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INTERNAL REVENUE SERVICE NATIONAL OFFICE

TECHNICAL ADVICE MEMORANDUM

September 22, 2000
Chief, Appeals Office

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's EIN:

Years Involved:

Date of Conference:

LEGEND:

P =

P1 =

P2 =

P3 =

P4 =

P5 =

M =

H =

A1 =

A2 =

Partnership =

Bank =

Bonds =

Note =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

D8 =

D9 =

D10 =

D11 =

$A =

$B =

$C =

$D =

$E =

$F =

$G =

$H =

ISSUES:

1. Whether P exchanged the installment obligation, resulting in capital gain income of $C in D8 and $H in D7, under the provisions of section 1031 of the Internal Revenue Code.

2. Whether P exchanged the installment obligation, resulting in capital gain income of $A in D7 under the provisions of section 1031 of the Internal Revenue Code Code.

3. Whether P constructively received $A in D9 from collection of the installment obligation, as provided by section 451 of the Internal Revenue Code.

CONCLUSION:

1. P did not exchange the installment obligation, resulting in capital gain income of $C in D8 and $H in D7, under the provisions of section 1031 of the Internal Revenue Code.

2. P did not exchange the installment obligation, resulting in capital gain income of $A in D7 under the provisions of section 1031 of the Internal Revenue Code Code.

3. P did not constructively receive $A in D9 from collection of the installment obligation, as provided by section 451 of the Internal Revenue Code.

FACTS:

P is a parent company that owns numerous other corporations. On D1 P sold its interest in certain corporations to H. For the stock sold, P received cash and Note from H. The face amount of Note was $A. Note was due on D9, but terms of the Note provided it could be prepaid at up to $F per year following the first anniversary date, or prepaid in larger amounts with 12 months written notice to P. Note was secured by an irrevocable letter of credit dated D1. The letter of credit was in turn secured by mortgages on the property owned by the corporations sold to H. P elected to report the sale on the installment method. The entire $A is a deferred gain, taxable in the year of receipt of payment.

H approached P in D5 about removing the mortgages on the property securing the letter of credit. On D6, H and P entered into an agreement pursuant to which H transferred $A to Bank. As a result, the letter of credit securing Note was now secured by a compensating cash deposit with Bank, as opposed to mortgages on H's property.

On D2, approximately 3 years later, P, as a first step in transferring Note to Partnership, transferred Note and the underlying letter of credit to P1, a newly formed subsidiary of P. Approximately a week later, on D3, P1 transferred Note and the underlying letter of credit to a newly formed partnership, Partnership. The partners of Partnership were P1, M, A1 and A2. A1 and A2 each contributed $B to Partnership for their respective partnership interest. Also on D3, the following transactions occurred: Partnership contributed $C to P2, a newly formed corporation, in exchange for all the stock in P2; P2 loaned the $C to P3, a wholly-owned subsidiary of P; P3 loaned $D to P and also loaned $E to P4, a wholly owned subsidiary of P. P3 subsequently contributed the P4 loan to the capital of P4. P4 used the $E received from P3 to pay off an inter-company debt it had to P. Accordingly, eight days after the cash contribution to Partnership by A1 and A2, and on the same day that the Note and the letter of credit were contributed to Partnership, the $C that Partnership had transferred to P2 as a purported equity contribution ended up with P.

Following the contribution of $C by Partnership to P2, the assets of Partnership consisted of Note, the underlying letter of credit, $G invested in Bonds, and an equity interest in P2. Partnership's sole activity has been collecting the payments made on Note and the interest payment from Bonds. On D11 and D10, P and H entered into negotiations whereby the Note was extended to D10 and D7 respectively.

For the 5 years following Partnership's contribution to P2, through the tax year D7, P2 conducted no activity and had no earnings. Partnership received no economic benefit from its investment in P2. Partnership's earnings through D7 were derived solely from Note and the investment in Bonds.

On D4, 5 years after the formation of Partnership, Note and the underlying letter of credit were distributed to A1 and A2 in liquidation of their respective interests in Partnership. Also in the same year, M's interest in Partnership was liquidated and a new partner, P5, a wholly-owned subsidiary of P, was admitted to Partnership. At the end of D7 the partners of Partnership were P1 and P5, wholly-owned subsidiaries of P.

At the end of D7, the only assets held by Partnership were its investment in P2 and an investment account with a brokerage firm with a value of $H.

The intent of the parties that formed Partnership, as evidenced by the action of the parties and by the partnership agreement, was to minimize the economic risk of A1 and A2 and to provide the $C that would ultimately be transferred to P.

LAW

Section 1031(a) of the Internal Revenue Code provides no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

Section 1031(b) provides if an exchange would be within the provisions of subsection(a), of section 1035(a), of section

1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

Section 1.451-1(a) of the Treasury Regulations provides that gains, profits and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer’s method of accounting . Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

Section 1.451-2(a) of the regulations provides that a taxpayer constructively receives income in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.

ANALYSIS

With respect to the first two issues, the appeals officer initially argues that the series of events that occurred in D8 was a sham transaction with no business purpose or economic substance. Accordingly, P should be viewed as having exchanged Note for the loan proceeds received from P3 and the loan repayment received from P4 in D8, as well as the assets in the brokerage firm investment account P acceded to in D7. In the first issue, the officer argues that this resulted in gain in those two years to the extent of the amounts received therein. In the second issue, the officer argues that all of the gain accrued in D7, the year the exchange was completed.

As a statutory framework to support these arguments, the appeals officer cites to section 1031(b). The officer notes that section 1031(b) provides that gain shall be recognized on the exchange of property that is not like kind. Thus, his reliance on section 1031(b) appears to be an attempt to treat the amounts received by P as "boot." However, it is unclear what other property was exchanged under section 1031(a). The treatment provided in section 1031(b) for property received in an exchange that is not of like kind applies only when other property that is of like kind is also exchanged. The facts as developed do not establish that other property qualifying for nonrecognition of gain or loss under section 1031(a) was also exchanged.

Accordingly, we are unable to agree with the officer's argument on the first two issues.

The appeals officer's last argument is that P constructively received $A in D9 from collection of the installment obligation, as provided by section 451.

We do not believe the doctrine of constructive receipt is applicable in this case. Section 1.451-2(a) of the regulations provides that a taxpayer constructively receives income in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.

On D10, P and H entered into negotiations that extended the due date of Note until D7. Therefore, on D9, the Note was not due and payable.

In this case Taxpayer was unable to draw upon the security for the standby letter of credit until H failed to make payment on the note at maturity. Prior to that time the $A was not credited to Taxpayer's account, set apart for him, or otherwise made available so that it could have drawn upon it during the taxable year.

THE END