INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS NO: TAM-107591-99/CC:DOM:CORP:B1

Attention:

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

LEGEND:

Taxpayer =

Subsidiary =

Company =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6	=
Month 7	=
Month 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
Year 1	=
Year 2	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=
m	=

n	=
o	=
p	=
q	=
r	=
s	=

ISSUE:

Whether the end result test under the step transaction doctrine is an appropriate test to determine whether to treat cash distributions from a wholly owned subsidiary corporation ("Subsidiary") to its parent corporation ("Taxpayer") of $e, $j, and $d as taxable “boot” in a § 351 transaction?

CONCLUSION:

The end result test is an appropriate test to determine whether to treat the cash distributions of $e, $j, and $d as taxable “boot” in a § 351 transaction.

FACTS:

Background

On Date 1, as part of a restructuring, Taxpayer (parent corporation of an affiliated group of corporations) established Company as a division of Taxpayer. On Date 2, Subsidiary (a subsidiary of Taxpayer) was incorporated as a shell corporation and a shares of voting common stock were issued to Taxpayer. On Date 3, Taxpayer and Subsidiary entered into a “Conveyance Agreement” in which Taxpayer agreed to transfer the assets and liabilities of Company to Subsidiary in exchange for an additional a shares of Subsidiary stock. On Date 4, Taxpayer unconditionally transferred the assets and liabilities of Company to Subsidiary. On Date 5, the Board of Directors approved the issuance of a shares of Subsidiary stock in consideration for Taxpayer’s transfer of the Company assets and liabilities to Subsidiary and a dividend to Taxpayer of b shares of Subsidiary stock. Also, on this date, Taxpayer issued a press release announcing that: (i) Taxpayer would sell c% of its stock in Subsidiary pursuant to an initial public offering (“IPO”), (ii) Subsidiary would take out a $d loan, and

(iii) Subsidiary would distribute the loan proceeds to Taxpayer in a “special” distribution if the offering proceeded.

Within the next three-month period, Subsidiary made several distributions to Taxpayer, which includes the three cash distributions at issue in this case. On Date 6, Subsidiary distributed $e to Taxpayer. During Month 7, Taxpayer released press reports and documents filed with the Securities and Exchange Commission (“SEC”) regarding the public offering of Subsidiary stock, which stated that: (i) Taxpayer intended to contribute $f to Subsidiary ’s capital, (ii) Subsidiary intended to distribute to Taxpayer all available cash at the end of Month 8, and (iii) Subsidiary intended to distribute to Taxpayer, just prior to the planned IPO, an amount equal to its net cash flow from the end of Month 8 to the consummation date of the IPO.

On Date 9, Subsidiary filed a restated certificate of incorporation under which the authorized common stock of Subsidiary was increased from a shares to g shares. Immediately thereafter, Subsidiary issued h additional shares of stock to Taxpayer as authorized on Date 5. As a result, Taxpayer owned a total of i shares of Subsidiary’s issued and outstanding common stock.

On Date 10, Subsidiary entered into a credit agreement with a third party bank to borrow $d. The $d of revolving credit facility was intended to finance the $d special distribution announced on Date 5. On Date 11, Subsidiary paid a dividend to Taxpayer in the amount of $j, which was equal to all available cash at the end of Month 8.

On Date 12, Subsidiary distributed the $d special distribution to Taxpayer. On Date 13, Taxpayer completed the IPO of k shares of stock it held in Subsidiary. The net price per share of the IPO proceeds received by Taxpayer totaled $l. As a result, Taxpayer’s ownership of Subsidiary stock dropped from m% to less than c%.

In its Year 1 federal tax return, Taxpayer reported dividends of $n as a result of the Month 7 and Month 8 distributions from Subsidiary. Additionally, as a result of regular cash distributions, Taxpayer reported another $o in distributions from Subsidiary. Because Subsidiary had $p in earnings and profits during Year 1, these distributions, including the regular distributions, were dividends that were eliminated pursuant to former Treas. Reg. § 1.1502-14(f). The distributions did not create an excess loss account in Subsidiary.

In its Year 2 federal tax return, Taxpayer made an election under Treas. Reg. Sec. 1.1502-76(b)(5)(ii) to treat Subsidiary as not having been a member of the Taxpayer consolidated group for the Year 2 taxable year. As a result of this election, Taxpayer reported that of the total $d special distribution, $q (the portion attributable to

Subsidiary's Year 2 earnings) was eligible for the 80% dividends received deduction under § 243 of the Code. The amount of $r was characterized as a return of capital and offset Taxpayer's basis in its Subsidiary stock under § 301(c)(2). The remaining amount of $s was reported as capital gain under § 301(c)(3). Finally, Taxpayer reported the entire net proceeds of $l received in the IPO as taxable capital gain because of full basis recovery as result of the $d special distribution.

Agent's Position

The Internal Revenue Agent takes the position that the transfer of Taxpayer's Company assets to Subsidiary and the cash distributions from Subsidiary to Taxpayer were part of an integrated § 351 transaction in which the cash distributions should be treated as taxable "boot" under § 351(b). In making this determination, the Agent applies the "end result" test under the step transaction doctrine.

Taxpayer's Position

Taxpayer contends that the cash distributions should not be integrated with the transfer of the Taxpayer's Company assets to Subsidiary and therefore, the cash distribution should not be treated as taxable "boot" under § 351. Taxpayer maintains that "binding commitment" is the only appropriate test under the step transaction doctrine for determining whether the cash distributions by Subsidiary to Taxpayer should be integrated with Taxpayer's transfer of the Company assets to Subsidiary.

DISCUSSION:

Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons "solely in exchange for stock or securities in such corporation," if immediately after the exchange such person or persons are in control of the corporation (as defined in § 368(c)).

Section 351(b) of the Code provides that if § 351(a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under § 351(a), other property or money ("boot"), then gain, if any, to such recipient shall be recognized to the extent of the other property or money received and no loss to such recipient shall be recognized.

Section 368(c) of the Code defines the term "control" to mean 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.

Under the judicially developed step transaction doctrine, a series of formally separate steps may be collapsed and treated as if they constituted a single integrated transaction. The Courts have applied three tests to determine if the step transaction doctrine should apply: the "binding commitment" test, the "mutual interdependence" test, and the "end result" test. Under the binding commitment test, a series of formally separate transactions will be stepped together or collapsed if, when the first step is taken, there is a binding commitment to take the later steps. Commissioner v. Gordon, 391 U.S. 83, 96 (1968). Under the mutual interdependence test, a series of formally separate transactions will be stepped together or collapsed if they "are so interdependent that the legal relations created by one transaction would be fruitless without a completion of the series." *See, e.g.,* American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948), *aff'd* 177 F.2d 513 (3d Cir. 1949). Finally, under the end result test, a series of formally separate transactions will be stepped together or collapsed if they appear to be "really arranged parts of a single transaction intended from the outset to reach the ultimate result" Penrod v. Commissioner, 88 T.C. 1415, 1429 (1987).

The Agent has not argued that Taxpayer's transfer of Company assets to Subsidiary should be integrated with Subsidiary's subsequent cash distributions to Taxpayer under the binding commitment test. The information submitted shows no indication that there existed a binding agreement for Subsidiary to make the subsequent cash distributions to Taxpayer. The Agent also has not argued that Taxpayer's transfer of Company assets to Subsidiary should be integrated with Subsidiary's subsequent cash distributions to Taxpayer under the mutual interdependence test. The information submitted indicates that Taxpayer unconditionally transferred Company assets to Subsidiary pursuant to the Conveyance Agreement. The transfer of Company assets to Subsidiary combined with Subsidiary's stock dividend of b shares enabled Taxpayer to complete the IPO of k shares of Subsidiary stock in exchange for $l. The IPO permitted Taxpayer to accelerate its receipt of a portion of Subsidiary's expected future cash flow so that Taxpayer could expand its repurchase programs of its own stock, repurchase a portion of Subsidiary stock sold in the IPO, and increase Taxpayer's immediate financial capacity to pursue investment opportunities. In addition, Taxpayer's transfer of Company assets to Subsidiary limited the exposure of Taxpayer to potential liabilities arising out of the business involving Company assets. Also, the transfer allowed Subsidiary to utilize an accounting system more compatible with Subsidiary's business in order to maximize earnings and return on investment. Thus, Taxpayer's transfer of Company assets to Subsidiary served an economic purpose apart from the subsequent cash distributions.

However, we reject Taxpayer's contention that the binding commitment test is the only appropriate test for determining whether the cash distributions by Subsidiary to Taxpayer should be integrated with Taxpayer's transfer of the Company assets to Subsidiary. Taxpayer cites Intermountain Lumber Company, Inc. v. Commissioner, 65 T.C. 1025 (1976) in support of its position. In Intemountain Lumber, the taxpayer incorporated and transferred assets to a newly formed corporation in exchange for stock. The taxpayer executed a binding contract providing for the sale of 50% of the shares of stock and the grant of an irrevocable proxy to vote the shares to a third party over a five year period. Intermountain Lumber is distinguishable from the facts in the instant case. In Intermountain Lumber, an individual shareholder contracted to sell stock to an outside third party; but here, not only is there no contractual commitment to sell Subsidiary stock, but Taxpayer is the sole shareholder dealing with its wholly owned corporation. Further, the court's holding in Intermountain Lumber concerned the "control immediately after" test under § 351. In the instant case, the "control" test is not at issue.

The facts of the instant case are similar to those in Makover v. Commissioner, 26 T.C.M. (CCH) 288 (1967), in which the court tested whether to apply the step transaction doctrine under both the mutual interdependence test and the end result test. In Makover, a partnership (transferor) transferred its business assets to a newly formed corporation in exchange for all of its stock and, at the same time, loaned the corporation $100,000 in cash in exchange for a demand note. The issue was whether the incorporation should be treated as a transfer of assets and cash in exchange for stock and the demand note so that the transfer of the demand note would be treated as taxable "boot" in a § 351 transaction. With respect to the mutual interdependence test, the Court found that the corporation could have borrowed whatever funds it needed from outside third parties and that the transfer of the partnership business to the corporation could have been accomplished without the transfer of the cash. With respect to the end result test, the Court held that the note did not constitute "other property" under § 351(b) because the transfer of the cash from the transferor to the corporation was not part of the plan for incorporating the partnership's business. Thus, while the court declined to apply either the mutual interdependence test or the end result test, the court's analysis supported the position that both are appropriate tests to determine whether to integrate Taxpayer's transfer of Company assets to Subsidiary with Subsidiary's subsequent cash distributions to Taxpayer in the instant case.

The Agent argues that the transfer of Company assets to Subsidiary and Subsidiary's subsequent cash distributions should be integrated based upon Month 7 public announcements of the pending transactions which were consummated as described and the Month 7 SEC filings, which provided details of the IPO, the $d loan, and the distribution of those proceeds as one of the cash distributions. The end result test, as applied by the courts and the Service, examines the parties' intent at the beginning of the transaction as to what the end result will be at a future date. *See* Ericsson Screw Machine Products, Co. v. Commissioner, 14 T.C. 757 (1950). Kind v. Commissioner, 54 T.C. 600, 608 (1970) requires that the intent necessary to support the end result test is the parties' "actual" intent and not their "constructive" or "hypothetical" intent. In the instant case, the end result test requires an examination of whether Taxpayer actually intended on Date 4, when Taxpayer transferred Company assets to Subsidiary, that Subsidiary would make the subsequent cash distributions to Taxpayer.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.