock at the time of its formation, or had purchased stock in Mirror X from Taxpayer prior to the formation of the acquisition subsidiary. Suppose that the other facts of the series of transactions, through the liquidation of Target, are unchanged. In the liquidation of Target, Mirror X, which had contributed $c to the formation of the acquisition subsidiary, received only the stock of Target Sub, an insolvent company whose debts greatly exceeded its assets. In such a case, the minority shareholders would clearly have had a valid claim for damages in a shareholder derivative action, because in the liquidation Mirror X simply did not receive value for money.

Similarly, the Date 3 contribution of $a by Taxpayer to Mirror X and then by Mirror X to Target Sub, allowing Target Sub to pay off its debt to Mirror Y in full, does not make economic sense. Those transactions could make economic sense only if, had the debt not been paid, Mirror Y would have expected to be able to enforce full payment of the debt by Target Sub following the sale. Given Target Sub=s financial condition at the time of the sale, this is utterly improbable. Again, it may be helpful to imagine a scenario involving unrelated parties. Suppose Shareholder entirely owns Corporation. Corporation has $100 in gross assets and $1000 in debt to an unrelated third party, Creditor. A rational person in Shareholder=s position would be unlikely to contribute $1000 to Corporation, cause Corporation to pay off its debt to Creditor, and then sell the stock of Corporation for its fair market value of $100 (even though Shareholder might recoup some of the $1000 paid over to Creditor in the form of a loss for tax purposes resulting from Shareholder=s increased basis in the Corporation stock).

When a series of transactions is undertaken for no economic purpose but simply for purposes of tax avoidance, the series of transactions should be given no effect for tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935). In the instant case, the series of transactions at issue was undertaken for no purpose other than to create a tax loss on the sale of Mirror X when in fact the Taxpayer group suffered no economic loss on that disposition and in fact apparently realized a gain. The claimed loss should disallowed.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Please call (202) 622-7770 if you have any other questions.

By: ________________________

ARTURO ESTRADA
Acting Branch Chief
Corporate Branch

cc: CC:NER
CC:NER:PODCIN:LC