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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JAMES E. GRAY
SENIOR ATTORNEY CC:SER:NCS:GBO

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated July 24, 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 =
S1 =
X =
S2 =
S3 =
S4 =

Date 1 =
Date 2 =
Date 3 =
Date 4 =

Month 1 =
Month 2 =

Year 1	=
Year 2	=
$a	=
$b	=
$c	=
$d	=
$e	=
$f	=
$g	=
$h	=
$i	=
$j	=
$k	=
$l	=
A	=
B	=
C	=
D	=
E	=
F	=
G	=
H	=
I	=

ISSUE(S):

Whether S1 properly calculated its basis in the S2 stock it received from S2, in exchange for the S4 note, the S3 stock and the assumption by S2 of the contingent liabilities, for purposes of determining the amount of its loss on the subsequent sale of its S2 stock to an unrelated party. More specifically, whether the Service can apply I.R.C. § 357(b) to reduce S1's basis in the S2 stock it received in the initial exchange.

CONCLUSION:

We do not recommend that the Service argue that I.R.C. § 357(b) applies to the exchange because, even if it does, such section would not have any effect on S1's basis in its S2 stock.

However, for the reasons noted below, we recommend that the Service argue that the transfer, followed by S1's sale of its S2 stock, did not meet the business purpose requirement of I.R.C. § 351(a). In that case, S1 would realize a loss on the sale of its property to S2, which would not be taken into account until either the property or S2 left the group. S1's sale of its S2 stock did not cause S2 to leave the group. Moreover, the property also stayed within the group.

As a result of the sale, S1 would take a basis in the S2 stock it received in the exchange equal to the value of such stock. We do not know what value S1 might assign to such stock. Because S1 and S2 are affiliated, any value assigned to the S2 stock by the parties can not be presumed to reflect the fair market value of that stock. However, several months after this exchange, S1 sold the S2 stock for $i. If there was no substantial change in the circumstances of S2 during this period, then the Service has a reasonable argument that $i also represents the fair market value of the S2 stock at the time it was issued to S1 in the exchange. In that case, when S1 sold its S2 stock, S1 would not recognize any gain or loss.

FACTS:

P is the common parent of an affiliated group of corporations filing a consolidated Federal income tax return. P owns all of the stock of S1.

As of Date 1, there were tort claims against S1. S1's estimated exposure was $a before considering insurance coverage and $b million after taking into account insurance coverage. Through Year 1 all paid-out claims were paid from insurance.

X had been a wholly owned subsidiary of P for more than A years, but had been dormant for a number of years prior to Date 2. On Date 2, X changed its name to S2.

On Date 3, S2 amended its charter, increasing its authorized capital stock to B shares of common stock and C shares of voting preferred stock. According to the taxpayer, this charter amendment was done to facilitate the operation of S2 as a litigation management company with equity participation by third-party investors, including independent lawyers who defend S1 and S3 in tort liability actions.

On Date 4, P contributed to S2:

(1) $c in cash in exchange for D shares of S2 common stock. P already owned E shares of S2 common stock, bringing its total to F shares.; and

(2) $d in cash in exchange for G shares of voting preferred stock.

Also on Date 4, S1 contributed to S2:

(A) a note in the amount of $e due to S1 from a related corporation, S4;

(B) all of the outstanding shares of S3, valued at $f; and

(C) the beneficial rights to all future insurance recoveries with respect to S1's tort obligations and certain other assets relating to the defense of S1's tort obligations, which were valued at H.

In exchange for the assets contributed to S2 pursuant to steps (A) - (C), S1 received F shares of S2 common stock and S2's assumption of S1's liability for the defense and payment of S1's tort obligations, including S3's tort obligations.

In Month 2 of Year 2, S1 sold I shares of its S2 stock to one unrelated party and the remaining I shares to another unrelated party. After these sales, S2 continued to be a member of the P group (because of P's ownership of S2's voting preferred stock). In the case of each sale, the consideration was $g. S1 reported a total capital loss of $h, determined as follows: S1 received consideration for the S2 stock in the amount of $i and its basis in the S2 stock was $j, its exchanged basis determined under I.R.C. § 358 by reference to the $e basis in the note and the $k basis in the S3 stock.

In Month 1 of Year 2, P sold all of the stock of three subsidiaries to an unrelated party and recognized capital gain of approximately $l. This gain was fully offset by P's capital loss upon the subsequent sale by S1 of some of its S2 stock. In fact, you believe that the transfer of assets by P and S1 to S2, followed by S1's sale of its S2 stock appear to have been structured to generate a substantial tax benefit to the taxpayer with no apparent bona fide business purpose.

You have asked whether S1 properly ignored the contingent tort liabilities in computing its basis in its S2 stock. In considering this issue, you note that Rev. Rul. 95-74, 1995-2 C.B. 36, concludes that certain contingent liabilities assumed by a transferee in an I.R.C. § 351 exchange are not liabilities for purposes of I.R.C. § 357(c)(1) and 358(d). You also note that the holding of Rev. Rul. 95-74 is limited to transactions that do not have a tax avoidance motive within the meaning of I.R.C. § 357(b). As noted above, you believe that the P group undertook the transfer of assets followed by the sale for tax avoidance motives. Thus, you have also asked whether, under these circumstances, Rev. Rul. 95-74 applies to the facts of this case.

LAW AND ANALYSIS

I.R.C. § 351

Law and Other Authorities

I.R.C. § 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by a person solely in exchange for stock in such corporation and immediately after the exchange such person is in control of the corporation.

I.R.C. § 351(b) provides that if I.R.C. § 351(a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under I.R.C. § 351(a), other property or money, then, gain (if any) to such recipient shall be recognized, but not in excess of the amount of money received, plus the fair market value of such other property received, and no loss to such recipient shall be recognized.

I.R.C. § 357(a) provides that, except as provided in I.R.C. § 357(b), if the taxpayer receives property which would be permitted to be received under I.R.C. § 351 without the recognition of gain if it were the sole consideration and, as part of the consideration, another party to the exchange assumes a liability of the taxpayer, then such assumption shall not be treated as money or other property and shall not prevent the exchange from being within the provisions of I.R.C. § 351.

I.R.C. § 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 the principal purpose of the taxpayer with respect to the assumption described in I.R.C. § 357(a) was a purpose to avoid Federal income tax on the exchange, or if not such a purpose, was not a bona fide business purpose, then such assumption shall, for purposes of I.R.C. § 351, be considered as money received by the taxpayer on the exchange.

I.R.C. § 357(c)(1) provides that in the case of an exchange (A) to which I.R.C. § 351 applies, or (B) to which I.R.C. § 361 applies by reason of a plan of reorganization within the meaning of I.R.C. § 368(a)(1)(D), if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

I.R.C. § 357(c)(2) provides that I.R.C. § 357(c)(1) shall not apply to any exchange (A) to which I.R.C. § 357(b)(1) applies, or (B) which is pursuant to a plan of reorganization within the meaning of I.R.C. § 368(a)(1)(G) where no former shareholder of the transferor corporation receives any consideration for his stock.

I.R.C. § 357(c)(3)(A) provides that if a taxpayer transfers, in an exchange to which I.R.C. § 351 applies, a liability the payment of which either (i) would give rise to a deduction, or (ii) would be described in I.R.C. § 736(a), then, for purposes of I.R.C. § 357(c)(1), the amount of such liability shall be excluded in determining the amount of liabilities assumed or to which the property transferred is subject.

I.R.C. § 357(c)(3)(B) provides that I.R.C. § 357(c)(3)(A) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or increase in, the basis of any property.

I.R.C. § 358(a)(1) provides that, in the case of an exchange to which I.R.C. § 351, 354, 355, 356, or 361 applies, the basis of property permitted to be received under such section without the recognition of gain or loss (i.e., the stock of the transferee corporation) shall be the same as that of the property exchanged, decreased by the amount of money received by the taxpayer, and increased by the amount of gain to the taxpayer which was recognized on such exchange.

I.R.C. § 358(d)(1) provides that where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of I.R.C. § 358, be treated as money received by the taxpayer on the exchange.

I.R.C. § 358(d)(2) provides that I.R.C. § 358(d)(1) shall not apply to the amount of any liability excluded under I.R.C. § 357(c)(3).

I.R.C. § 368(c) provided that, for purposes of I.R.C. § 351, the term "control" means the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

Treas. Reg. § 1.1502-34 provides that, for purposes of Treas. Reg. §§ 1.1502-1 through 1.1502-80, in determining the stock ownership of a member of the group in another corporation (the “issuing corporation”) for purposes of determining the application of, e.g., I.R.C. § 351(a) in a consolidated return year, there shall be included stock owned by all other members of the group in the issuing corporation.

Rev. Rul. 95-74, 1995-2 C.B. 36

The relevant facts of Rev. Rul. 95-74 are that a transferor owns a manufacturing business, including the land upon which the business sits. Since that corporation acquired the land, it has become polluted as a result of the manufacturing business. For valid business reasons, the corporation transfers the manufacturing business, including the land, to a newly-formed subsidiary in exchange for all of the stock of that subsidiary and the assumption by the subsidiary of the liabilities associated with the transferred assets, including the environmental liabilities. The transferor has no plan or intention to dispose of (or have the subsidiary issue) any subsidiary stock.

Rev. Rul. 95-74 noted that the contingent environmental liabilities had not been taken into account, within the meaning of I.R.C. § 357(c)(3), by the transferor prior to the transfer. Consequently, Rev. Rul. 95-74 held that these liabilities are not included in determining whether the amount of liabilities assumed by the subsidiary exceeds the adjusted basis of the property transferred by the transferor, within the meaning of I.R.C. § 357(c)(1).

In addition, Rev. Rul. 95-74 noted that any liabilities that are not included in the determination under I.R.C. § 357(c)(1) are also not included in the I.R.C. § 358 determination of the transferor's basis in the stock received in the I.R.C. § 351 exchange. Therefore, Rev. Rul. 95-74 held that the transferor does not reduce its basis in its subsidiary stock by the amount of such liabilities.

Analysis

As a threshold matter, we note that this case potentially raises the issue of whether a contingent liability is the type of liability that is to be taken into account currently under I.R.C. §§ 357 and 358. However, because of the specific language of I.R.C. §§ 357(c)(3) and 358(d)(2), as interpreted by Rev. Rul. 95-74, 1995-2 C. B. 36, we do not believe it is necessary to address this broader issue. That is, we will assume for purposes of the following discussion that such contingent liability is the type of liability to be taken into account currently under I.R.C. §§ 357 and 358.[1]

Section 351(a) provides that no gain or loss shall be recognized if property (i.e., the cash from P, and the S4 note and the S3 stock from S1) is transferred to a corporation (i.e., S2) by members of a consolidated group (i.e., P and S1) solely in exchange for voting stock in S2 and immediately after the exchange P and S1 are

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[1] Of course, if such liability is not taken into account currently, then there is no argument that it can reduce basis currently.

in control of S2 (as defined in I.R.C. § 368(c) and Treas. Reg. § 1.1502-34). For purposes of I.R.C. § 351(a), I.R.C. § 368(c) defines control as the ownership of at least 80% of the outstanding voting stock of the transferee corporation (i.e., S2). For purposes of these two sections, Treas. Reg. § 1.1502-34 provides that any stock of S2 owned by the members of the P group are included. In other words, it is not necessary for any one member of the P group to meet the control requirement of I.R.C. § 368(c). In this case, of course, P and S1 initially own all of the stock of S2 immediately after the exchange. Therefore, the P group satisfies the control requirement of I.R.C. §§ 351(a) and 368(c).[2]

However, P and S1 did not transfer property to S2 solely in exchange for the S2 stock because S2 also assumed the contingent tort liability. Therefore, the transfer does not fit the literal terms of I.R.C. § 351(a). However, I.R.C. § 357(a) provides that, except as provided in I.R.C. § 357(b) and (c), if the taxpayer (i.e., S1) receives property (i.e., the S2 stock) which it would be permitted to receive under I.R.C. § 351 without the recognition of gain if such property were the sole consideration and, as part of the consideration, another party to the transfer (i.e., S2) assumes a liability of S1 (i.e., the contingent tort liability), then such assumption shall not be treated as money or other property and shall not prevent the transfer from being within the provisions of I.R.C. § 351. Thus, except as provided in I.R.C. § 357(b) and (c), S1 would not recognize gain or loss on the transfer as a result of the assumption of the contingent tort liability by S2 if I.R.C. §§ 351(a) and 357(a) applied.

S1's basis in the S2 stock would be determined under I.R.C. § 358. Section 358(a)(1) provides that a transferor's basis in the stock received from the transferee in an exchange to which I.R.C. § 351 applies is the same as the basis of the property surrendered, reduced by the amount of any money received. Section 358(d)(1) provides that, for purposes of I.R.C. § 358, an assumption of liability shall be treated as money received by the transferor. Thus, a transferor reduces its basis in the stock received from the transferee by the amount of any liability assumed.

In Rev. Rul. 95-74, the Service held that certain contingent liabilities had not been taken into account, within the meaning of I.R.C. § 357(c)(3), by the transferor prior to the transfer. Thus, such liabilities were excluded in determining whether the

[2] Of course, S1 subsequently sold all of its S2 stock to an unrelated party. However, even if the facts were to indicate that that sale should be taken into account in determining whether the I.R.C. § 368(c) control requirement for the I.R.C. § 351 exchange was satisfied, P's continuing ownership of its S2 common and voting preferred stock appears to have assured that that requirement was satisfied.

amount of the liabilities assumed exceeded, within the meaning of I.R.C. § 357(c)(1), the transferor's basis in the transferred assets. In addition, such liabilities did not reduce the transferor's basis. Section 358(d)(2). Thus, in this case, if the rationale of Rev. Rul. 95-74 applies, S1 would not reduce the basis of its S2 stock by the amount of the contingent liabilities assumed by S2. This would be the case whether or not the contingent liabilities would, absent I.R.C. § 357(c)(3) and I.R.C. § 358(d)(2), otherwise be considered liabilities for purposes of I.R.C. §§ 357 and 358.

However, you note that Rev. Rul. 95-74 does not apply if the transfer has no business purpose. As one line of attack, you have suggested that the Service apply I.R.C. § 357(b).

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 the principal purpose of the taxpayer with respect to the assumption described in I.R.C. § 357(a) was a purpose to avoid Federal income tax on the exchange, or if not such a purpose, was not a bona fide business purpose, then such assumption shall, for purposes of I.R.C. § 351, be considered as money received by the taxpayer on the exchange.

In this case, whether either I.R.C. § 357(a) or I.R.C. § 357(b) applies is not determinative of whether a liability assumed will reduce the transferor's basis in the stock of the transferee under I.R.C. § 358(d)(2). Under I.R.C. § 358(d)(2), a transferor does not reduce its basis in the stock it receives by the amount of any liability excluded under I.R.C. § 357(c)(3). Based on the policy reasons discussed later in this memo, we interpret this provision as applying to a liability that could be excluded under I.R.C. § 357(c)(3).

Moreover, I.R.C. § 357(c)(3), unlike I.R.C. § 357(a) and I.R.C. § 357(c)(1) (by virtue of I.R.C. § 357(c)(2)(A)), does not contain an exception for I.R.C. § 357(b). Thus, even if I.R.C. § 357(b) applied, S1 would not be required to reduce the basis of its S2 stock by the amount of the contingent liabilities assumed. Consequently, we do not believe that the application of I.R.C. § 357(b) will cause S1 to reduce the basis of its S2 stock by any liabilities assumed.

In addition, you have asked whether Rev. Rul. 95-74 is distinguishable because it relied on an analysis of I.R.C. § 357 in reaching its conclusion that such liabilities also do not reduce basis under I.R.C. § 358(d). As noted above, applying I.R.C. § 357 in the instant case does not cause S1 to recognize any portion of such amount. Therefore, you have asked whether I.R.C. § 358(d) provides an independent rationale for reducing S1's basis in the S2 stock. It is the position of the Service, as stated in Rev. Rul. 95-74, that I.R.C. §§ 357(a) and 358(d) operate on similar principles. See also Focht v. Commissioner, 68 T.C. 223 (1977); S. Rep. No. 1263, 95th Cong., 2d Sess. 183-85 (1978), 1978-3 C.B. 481-83, adding I.R.C. § 357(c)(3) to the Code. Therefore, it is not determinative that in this case I.R.C. § 357 is not applicable.[3]

In 1978, in adding I.R.C. § 357(c)(3) to I.R.C. § 357(c), Congress, in the legislative history cited above, expressly approved of Focht. Focht had held that an obligation should not be treated as a liability under I.R.C. §§ 357 and 358 to the extent its payment would have been deductible if made by the transferor. The Tax Court further held that, under I.R.C. § 358, deductible liabilities are excluded in determining the transferor's basis in stock received as part of the exchange. More generally, the legislative history of I.R.C. § 351 indicates that Congress viewed incorporation exchanges as merely changes in form and intended to enact I.R.C. § 351 to eliminate impediments to business readjustments by making incorporations tax free. S. Rep. No. 398, 68th Cong., 1st Sess. 17 (1924); H.R. Rep. No. 350, 67th Cong., 1st Sess. 9 (1921). Sections 357(c)(3) and 358(d)(2) now provide that a corporation's assumption of a liability that, if paid, would give rise to a deduction shall neither be taken into account under I.R.C. § 357(c)(1) nor diminish the shareholder's basis under I.R.C. § 358.

The first holding in Rev. Rul. 95-74 applied the logic of I.R.C. §§ 357(c)(3) and 358(d)(2) to any liability which had not yet given rise to a deduction or to basis--a larger sphere than the liabilities covered by I.R.C. § 357(c)(3). Nothing in Focht, or in the legislative history, or in logic suggests that the holding of the revenue ruling as regards I.R.C. § 358(d) is not fully applicable in a case where I.R.C. § 357(c) happens not to apply because assumed liabilities do not exceed basis. Nothing in logic suggests that a shareholder gets a lower basis in his stock just because liabilities do not exceed basis; especially when, if he had realized gain, it would be insulated anyway from tax by Rev. Rul. 95-74.

Also, the result dictated by the logic of Rev. Rul. 95-74 makes technical sense. Suppose individual A owns a building with a basis and value of $100, but burdened by a contingent environmental liability reasonably valued at $100. In other words, A will very likely lose his entire investment. If he waited for the liability to become non-contingent, he could take a $100 deduction. Instead, he contributes the building to his controlled corporation, which also assumes the contingent liability. Thereafter, the liability becomes non-contingent. Section 357(c) did not apply, because liabilities did not exceed basis. The corporation's paying the liability wipes

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[3] For a further discussion of this issue, please read the legal memorandum written in support of Rev. Rul. 95-74, which we have attached to this memorandum.

out his equity; thus he should get a $100 tax benefit. Had he continued to owe the liability personally, that benefit would have come in the form of a deduction. He ultimately gets the appropriate $100 tax benefit because, pursuant to Rev. Rul. 95-74, I.R.C. § 358 does not operate to reduce his $100 stock basis. Instead, he ultimately gets a $100 stock loss. Were his stock basis reduced by the contingent liability to $0, he would never get the $100 tax benefit to which he is entitled. The taxpayer in the FSA has abused the rules, but I.R.C. § 358, a section that does not inquire into taxpayer intent, is not the means of correcting that. The legislative history and Rev. Rul. 95-74 preclude that.

Alternatively, we recommend that you consider arguing that the transfer of property by P and S1 to S2 followed by S1's sale of the S2 stock does not satisfy the business purpose requirement of I.R.C. § 351(a).

Courts have hinted at the concept of a business purpose requirement in I.R.C. § 351 repeatedly. Opinions discussing other I.R.C. § 351 issues often indicate that the taxpayer had a valid business purpose for the transaction in question. See Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1178 (3d Cir. 1974), cert. denied, 419 U.S. 826 (1974); Stewart v. Commissioner, 714 F.2d 977, 992 (9th Cir. 1983). Perhaps the most thorough judicial exploration of the business purpose doctrine in I.R.C. § 351 is in Caruth v. United States, 688 F. Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989). In Caruth, the court explains that I.R.C. § 351 is tied very closely to the reorganization provisions and reasons that the doctrines applicable there are equally valid for capital contributions. Under Caruth, the business purpose requirement for I.R.C. § 351 transactions appears to be the same as the business purpose requirement for acquisitive reorganizations. Generally, I.R.C. § 351 will apply to a transaction if the taxpayer has a valid business purpose for the transaction other than tax savings. See Stewart v. Commissioner, 714 F.2d 977, 991 (9th Cir. 1983); Rev. Rul. 60-331, 1960-2 C.B. 189, 191.

In this case, P and S1 will probably argue that the business purpose for the transfer of the cash, S3 stock and S4 note in exchange for S2 stock and the assumption of the contingent tort liabilities was to isolate such liabilities in a separate corporation. However, S1 sold the S2 stock several months after this transfer. The loss that S1 recognized offset a capital gain P recognized several months prior to the transfer. In that case, S1 may not be able to articulate a reason for selling such stock other than to recognize a capital loss to offset that gain. In other words, the Service may be able to argue that S1's sale of its S2 stock is inconsistent with the stated business purpose for the transfer to S2.

If the transfer does not qualify under I.R.C. § 351, then it would be treated as a taxable exchange under I.R.C. § 1001. In that case, but for the application of certain provisions of Treas. Reg. § 1.1502-13, S1 might be entitled to recognize its loss arising from the transfer.[4] In the next section of this letter, we explain under what circumstances S1 may deduct the loss.

Consolidated Return Regulations

Law:

Treas. Reg. § 1.1502-13:

(a) In general--(1) Purpose. This section provides rules for taking into account items of income, gain, deduction, and loss of members from intercompany transactions. The purpose of this section is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).

(b) Definitions. For purposes of this section–

(1) Intercompany transactions--(i) In general. An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction. S is the member transferring property or providing services, and B is the member receiving the property or services. Intercompany transactions include: (A) S's sale of property (or other transfer, such as an exchange or contribution) to B, whether or not gain or loss is recognized.

(2) Intercompany items--(i) In general. S's income, gain, deduction, and loss from an intercompany transaction are its intercompany items. For example, S's gain

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[4] The field believes that, even if the contingent liabilities S2 assumed were included in the amount realized under I.R.C. § 1001 (because I.R.C. § 351 did not apply), S1 would have realized a loss on its exchange with S2. We assume that is the case, but note that (i) the numbers in the case do not self-evidently support that conclusion and (ii) the appeals officer has informally indicated that the taxpayer contends that if the assumed contingent liabilities were included in the amount realized, then it would have had a gain if I.R.C. § 1001 applied. However, even if the taxpayer realized a nominal amount of gain, and even if the Service were able to invoke I.R.C. § 357(b), that section would trigger recognition of gain only to the extent of that nominal amount.

from the sale of property to B is intercompany gain. An item is an intercompany item whether it is directly or indirectly from an intercompany transaction.

(3) Corresponding items--(i) In general. B's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items. For example, if B pays rent to S, B's deduction for the rent is a corresponding deduction. <u>If B buys property from S and sells it to a nonmember, B's gain or loss from the sale to the nonmember is a corresponding gain or loss</u> (emphasis supplied); alternatively, if B recovers the cost of the property through depreciation, B's depreciation deductions are corresponding deductions. An item is a corresponding item whether it is directly or indirectly from an intercompany transaction (or from property acquired in an intercompany transaction).

(4) Recomputed corresponding items. The recomputed corresponding item is the corresponding item that B would take into account if S and B were divisions of a single corporation and the intercompany transaction were between those divisions. For example, if S sells property with a $70 basis to B for $100, and B later sells the property to a nonmember for $90, B's corresponding item is its $10 loss, and the recomputed corresponding item is $20 of gain (determined by comparing the $90 sales price with the $70 basis the property would have if S and B were divisions of a single corporation). Although neither S nor B actually takes the recomputed corresponding item into account, it is computed as if B did take it into account (based on reasonable and consistently applied assumptions, including any provision of the Internal Revenue Code or regulations that would affect its timing or attributes).

(c) Matching rule. For each consolidated return year, B's corresponding items and S's intercompany items are taken into account under the following rules:

(2) Timing–

(ii) S's items. S takes its intercompany item into account to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item.

(d) Acceleration rule. S's intercompany items and B's corresponding items are taken into account under this paragraph (d) to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation. For this purpose, the following rules apply:

(1) S's items--(i) Timing. S takes its intercompany items into account to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation. The items are taken into account immediately before it first becomes impossible to achieve this effect. For this purpose, the effect cannot be achieved–

(A) To the extent an intercompany item or corresponding item will not be taken into account in determining the group's consolidated taxable income (or consolidated tax liability) under the matching rule (for example, if S or B becomes a nonmember, or if S's intercompany item is no longer reflected in the difference between B's basis (or an amount equivalent to basis) in property and the basis (or equivalent amount) the property would have if S and B were divisions of a single corporation); or

(B) To the extent a nonmember reflects, directly or indirectly, any aspect of the intercompany transaction (e.g., if B's cost basis in property purchased from S is reflected by a nonmember under section 362 following a section 351 transaction).

Analysis:

If I.R.C. § 351 does not apply, then S1 would recognize gain or loss under I.R.C. § 1001 upon the sale of the S3 stock and S4 note to S2 (the first sale). S1 would determine the amount of its gain or loss from the first sale by subtracting its basis in the property sold, $j, from the value of the consideration it received, the S2 stock.

We do not know what value S1 and S2 might assign to such stock. Because S1 and S2 are affiliated, any value they assign to the S2 stock can not be presumed to reflect the fair market value of that stock. However, several months after the first sale, S1 sold the S2 stock to unrelated parties for $i (the second sale). If there was no substantial change in the circumstances of S2 during this period, then the Service has a reasonable argument that $i also represents the fair market value of the S2 stock at the time of the first sale. In that case, $i also represents S1's basis in the S2 stock for purposes of the first sale. Treas. Reg. § 1.1001-1(a). Consequently, S1 would recognize a loss on the first sale.

The first sale would be an intercompany transaction. Treas. Reg. § 1.1502-13(b)(1)(i). S1's loss would be an intercompany item. Treas. Reg. § 1.1502-13(b)(2)(i). However, as long as the property sold by S1 to S2 remains in S2 and S2 remains a member of the group, there is no provision in Treas. Reg. § 1.1502-13 which would allow S to claim the loss upon the sale of such property. Treas. Reg.

§ 1.1502-13(d)(1)(i)(A). Thus, the second sale would not allow S1 to take into account currently any portion of its intercompany item attributable to the loss.[5]

With respect to the second sale, as noted above, S1 has a basis in the S2 stock of $i, which is equal to the amount that the unrelated buyers paid for such stock. Consequently, S1 would not recognize any gain or loss as a result of this sale.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

ACM Partnership v. Commissioner, #97-7484 (3d Cir., 10/13/98) suggests two other possible routes of attack on the group's claimed loss on S1's sale of its S2 stock to the unrelated parties. First, the Third Circuit noted the Supreme Court case Knetsch v. United States, 364 U.S. 361 (1960). In Knetsch, the taxpayer had purchased annuity savings bonds from an insurance company, borrowed virtually their entire value against them, made payments back to the insurance company, and characterized those payments as deductible interest. Because the borrowing against the bonds had reduced their value to a mere "pittance," leaving the taxpayer with nothing of value apart from tax deductions, the Supreme Court concluded that the net effect of the transfers between the taxpayer and the insurance company amounted only to a payment of a "fee for providing the facade of 'loans' whereby the [taxpayers] sought to reduce" their taxes and therefore could not be characterized as payment of interest on a debt. Knetsch, at 366.

We recommend [redacted]

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[5] Assuming the value of the S2 stock is $i, then substantially all of that amount also represents S2's basis in the S4 note (because a small portion of that amount would be allocated to the S3 stock). Any payments on the note that constitute repayment of principal (as opposed to payment of interest) in excess of $i would result in income to S2 (as a corresponding item under Treas. Reg. § 1.1502-13(b)(3)) and an equal offsetting amount of loss to S1. However, see also Treas. Reg. § 1.1502-13(g), relating to the treatment of intercompany obligations.

[redacted].

The second route of attack suggested by ACM is an alternative argument that the Service made at the trial level (see footnote 42 of the Third Circuit ACM opinion). The Service argued that the "tax consequences of the transaction must be disregarded because ACM's partnership structure artificially 'bifurcat[ed] the tax consequences of the transaction' by allocating taxable gains to a foreign partner and offsetting tax losses to a taxpayer in a manner which the relevant statue and regulations did not intend."

In this case, the abuse is that by means of the I.R.C. § 351 exchange and S1's subsequent sale of its S2 stock, the taxpayer has attempted to turn a liability not currently deductible, because it is contingent, into a currently deductible loss. Those steps also abuse a second rule, the I.R.C. § 461(h) economic performance requirement, under which a deduction generally is not allowed until the liability in question is actually paid. The tort liabilities here had not been paid when S1 claimed the loss. In connection with this argument, you may want to request Field Service Advice from CC:DOM:FS:IT&A.

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

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cc: