Department
of the
Treasury

Internal Revenue Service

Office of Chief Counsel

Notice

CC-2001-033a

June 28, 2001

Subject: Contingent Liability Tax Shelters (Revised) **Cancel Date:** June 28, 2002

PURPOSE

The purpose of this Notice is to assist Chief Counsel attorneys in advising field personnel in the development of cases involving transactions that are the same as or similar to those described in Notice 2001-17, 2001-09 I.R.B. 1 ("contingent liability tax shelters").

SUMMARY

The basis of the stock received in the transaction is either limited to its fair market value or reduced by the amount of the liabilities assumed in the transaction, with the result that the taxpayer recognizes no loss on the sale of the stock. Furthermore, even if the basis of the stock received in the transaction exceeds its fair market value, if the transferor and the transferee are members of the same consolidated group, any loss on the sale is disallowed under § 1.1502-20 of the Income Tax Regulations.

DISCUSSION

The transaction involves the transfer of one or more assets to a corporation in exchange for the transferee corporation's stock (often a newly authorized class of preferred stock) and the transferee corporation's assumption of a liability that would be deductible if and when paid by the transferor. The asset has a basis that approximately equals its value. The asset will typically be cash or a security; in the case of a consolidated group, the asset will be a security issued by a member of the group (or other property that is used to acquire a member security). The liability is only slightly less than the basis of the asset. The liabilities are most often for environmental remediation, contingent tort liabilities, or employee medical or retirement benefits.

The transaction is purported to qualify as an exchange under section 351 of the Internal Revenue Code, with the intent that the basis of the stock that the transferor receives from the transferee corporation will be determined by the basis of the transferred asset. The liability is

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purported to be a liability described in section 357(c)(3)(A) because the assumption of such a liability does not reduce the basis of the stock received. Section 358(d)(2).

Shortly after the exchange, and as part of the overall plan, the transferor sells the stock received in the exchange for its fair market value and claims a loss in an amount approximating the present value of the liability assumed by the transferee corporation. The effect is to accelerate the tax benefit of the deduction of the liabilities assumed by the transferee. In the case of a transaction involving members of an affiliated group that has elected to file a consolidated return, the transaction is structured to avoid deconsolidation so that, when the transferee pays the liability, the group may claim that it is entitled to a deduction for the payments, thus duplicating the tax benefit within the group.

Taxpayers assert various business purposes as their motivation for engaging in these transactions, but the asserted purposes are far outweighed by the purpose to generate deductible losses for federal income tax purposes.

These transactions are engaged in by taxpayers in all industries.

DISCUSSION

The following discussion amplifies several (but not all) of the reasons set forth in Notice 2001-17 for disallowing the stock loss.

I. <u>The basis of the stock is not equal to the basis in the asset transferred for the stock</u>.

A. <u>The basis of the stock is its fair market value because the transfer of the asset in exchange for the stock does not qualify as a section 351 exchange</u>.

The transaction in which the transferee stock is received must be carefully analyzed to ensure that it satisfies the technical requirements of section 351.[1] In addition, there is authority that the transaction must have a bona fide business purpose to qualify under section 351. <u>See Caruth v. United States</u>, 688 F.Supp. 1129, 1138-41 (N.D. Tex. 1987), <u>aff'd</u>, 865 F.2d 644 (5th Cir. 1989).

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[1] Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for stock, and, immediately after the exchange, the transferor or transferors are in control of the corporation. “Control” is defined in section 368(c), which provides that control requires ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. For this purpose, ownership must be direct, not by attribution, unless the transferor is a member of a consolidated group (in which case it may be treated as owning stock owned by members of the same group, see § 1.1502-34). See Rev. Rul. 56-613, 1956-2 C.B. 212; Rev. Rul. 78-130, 1978-1 C.B. 114.

If the exchange fails to qualify as a section 351 exchange, the transaction in which the transferor obtained the stock is a section 1001 exchange and the basis of the stock is its fair market value. Thus, there is no loss realized on the stock sale.

B. Even if the transaction qualifies as a section 351 exchange, the basis of the stock is less than the basis of the asset transferred because it is reduced by the amount of the assumed liability.

1. Stock acquired in transactions subject to section 358(h):

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Section 358(h)(1) provides that, if, in a section 351 exchange, the basis of the stock received exceeds its fair market value, then such basis shall be reduced (but not below fair market value) by the amount of any liability assumed in exchange for the stock (unless the assumption was treated as money received by the transferor under section 358(d)(1)). Section 358(h)(2)(A) excludes the assumption of any liability that is assumed in connection with the transfer of the trade or business with which the liability is associated; section 358(h)(2)(B) provides a similar exclusion for the assumption of a liability in connection with the transfer of substantially all of the assets with which the liability is associated. Section 358(h) is effective for transfers after October 18, 1999.

The position of this office is that transactions described in Notice 2001-17 in which the section 351 exchange occurred after October 18, 1999 are subject to section 358(h). Thus, in these cases, even if the stock would otherwise be treated as having a basis equal to the transferor's basis in the property transferred, the stock basis will be reduced by the amount of the liability assumption (but not below the fair market value of the stock).[2] We note that, in some cases, e.g., those involving the transfer of post-employment retirement obligations of an inactive corporation, taxpayers may claim that the transfer is within the scope of section 358(h)(2)(A) (exceptions for the transfer of a trade or business) because they have transferred all that remains of the business. While guidance has not been issued on the scope of the exception, our position is that the exception will not apply to cases described in Notice 2001-17, as such cases present the very abuse at which the provision was directed.

2. Stock acquired in transactions not subject to section 358(h):

. a. The liability is not within the scope of section 357(c)(3); therefore, section 358(d)(2) does not prevent the application of section 358(d)(1) to reduce basis by amount of the liability assumed.

The liability in these cases is one the assumption of which would be taken into account in amount realized in a section 1001 transaction. Therefore, under a straightforward application of

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[2] Note that, in such cases, no further adjustment is made to the stock basis when the transferee makes a payment with respect to the assumed liability. See § 1.1502-32(a)(2) (subsidiary stock basis "must not be adjusted under this section and other rules of law in a manner that has the effect of duplicating an adjustment").

section 358(d)(1), the liability assumption reduces the basis of the stock received in the exchange.

Taxpayers will claim that, because the liability is one that will give rise to a deduction, it is a liability described in section 357(c)(3), and that, therefore, section 358(d)(2) prevents the basis reduction required under section 358(d)(1). In a Notice 2001-17 transaction, however, the liabilities assumed are not within the intended scope of section 357(c)(3) and therefore section 358(d)(2) is inapplicable. Accordingly, section 358(d)(1) requires the reduction of stock basis by the amount of the assumed liability.

The rationale for this position is that section 357(c)(3)(A)(i) refers to a liability that would give rise to a deduction to the transferee, not the transferor. Although authorities such as Rev. Rul. 95-74,1995-2 C.B. 36, permit a corporate transferee to claim deductions accruing upon payment of assumed liabilities, such authorities only apply if there is a transfer of a trade or business and, at the time of the section 351 exchange, the taxpayer had no plan to dispose of the stock received. In Notice 2001-17 transactions, there is no transfer of a trade or business and there is a plan to dispose of the stock immediately after the sale. Therefore, these transactions are not within the scope of Rev. Rul. 95-74. As a result, the taxpayers in these cases are subject to the rule set forth in Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946), that the assumption of the liability is part of the cost of acquiring the transferred asset and so the payment of the liability does not give rise to a deductible expense for the transferee.[3] In such a case, the deduction upon payment by the transferee should accrue to the transferor, in which case there is no need to preserve the loss in the stock basis.[4] Accordingly, the liability is not within the scope of section 357(c)(3)(A)(i), its assumption is therefore not within the scope of section 358(d)(2), and the general rule of section 358(d)(1) applies to reduce the stock basis by the amount of the liability.

b. Alternatively, the liability assumption is treated as a distribution of money under section 357(b).

Even if the liabilities are considered liabilities described in section 357(c)(3), with the result that section 358(d)(2) would prevent the reduction of stock basis otherwise required by section 358(d)(1), section 357(b) prevents the result sought in Notice 2001-17 transactions.

Section 357(b) provides that, if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that

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[3] Note that the transferee's basis in the assets received is determined under section 362; therefore, the later payment of the liability gives rise to no additional basis to the transferee. See Ways and Means Committee Report, H. Rept. No. 855, 76th Congress 1st Sess. (1939), 1939-2 C.B. 518, 519.

[4] In this case, as in the case of a basis reduction under section 358(h), no further adjustment is made to the stock basis when the transferee makes a payment with respect to the assumed liability. Section 1.1502-32(a)(2).

the principal purpose of the taxpayer with respect to a liability assumption in connection with a section 351 exchange was not a bona fide business purpose, then the assumption (in the total amount of the liability assumed pursuant to such exchange) shall be considered as money received by the taxpayer on the exchange.

In a Notice 2001-17 transaction, the principal purpose of the liability assumption is to facilitate the creation of high basis, low value stock the disposition of which could accelerate and, in some cases, duplicate the deduction of the underlying liability. This is not a bona fide business purpose. Accordingly, under section 357(b), the assumption of the liability is considered a distribution of money that, under section 358(a), reduces stock basis.[5]

It is important to note that, unlike the requirement in section 351 (which is only that the taxpayer have *a* business purpose), section 357(b) applies if the taxpayer's *principal* purpose is not a bona fide business purpose. Thus, section 357(b) can apply even if the taxpayer in fact has some business purpose, as may arguably be the case in some of the Notice 2001-17 transactions under consideration.

II. Even if the basis in the stock is greater than fair market value, if the transferor and the transferee are members of the same consolidated group, the loss is disallowed under § 1.1502-20 (the loss disallowance rule, or, LDR).[6]

The LDR prevents members of consolidated groups from deducting loss on the disposition of stock of a subsidiary member of the group if the loss is either not a true economic loss *or* the loss is duplicated (i.e., reflected in both the stock basis and in an underlying asset or expense).[7] To accomplish this, the LDR limits the member's deduction to the amount by which the loss realized exceeds the "Loss Disallowance Amount." The LDR is applicable to stock dispositions on or after February 1, 1991; certain transitional rules, not generally relevant to the subject transactions, apply to transactions prior to that date.

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[5] In this case, as in the case of a basis reductions under either section 358(h) or section 358(d)(1), no further adjustment is made to the stock basis when the transferee makes a payment with respect to the assumed liability. Section 1.1502-32(a)(2).

[6] Note that any stock loss disallowed under the LDR is a noncapital, nondeductible expense under § 1.1502-32 and appropriate adjustments must be made to the stock basis of the selling member (and any higher tier members). See § 1.1502-32(f)(2)(ii).

[7] This rule will generally apply only where the selling shareholder and the subsidiary are members of the consolidated group at the time of the sale. It is possible, however, that the facts in an individual case could support an LDR argument if the selling shareholder and the subsidiary were members of the same consolidated group, but deconsolidated as part of the overall plan to effect the Notice 2001-17 transaction. See § 1.1502-20(e), the LDR anti-avoidance rule, discussed below.

The Loss Disallowance Amount is the sum of three separate computations: (1) extraordinary gain dispositions (EGD), defined generally as gains recognized on property dispositions, section 481 adjustments and cancellation of indebtedness income, (2) positive investment adjustments (PIA), defined as all positive adjustments to stock basis made under § 1.1502-32 (but recomputed to exclude distributions and any amounts taken into account as EGD), and (3) duplicated loss, defined as the excess of the sum of the subsidiary's aggregate asset basis (excluding the stock and securities of other group members[8]), loss carryforwards, and deferred deductions, over the sum of the price paid for the stock and the subsidiary's liabilities. The first two computations (EGD and PIA) comprise the component intended to prevent non-economic stock loss; the third computation is the component intended to eliminate the potential for loss duplication.

In transactions described in Notice 2001-17, there will be little or no amounts of EGD or PIA (because the stock is only held for a brief time). The LDR factor at issue in Notice 2001-17 transactions is the duplicated loss amount and the controversy centers on the proper computation of that amount.

> Example. Assume the transferee (Sub) and the transferor (Parent) are members of the same consolidated group and that, prior to the transaction, Sub held only a de minimis amount of assets and had no loss carryforwards, deferred deductions or liabilities. To simplify further, assume also that Sub had no EGD or PIA amounts. Parent transfers a $100x (basis and value) security (issued by another member of the Parent group) to Sub in exchange for Sub stock and Sub's assumption of a $99x liability that Parent has not taken into account for tax purposes (i.e., a contingent liability). Parent immediately sells the Sub stock for its fair market value ($1x). At the time of the stock sale, the proper computation of the duplicated loss amount would be $100x (the basis in the security) less $1x (the stock price[9]), or $99x, which reflects the $99x built-in loss generated by the

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[8] Note that "member" is defined as a corporation that is included in a group, which is generally defined as an affiliated group of corporations filing a consolidated return. Sections 1.1502-1(a), (b), (h). The term member does not, therefore, include all affiliated corporations.

[9] Note that, when computing duplicated loss, liabilities that have not been taken into account for tax purposes are not included in the subtrahend. The reason is that, when such a liability is ultimately taken into account for tax purposes, it will give rise to additional items (of basis or deduction) that will eliminate the effect of including the liability in the subtrahend. If the liability is included in the subtrahend before those other items are generated, there is an inappropriate reduction of the amount of disallowed stock loss. To illustrate, using the facts of our example, assume the liability is properly taken into account for tax purposes. At that point, one of two things happens. Either the minuend increases by $99x (because the liability produces a deduction that is unabsorbed or deferred), resulting in a $99x duplicated loss (($100x+$99x)-($1x+$99x)) and therefore $0 stock loss allowed). Or, the liability produces a deduction that can be currently absorbed (reducing the stock basis to $1x), resulting in $0 stock loss recognized (and therefore $0x stock loss allowed). In either case, the built-in loss created upon the transfer produces no allowable stock loss.

assumption of the contingent liability. The loss disallowance amount is $99x and so the loss allowed is $0 (the excess of the loss on the sale, $99x, over the loss disallowance amount, $99x).

Taxpayers will assert that, because the asset held by the transferee at the time of the disposition is a member security (whether because it was transferred in the purported section 351 exchange or acquired by the subsidiary shortly thereafter), it is eliminated from the loss duplication computation under § 1.1502-20(c)(2)(vi)(A)(*1*). If so, under the facts of the example above, the result of the elimination of the security would be a duplicated loss amount (and thus a loss disallowance amount) of $0 (the excess of $0 asset basis over the $1x stock price). While § 1.1502-20(c)(2)(vi)(A)(*1*) does exclude member securities from the computation of aggregate asset basis, the proper result is nevertheless reached only if the basis of the security is reflected in the subsidiary's aggregate asset basis. That result is reached for reasons discussed below.

A. Section 1.1502-13(g) causes the member security to be treated as satisfied immediately before the stock sale with the result that, at the time the computation of duplicated loss is made, the subsidiary is treated as holding the loan satisfaction proceeds, not a member security.

Section 1.1502-13(g) provides special rules for intercompany obligations. The term intercompany obligation is broadly defined in § 1.1502-13(g)(2) and would include the securities used in Notice 2001-17 transactions.[10] The general rule of § 1.1502-13(g) is set forth in § 1.1502-13(g)(3)(i)(A), which provides that, if a member of a group realizes an amount (other than zero) of income, gain, deduction or loss, directly or indirectly, from the assignment or extinguishment of all or part of its remaining rights or obligations under the obligation, the obligation is deemed satisfied under § 1.1502-13(g)(3)(ii) and, if the obligation remains outstanding, it is treated as reissued under § 1.1502-13(g)(3)(iii). Section 1.1502-13(g)(3)(ii) provides that the obligation is deemed satisfied immediately before the transaction in which the amount is realized. Section 1.1502-13(g)(3)(iii) provides that the obligation is treated as reissued immediately after the transaction. As a result, at the time of the transaction, the obligation is treated as liquidated and the creditor is treated as holding the deemed satisfaction proceeds.

Under this approach, the distortion of the duplicated loss computation by reason of the intercompany obligation is eliminated, as required by § 1.1502-13(h)(1) (which provides that, if a transaction is engaged in or structured with a principal purpose to avoid the purposes of § 1.1502-13, which, in the case of intercompany obligations, include avoiding distortion resulting from the use of intercompany obligations, adjustments must be made to carry out the purposes of this section).

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[10] If the liability fails to qualify as an intercompany obligation under § 1.1502-13(g), it would clearly fail to qualify as a "security" under § 1.1502-20((c)(2)(vi)(A)(1) and there would be no argument that the duplicated loss computation would exclude the evidence of that debt.

In Notice 2001-17 transactions, the sale of the stock is subject to § 1.1502-13(g) because the sale produces an indirect realization of loss from the assignment of all or part of an interest in an intercompany obligation.[11] Accordingly, under § 1.1502-13(g)(3)(ii), the security is treated as satisfied immediately before the stock sale and, because § 1.1502-13(g)(3)(iii) does not treat the security as reissued until after the sale, at the time of the sale, the transferee subsidiary is treated as holding the deemed satisfaction proceeds of the intercompany obligation, not a member security. Using the facts of the above example, the loss duplication amount (and thus the loss disallowance amount) is $99x (the excess of the $100 satisfaction proceeds over the $1x stock price), which is the proper result.[12]

B. Application of LDR anti-avoidance Rules.

In addition to the technical argument based on the interaction of the intercompany obligation rules and the LDR, arguments should be asserted under the various provisions of § 1.1502-20(e), the LDR anti-avoidance rule.

1. Reasonable and consistent application of the LDR.

Section 1.1502-20(e)(1) provides that the rules of § 1.1502-20 must be applied in a manner that is consistent with and reasonably carries out its purposes. Excluding a member security from the duplicated loss computation produces a result that is wholly inconsistent with and fails to reasonably carry out the purposes of the LDR (because it permits the deduction of stock loss that duplicates another deduction or expense within the group). Accordingly, under § 1.1502-20(e)(1), appropriate adjustment must be made to effect the inclusion of the member security in the Loss Disallowance Amount.

This argument presents issues of first impression with considerable significance beyond the LDR and must be closely coordinated with the National Office.

2. Taxpayer acting with a view to avoid the LDR.

Section 1.1502-20(e)(1) further provides that, if a taxpayer acts with a view to avoid the effect of the provisions of § 1.1502-20, adjustments must be made as necessary to carry out their purpose. In individual cases, the facts may establish that there was no purpose for the creation and transfer of the member security in the purported section 351 exchange, i.e., except to avoid the application of the LDR. In such a case, the taxpayer acted with a view to avoid the

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[11] In some Notice 2001-17 transactions, the provisions of § 1.1502-13(g) will also apply to the sale of the stock because the stock is a "successor asset" of the security under § 1.1502-13(j)(1). This will be the case where the transfer of the intercompany obligation qualifies as a section 351 exchange and the amount realized on the exchange is zero.

[12] Note that the entire duplicated loss amount is allocated to the stock received in the Notice 2001-17 exchange. See § 1.1502-20(e)(1), (3) Example 1.

LDR and, under § 1.1502-20(e)(1), appropriate adjustment must be made to effect the inclusion of the member security in the Loss Disallowance Amount.

3. The anti-stuffing rule.

Section 1.1502-20(e)(2) (the "anti-stuffing" rule) provides that, if, within two years of the transfer of any asset (including stock and securities), there is a disposition of stock and the transfer is with a view to avoid the disallowance of loss on the disposition of the stock, the basis of the stock is reduced to cause the disallowance of loss otherwise avoided by reason of the transfer. Thus, where the facts establish that the transfer of the member security to the subsidiary was made with a view to avoid the LDR, and the stock received in the transfer is sold within two years, the basis of the stock is reduced to prevent the LDR avoidance that would have resulted from the transfer of the security.

III. The stock loss is not allowable in any case because the transaction as a whole lacks economic substance and business purpose apart from tax savings.

In addition to the technical reasons discussed above, the stock loss claimed in Notice 2001-17 transactions must be disallowed because the transactions lack economic substance separate and distinct from the economic benefit achieved solely by tax reduction. Taxpayers engaging in these transactions are seeking to claim tax benefits that were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, and therefore the doctrine of economic substance is applicable to disallow that benefit. See generally Rev. Rul. 99-14, 1999-1 C.B. 835.

IV. Additional Arguments and Case Development.

As stated in Notice 2001-17, Service position is that the stock loss claimed in Notice 2001-17 transactions is not allowed for federal tax purposes. Because the specific fact patterns vary, all the arguments set forth above should be considered in developing Notice 2001-17 cases. Note that the facts of a particular case may support arguments not discussed in this Notice, including additional arguments noted in Notice 2001-17, such as section 269, as well as arguments not discussed in either this Notice or in Notice 2001-17. As facts are developed, some arguments will emerge as stronger than others in a particular case. Initially, however, the facts of each case should be explored and developed with all potential arguments, including all appropriate penalties, in mind.

Facts should be developed from the date the transaction was first contemplated up to the present and include: The source of the proposal (e.g., whether it was proposed by a tax consulting firm); analysis and assessments of the purported business benefits to both the transferor and transferee (including the profitability potential to the transferee) prepared by or for the taxpayer prior to the transaction, if any; whether employees, assets, liabilities, etc. were in fact physically relocated to the transferee; the activities of the transferor and transferee before and after the transaction (including the duties of the employees prior to and after the transaction); treatment of the transaction for financial purposes; treatment of the assumed liability subsequent to the exchange (e.g., any deductions claimed).

With respect to an analysis of the purported business purpose, the activities of the transferor and transferee prior to and after the exchange should be closely scrutinized as they may further evidence the taxpayer's purpose for engaging in the transaction. See Simpson v. Commissioner, 43 T.C. 900 (1965), acq., 1965-2 C.B. 6. In addition, state law and other regulatory considerations regarding the effect, if any, of the purported assumption or the purported equity investment should be analyzed to determine whether, as a legal or practical matter, the purported business purposes could in fact be accomplished.

As noted above, there may be arguments (or counter-arguments) advanced by individual taxpayers that are not addressed in this Notice, or in Notice 2001-17, and there may be facts in a particular case that suggest additional arguments to be made by the Service. In such cases, the matter should be coordinated with the National Office. Notice 2001-17 and this Notice provide non-taxpayer specific guidance that is to be applied in all cases other than those in which binding, taxpayer specific guidance or case resolution has been issued or entered into.

Field contact for case coordination and development assistance, including asserting penalties in individual cases: Rose Gole, CC:LM:FSH:LI, 516/688-1702.

National Office contact for questions regarding National Office guidance, including questions regarding this Notice, Notice 2001-17, and the need for further taxpayer specific guidance (e.g., Nondocketed Significant Advice Review, Field Service Advice, or Technical Assistance Memoranda): Theresa Abell, CC:CORP, 202/622-8130.

/s/
Jasper L. Cummings, Jr.
Associate Chief Counsel (Corporate)