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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Associate Area Counsel Strategic Litigation (LMSB)
CC:LM:RFP:SLATL

FROM: Richard E. Coss
Assistant to the Branch Chief, CC:CORP:B03

SUBJECT:

This Field Service Advice responds to your memorandum dated June 29, 2001. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. In accordance with § 6110(k)(3), this Field Service Advice should not to be used or cited as precedent.

LEGEND

Parent =

Sub 1 =

Sub 2 =

Sub 3 =

F Sub =

FX =

A =

B =

LLC 1 = [1]

LLC 2 = [2]

Foreign Bank =

Currency a =

Currency b =

Country A =

Country B =

Country D =

Country E =

City F =

City G =

[1]

State H	=
Date 1	=
Date 1a	=
Date 2	=
Date 2a	=
Date 3	=
Date 4	=
Date 5	=
w%	=
x%	=
y%	=
z%	=
reason c	=
[Description of Currency b]	=
$Amount d	=
$Amount e	=
Amount f	=
Amount g	=
Amount h	=
Amount i	=
$Amount j	=

$Amount k =

Amount m =

$Amount n =

$Amount o =

$Amount p =

$Amount r =

$Amount s =

$Amount t =

$Amount v =

$Amount w =

Amount x =

$Amount y =

$Amount z =

$Amount aa =

$Amount bb =

$Amount cc =

$Amount dd =

ISSUES:

1. Can each of the two Loans be bifurcated into two pieces, one representing the obligation by the LLCs to pay interest only and one representing the obligation by Sub 2 to pay principal only?

2. Does the Step Transaction Doctrine apply to the facts of this case, with the result that the principal portion of the Loan ($Amount o) is assumed by Sub 2 outside of the § 351 transaction (with the result that there is no gain

recognized by the LLCs under § 357(c), no basis increase to Sub 2 under § 362(a), and no loss recognized by Sub 2 on the sale of the Currency b)?

3. Should the transaction at issue be recharacterized in accordance with its substance and Sub 2's loss totally disallowed under § 1.988-2(f)? Alternatively, if the loss is not totally disallowed under § 1.988-2(f), should the loss be recharacterized under § 1.988-1(a)(11)?

4. Can the Commissioner apply § 482 to reallocate the loss from Sub 2 to the LLCs, who are not subject to United States taxation?

5. Whether the overall transaction lacks sufficient economic substance to be respected for federal income tax purposes?

CONCLUSIONS

1. The parties factually bifurcated each Loan into the interest piece, with the LLCs as the primary obligor and thus expected to pay, and the principal piece, with Sub 2 as the primary obligor and thus expected to pay (with the latter being valued at its fair market value, $Amount o). As a result, there is an argument that we should be able to make a fair market value allocation of the adjusted issue price of the original instrument ($Amount k) between the two instruments ($Amount s and $Amount o for the interest piece and the principal piece, respectively). This analysis would apply for § 357(c) purposes. As a result, the “true amount” assumed by Sub 2 in the § 351 transaction would be the fair market value of the principal piece, or $Amount o. Because the liability assumed by Sub 2 would equal the basis in the hands of the LLCs, there would be no § 357(c) gain recognized by the LLCs and, thus, there would be no increase in the basis of the Currency b by Sub 2 under § 362(a). Accordingly, no loss would be recognized by Sub 2 on the sale of the Currency b. This is the correct economic result. When we determine if this argument can be made, we will inform you.

2. The Step Transaction Doctrine may apply to this case because there is strong evidence that Parent at least had preliminary discussions with the other parties to the transaction and contemplated Foreign Bank extending a loan to the LLCs before Sub 2, as a literal matter, was committed to participate in the loan transaction. To the extent the Step Transaction Doctrine is successfully applied, the purported loss recognized by Sub 2 is eliminated, *i.e.,* the basis of the assumed portion of the Loan equals the adjusted issue price. We suggest further factual development to determine if the LLCs were acting as an agent or an intermediary of Sub 2 and/or any other member of the Parent Group with respect to the loan transaction.

3. Parent and its related entities may not deduct as a foreign currency loss under § 988 an amount that does not reflect movements in exchange rates but rather basis shifting under §§ 357(c) and 362(a). Under §1.988-2(f), the $Amount r loss is disallowed. Alternatively, under §1.988-1(a)(11), the Service may conclude that the $Amount r loss is recognized in its entirety, but is recharacterized as a capital loss.

4. The Commissioner can apply § 482 to reallocate the loss from Sub 2 to the LLCs, who are not subject to United States taxation. The actions jointly undertaken by the contributing LLCs and Parent constituted "control" within the meaning of § 1.482-1(i)(4). Consequently, the loss from the transaction may be reallocated to reflect clearly the income, expense, gains and losses of the LLCs and Parent. Section 1.482-1(f)(1)(iii) provides particular authority for allocating the loss with respect to the foreign currency that was acquired by Sub 2 in a § 351 nonrecognition transaction to the LLCs. The fact that the LLCs sought to recognize gain under § 357(c) does not bar application of the regulation because the gain recognition and step-up in basis was caused only incident to the property transfer initially qualifying for nonrecognition under § 351. Without application of § 351, we do not believe the gain recognition and attendant basis step-up could have been achieved without an economic cost to Sub 2.

5. Sub 2's assumption and hedge transactions did not have economic substance and, thus, Sub 2's § 988 loss should not be allowed. See Lerman v. Commissioner, 939 F.2d 44, 45 (1991) (a transaction devoid of economic substance cannot be the basis of a deductible loss).

FACTS

F Sub is a wholly owned County B subsidiary of Parent, a domestic corporation and parent of a consolidated group that includes, among other corporations, Sub 1, Sub 2, and Sub 3. LLC 1 and LLC 2 (collectively, the "LLCs"), unrelated to Parent and its affiliates, are each w% owned by FX, a Country D corporation, and x% owned by A, a Country E individual. FX's controlling member is B, an individual (we have no information as to B). The owners of the LLCs are not subject to United States taxation.

Both LLCs were formed prior to Date 1 with contributions of $Amount d and $Amount e, respectively, by FX. The proceeds from the contributions were used to purchase the Securities, discussed below. It appears that the LLCs did not engage in business other than the transactions at issue.

On Date 1, each LLC purchased from Foreign Bank Currency a Amount f face amount of y% Country A government debt and Currency a Amount g face

amount of z% Country A government debt (collectively the "Securities") for settlement on Date 2, at an aggregate purchase price of Currency a Amount h each. Also on Date 1, the LLCs entered into separate confirmations with Foreign Bank providing for a cross-currency rate swap under which the LLCs would swap Currency b for Currency a.

On Date 2, each LLC borrowed Currency b Amount i worth $Amount j (or $Amount k in total) from Foreign Bank for a term of 30 years (collectively, the "Loans"). Interest on the Loans resets every three years. The LLCs applied the Currency b received from the Loans to meet their initial exchange obligations under the cross-currency rate swap transactions. The LLCs then used the Currency a Amount h proceeds of the amount received from Foreign Bank under the cross-currency swap transactions to settle the purchases of the Securities. The remaining proceeds were deposited in a time deposit account of the Country E branch of Foreign Bank. Both the Securities and the time deposit were held by Foreign Bank as collateral to secure the Loans.

Foreign Bank had sole dominion and control over the Securities, subject to the requirement that security for the Loans be invested only in "Permitted Investments," essentially debt instruments of sufficient grade and quality to satisfy Foreign Bank. The credit agreement provided that upon the substitution of the collateral, the LLCs were required to have another party acceptable to Foreign Bank assume the Loan as co-obligor. The collateral was the principal source of repayment on the Loans; however, the owners of the LLCs were also fully liable for the repayment.

On Date 3, two days following the maturity of the Securities, each LLC agreed to purchase a pool of mortgage securities from F Sub for Currency b Amount m, representing about $Amount n for each LLC (for a total of $Amount s). F Sub continued to service the mortgages. Parent claims that F Sub's sale of the Currency b denominated mortgages allowed F Sub to remove the mortgages from its balance sheet, and provided term funding for F Sub, in the absence of an efficient securitization market for Currency b mortgages. The sale of the mortgages also provided an asset substitution for Currency b dollar assets. Parent claims that F Sub needed to hedge its Currency b dollar assets, since at that point in time the Currency b financial markets were unstable due to reason c.

These mortgage securities were accepted as substitute collateral for the Loans. In order to allow for a substitution of the collateral, Sub 2, a wholly owned domestic subsidiary of Sub 1 (another Parent consolidated group member), agreed to assume the obligations of the LLCs under the Loans as a co-obligor. Sub 1 agreed to guarantee Sub 2's performance as co-obligor. The LLCs pledged their assets to reimburse Sub 1 for any amount it might pay under its guarantee. Under separate agreements, Sub 2 agreed to be liable for the principal repayment on the

Loans and the LLCs agreed to pay the interest on the Loans. Parent alleges that the present value of the assumption by Sub 2 of $Amount k in future obligations was $Amount o. Apparently no present value was attached to Sub 2's becoming co-obligor to Foreign Bank on the LLCs' obligation to pay the interest on the debt.

The LLCs transferred $Amount p in Currency b (the "Assets") to Sub 2 in exchange for non-voting preferred stock of Sub 2 and Sub 2's assumption of the Loans as co-obligor in a purported § 351 transaction. Simultaneously, and as part of the same purported § 351 transaction, Sub 3, another wholly owned domestic subsidiary of Sub 1, contributed $Amount t to Sub 2 in exchange for Sub 2 common stock. Sub 3 immediately distributed the common stock of Sub 2 to Sub 1.

Sub 2 sold the Currency b for U.S. dollars. Sub 2 purchased a U.S. dollar denominated zero coupon note issued by Sub 1 for $Amount v, which in 30 years will yield $Amount w. In addition, Sub 2 entered into a forward contract with Sub 1 under which it will be able to convert the $Amount w into Amount x of Currency b. Accordingly, Sub 2 has no risk of currency or interest rate loss regarding its loan obligation. From the numbers you have provided, it appears that Sub 2 made an arbitrage profit of $Amount y, in that Sub 2 received the Currency b equivalent of $Amount o from the LLCs to assume the principal of the Loans, and paid $Amount v to Sub 1 for its hedge. Given Parent's representation that the present value of the Amount x Currency b Loan was $Amount o, we do not believe that the $Amount v purchase price of the hedge was arm's length. We proceed under the assumption that no arbitrage profit was realized with respect to this transaction. We suggest additional factual development on this point.

According to Sub 2's balance sheet as of Date 5, Sub 2 held assets of $Amount z.[3] According to an internal Parent memo written prior to the transactions at issue, Sub 2's assets consisted of City F industrial revenue bonds and foreclosed real estate located in City G. Sub 2's primary liability was $Amount aa owed to Sub 1, and Sub 2's book value was $Amount bb. The memo further stated that Sub 2 did not have a viable long term business, and that no growth was anticipated. Lastly, the memo stated that this transaction was executed through Sub 2 so as to maximize the tax benefits of the anticipated loss, since Sub 2 was subject to tax in a high tax rate state (presumably State H).

Parent took the position on its U.S. consolidated return that the exchange transaction among Sub 2, Sub 3, LLC 1, and LLC 2 qualifies as a § 351 exchange because in exchange for property, the Currency b and the cash of $Amount t, the transferors (the LLCs and Sub 3) received stock in the transferee (Sub 2) and the

[3] Apparently the assets and liabilities do not include the assets received and the liabilities assumed in the § 351 transaction.

transferors were in control of the transferee immediately after the exchange.[4] Under § 357(c),[5] the LLCs recognized approximately $Amount s in gain from the exchange to the extent that liabilities assumed by Sub 2, which presumably was $Amount k, exceeded the LLCs' combined basis in the contributed property, which was $Amount o. The gain, however, was not subject to United States taxation since the LLCs' members are not subject to United States tax. Accordingly, Parent's position is that pursuant to § 362(a), Sub 2's basis in the Currency b is equal to the transferor's basis, which is $Amount o, plus the gain recognized in the exchange, which is $Amount s, for a total basis of $Amount k. Thus, Parent's position is that Sub 2's sale of the Currency b generated a loss of $Amount r, which is characterized as an ordinary loss under § 988(a)(1) and (c)(1)(C). For financial accounting purposes, Sub 2 booked its liability to Foreign Bank at its present value, $Amount o, and accrues interest expense over the 30-year term.

You have requested Field Service Advice on possible arguments for denying the loss claimed from this abusive basis shifting transaction.

LAW AND ANALYSIS

1. Bifurcation of the Loans

In the instant case, the parties by agreement have factually bifurcated each Loan as between interest, with the LLCs as the primary obligor and thus expected to pay, and principal, with Sub 2 as the primary obligor and thus expected to pay. To the extent we are able to successfully bifurcate each Loan into two debt instruments, one instrument representing the obligation to pay interest and the other representing the obligation to pay principal (for any of the reasons set forth above), we would make a fair market value allocation of the adjusted issue price of the original instrument ($Amount k) between the two instruments ($Amount s and $Amount o for the interest piece and the principal piece, respectively). This analysis would apply for § 357(c) purposes. As a result, the "true amount" assumed by Sub 2 in the § 351 transaction would be the fair market value of the principal piece, or $Amount o. Because the liability assumed by Sub 2 would equal the basis in the hands of the LLCs, there would be no § 357(c) gain recognized by the LLCs and, thus, there would be no increase in the basis of the Currency b by Sub 2 under § 362(a). Accordingly, no loss would be recognized by Sub 2 on the sale of the Currency b. This is the correct economic result.

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[4] The transferors (Sub 3 and the LLCs) meet the "control immediately after" requirement because Sub 1, Sub 2, and Sub 3 are in the same affiliated group and Sub 2 and Sub 3 are 100 percent owned by Sub 1 (§ 1.1502-34).

[5] Effective for transfers before October 19, 1998.

2. Step Transaction Doctrine

The step transaction doctrine provides that "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction." Commissioner v. Clark, 489 U.S. 726, 738 (1989) (The step transaction doctrine is a corollary of the general tax principle that ...taxation depends on the substance of a transaction rather than its form.) The doctrine requires that all interdependent steps are linked together, rather than taken in isolation so that the federal tax liability may be based on a realistic view of the entire transaction. Clark, 489 U.S. at 738. There are three tests for determining when the step transaction doctrine should operate to collapse the individual steps of a transaction into a single integrated transaction for tax purposes: (1) end result, (2) interdependence, and (3) binding commitment.

The end result test combines into a single transaction separate events which appear to be component parts of something undertaken to reach a particular result. Under this test, if the series of closely related steps in a transaction are merely the means to reach a particular result, the steps will not be treated as separate, but instead will be treated as a single transaction. The end result test focuses on whether the taxpayer intended to reach a particular result by structuring a series of transactions in a certain way. See King Enterprises v, United States, 418 F.2d 511 (1969).

In the present transaction, Parent and Sub 2 were involved with the loan transaction prior to the purported § 351 transaction and assumption of the liability. Parent has asserted that Foreign Bank loaned the money to the LLCs before Sub 2 and Parent were involved with the transaction. However, a Parent internal document, dated Date 1a, states the following:

> The loan would be extended by [Foreign Bank] to the LLC before [Sub 2] is committed to participate. [Sub 2] would agree with the LLC to repay the principal portion of the loan and the LLC would agree to make the periodic interest payments. About 90% of the loan proceeds would be used by the LLC to purchase securities that, in turn, would be used to collateralize and satisfy the interest payments on the loan. The remaining 10% of the loan proceeds, representing the PV [present value] of the loan principal, would be transferred to [Sub 2].

This statement provides strong evidence that Parent at least had preliminary discussions with the other parties to this transaction and contemplated Foreign Bank extending a loan to the LLC's before Sub 2 literally was committed to participate in the loan transaction. We suggest further factual development to determine if the LLCs were acting as an agent or an intermediary of Sub 2 and/or any other member of the Parent Group with respect to the loan transaction.

3. Section 988 loss argument

(a) Relevant Law.

Sections 985-989, which were enacted as part of the Tax Reform Act of 1986, set forth a comprehensive set of rules for the treatment of foreign currency transactions. Section 988(a)(1)(A) provides that foreign currency gain or loss attributable to a § 988 transaction is computed separately and treated as ordinary income or loss. Foreign currency gain on a § 988 transaction is generally defined as the gain on the transaction to the extent such gain does not exceed gain realized by reasons of changes in exchange rates on or after the booking date and before the payment date. Section 988(b)(1). Foreign currency loss is similarly defined in § 988(b)(2). In this manner, Congress intended that only gain or loss to the extent it is realized by reason of a change in exchange rates between the date the asset or liability is taken into account for tax purposes and the date it is paid or otherwise disposed of, will be treated as foreign currency gain or loss. S. Rep. No. 313., 99th Cong., 2d Sess. 461 (1986). In addition, any gain or loss from the disposition of nonfunctional currency is treated as foreign currency gain or loss under the assumption that any gain or loss realized on the disposition of nonfunctional currency must be attributable to the fluctuation in the foreign exchange rates between the purchase and sale of the currency. Section 988(c)(1)(C)(i). This is confirmed by committee reports describing the principles of § 988 prior to its amendment to address issues not implicated in this case by the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). Thus, the House Ways and Means Committee Report to the Miscellaneous Revenue Act of 1988 stated that "[i]n the case of any disposition of nonfunctional currency, the relevant period for measuring rate changes is the time between acquisition and disposition of the currency." H.R. Rep. No. 795, 100th Cong., 2d Sess. 296 (1988).

The legislative history of §§ 985 - 989 suggests a consistent concern about tax motivated transactions. The Senate Finance Committee Report accompanying the Tax Reform Act of 1986 stated that one of the two reasons §§ 985 - 989 were enacted was prior law provided opportunities for tax motivated transactions. S. Rep. No. 313., 99th Cong., 2d Sess. 450 (1986). Accordingly, in enacting §§ 985 - 989, Congress granted broad authority for the Service to promulgate regulations "as may be necessary or appropriate to carry out the purposes of [§§ 985 - 989] . . . ." Section 989(c). The legislative history to the TAMRA, in discussing the law prior to the enactment of TAMRA, stated that "[t]he Secretary has general authority to provide the regulations necessary or appropriate to carry out the purposes of new subpart J. For example, the Secretary may prescribe regulations appropriately recharacterizing transactions to harmonize the general realization and recognition provisions of the Code with the policies of § 988." H.R. Rep. No. 795, 100th Cong., 2d Sess. 296 (1988); S. Rep. No. 445, 100th Cong., 2d Sess. 311 (1988) (containing identical language).

In response to Congress's concern about tax motivated transactions, the Service, under the authority of § 989(c) promulgated § 1.988-2(f) and § 1.988-1(a)(11). Section 1.988-2(f) states that if the substance of a transaction differs from its form, the Commissioner may recharacterize the timing, source, and character of gains or losses with respect to the transaction in accordance with the substance of the transaction. Section 1.988-1(a)(11) states in part that the Commissioner may exclude a transaction or series of transactions which in form is a § 988 transaction from the provisions of § 988 if the substance of the transaction, or series of transactions indicates that it is not properly considered a § 988 transaction.

(b) Analysis.

We believe that the transaction at issue should be recharacterized in accordance with its substance and Taxpayer's loss totally disallowed under § 1.988-2(f). Alternatively, if the loss is not totally disallowed under § 1.988-2(f), the loss may be excluded from § 988 under § 1.988-1(a)(11).

Section 1.988-2(f). As stated previously, § 1.988-2(f) states that "[i]f the substance of a transaction described in § 1.988-1(a)(1) differs from its form, the timing, source, and character of gains or losses with respect to such transaction may be recharacterized by the Commissioner in accordance with its substance." In this case, in form the loss results from the sale of Currency b, a transaction described in § 1.988-1(a)(1)(i), in which their amount realized exceeded their basis by approximately $Amount cc[6]. For purposes of § 988, however, the substance of the transaction may be viewed as Foreign Bank loaning the Currency b equivalent of $Amount o to Sub 2, and the remaining Currency b equivalent of $Amount cc was loaned to the LLCs or F Sub. In form, Sub 2 borrowed the $Amount o indirectly through the LLCs as a zero coupon loan, and used the § 351 transaction to receive the loan proceeds. In this manner under the purported application of § 357(c) the LLCs recognized gain when Sub 2 assumed as co-obligor the total amount of the loan, and under § 362(a)(1) Sub 2 increased its basis in the Currency b in the amount of the gain purportedly recognized by the LLCs. Accordingly, Sub 2 inappropriately increased its basis in the Currency b, so that it prematurely recognized a large current foreign currency loss, and forswore future interest deductions over the thirty year term of the loan. Artificially shifting basis to the Currency b so that the computation of foreign currency loss does not reflect the substance of the transaction is manifestly contrary to the intent of Congress as set forth above that currency gain or loss be computed by reference to movements in exchange rates. In this case, the claimed loss is not the result of exchange rate fluctuations in that Sub 2 only held the Currency b [Description of Currency b] for a

[6] The exact amount of the purported foreign currency loss is unclear.

single day.[7] Accordingly, under § 1.988-2(f), Sub 2 may not deduct the artificial § 988 loss.

Section 1.988-1(a)(11). Alternatively, under § 1.988-1(a)(11) Sub 2's loss on the sale of Currency b should not be characterized as a § 988 transaction, since the purported loss is totally unrelated to the fluctuation of foreign currency rates.

Substance over Form. The following factors support our characterization of the substance of the transaction as Foreign Bank lending the Currency b equivalent of $Amount o directly to Sub 2, and Sub 2 being required to repay Amount x Currency b (equivalent to $Amount k at current exchange rates) in thirty years.

1. The proximity of time between the various transactions, i.e., Foreign Bank's loan to the LLCs, the LLCs' purchase of the Securities, the maturity of the Securities, the LLCs' purchase of the mortgage pool, and the purported § 351 transaction, indicates that the various transactions were planned as a single transaction. In particular, the fact that the Securities were purchased on Date 2, that the Securities matured on Date 2a, and that the mortgage pool was purchased on Date 3, supports the conclusion that all of the transactions were planned together.[8] Accordingly, we believe Foreign Bank, when it disbursed the loan proceeds, expected that Sub 2 would become a co-obligor of the loan when the Securities matured.

2. The LLCs were formed immediately prior to the transactions at issue, and other than their initial capital contributions, had no other assets. The LLCs did not conduct any other business than the transactions at issue. Accordingly, it is doubtful that Foreign Bank would have lent the LLCs the Currency b equivalent of $Amount k without the knowledge that the other transactions would have occurred. Furthermore, since the mortgage pool, the LLCs' only substantial asset, was valued at only $Amount s, Foreign Bank must have looked to Sub 2 (or other members of Parent group) for repayment of the $Amount o, and accrued interest thereon.

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[7] It is not clear whether Sub 2 economically recognized a gain or loss on its holding the Currency b for one day.

[8] Obviously, the LLCs borrowing the funds from Foreign Bank and their purchase of the Securities were planned together, since the contracts were entered into on the same day. In addition, the LLCs and Foreign Bank entered into currency swaps on the same day under which the LLCs were first to exchange its Currency b proceeds of the borrowing for Currency a to be used to purchase the Securities, and then upon maturity of the Securities, the LLCs were to exchange the Currency a proceeds of the Securities back into Currency b.

3. It is not clear that the LLCs could have earned a profit had they merely continued to invest the proceeds of the loan in short term government or other highly rated securities, which would have satisfied Foreign Bank as to the safety of the collateral, rather than in F Sub's Currency b denominated mortgage pool. This further demonstrates that the transactions were planned as a single transaction, and that it was intended by Foreign Bank that the Currency b equivalent of $Amount o would be transferred to Sub 2 in the § 351 transaction.

The above factors indicate that Foreign Bank intended that the Currency b equivalent of $Amount o of the proceeds would be transferred by the LLCs to Sub 2 in exchange for its repaying the principal of the loan.

4. Aside from the zero coupon note used to provide for the loan's principal payment, Sub 2's assets consisted of only the $Amount dd (approximately) that Sub 2 received in the § 351 transaction from the LLCs and Sub 3, and net assets of $Amount bb that it held prior to the § 351 transaction. Sub 2 was not engaged in any significant business activity other than purchasing the zero coupon note, and the forward contract. Accordingly, it is clear that aside from Sub 1's guarantee of Sub 2's performance as co-obligor, Sub 2 did not have the ability to pay the interest on the Amount x Currency b loan (equivalent to $Amount k), should the LLCs default on their obligation, i.e., if the mortgage pool does not produce sufficient interest income to service the loan. Accordingly, Foreign Bank must have looked to Sub 1's guarantee of Sub 2's performance in making the loan.

5. In calculating the value of the preferred stock and the present value of Sub 2's obligation as co-obligor for financial accounting purposes, Parent discounted Sub 2's obligation to repay the Currency b equivalent of $Amount o using (what it considered) an appropriate interest rate. Apparently Parent did not increase the value of Sub 2's obligation to take into account its obligation to make interest payments should the LLCs not be able to make the payments. This further supports the fact that Sub 2 did not expect to make interest payments on the loan, and if it would be required to make the interest payments, that the ultimate economic burden of making the payments would be borne by Sub 1 through its guarantee.

4. Section 482 Allocation of § 988 loss.

If the § 988 loss is respected, the Commissioner may apply § 482 to reallocate the loss from Sub 2 to the LLCs. The LLCs and Sub 1 acted "in concert" and "with a common goal or purpose" as used in § 1.482-1(i)(4) with respect to the § 351 contribution of property. Consequently, the transaction undertaken jointly by the parties with respect to the contribution to Sub 2 constituted a controlled transaction within the meaning of § 1.482-1(i)(8). Under § 1.482-1(f)(1)(iii), the

presence of a § 351 nonrecognition transaction does not bar the use of § 482 to allocate income to reflect clearly the income of the controlled parties.

a. Section 482 -- Generally

Section 482 provides the following:

> In any case of two or more organizations, trades, or businesses owned or ***controlled*** directly or indirectly by the ***same interests***, the Secretary may distribute, apportion, or allocate gross income, deductions... between or among such organizations...if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations. [Emphasis Added.]

See also § 1.482-1(a)(2) ("The district director may make allocations between or among the members of a controlled group if a controlled Taxpayer has not reported its true taxable income. In such case, the district director may allocate income, deductions . . . or any other item or element affecting taxable income (referred to as allocations). ")

Thus, in order for § 482 to apply to a transaction, the transaction must be between two or more entities owned or controlled by the same interests. If it is determined that the parties to the transaction are members of a controlled group, the Service may make allocations among the members if the Taxpayer had not reported its true taxable income. As there is no common ownership between the LLCs and Sub 2, and the other members of Parent group (other than between the members of Parent group), the primary question under § 482 becomes whether the LLCs and the Parent group are controlled by the same interests. See § 1.482-1(i)(6) (a controlled group is defined as Taxpayers controlled directly or indirectly by the same interests).

b. Legal Standard for Control

The § 482 regulations[9] define controlled as

> [including] any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more Taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or

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[9] The applicable regulations are the current regulations, which were finalized in T.D. 8552, in 1994.

> the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

§ 1.482-1(i)(4).

Where the actions of two unrelated parties were undertaken with respect to a joint-venture, the Tax Court found the unrelated parties to be in common control of a company owned 50% by each. B. Forman v. Commissioner, 453 F.2d 1144 (2nd Cir. 1972), reversing in relevant part 54 T.C. 912 (1970), cert denied, 407 U.S. 934 (1972), reh'g denied, 409 U.S. 899 (1972), nonacq, 1975-2 C.B. 3 (nonacquiescence relates to Tax Court opinion only, as the Second Circuit adopted an interpretation of control that is consistent with 1968, 1993, and 1994 § 482 regulations). The regulations also state that "[i]t is the reality of control that is decisive," rather than a rigid focus on record ownership of the entities at issue. Id. Accord Ach v. Commissioner, 42 T.C. 114 (1964), aff'd, 358 F.2d 342 (6th Cir.), cert. denied, 385 U.S. 899 (1966); Grenada Indus., Inc. v. Commissioner, 17 T.C. 231 (1951), aff'd, 202 F.2d 873 (5th Cir. 1953), cert. denied, 346 U.S. 819 (1953), acq. in part and nonacq. in part, 1952-2 C.B. 2, 5; Rev. Rul. 65-142, 1965-1 C.B. 223, 224; Charles Town, Inc. v. Commissioner, 372 F.2d 415 (4th Cir. 1967), aff'g, T.C. Memo. 1966-015, cert. denied, 389 U.S. 841 (1967).

Moreover, the regulations provide that a "presumption of control arises if income or deductions have been arbitrarily shifted." § 1.482-1(i)(4). See Dallas Ceramic Co. v. Commissioner, 598 F.2d 1382, 1389 (5th Cir. 1979), rev'g, 35 A.F.T.R.2d (RIA) ¶ 75-394 (N.D. Tex. 1974) (holding that based on § 1.482-1(a)(3) (1968) (which contained language similar to § 1.482-1(i)(4) of the current regulation), the Service properly argued that proof of income shifting between two corporations establishes a presumption of common control). Accord Hall v. Commissioner, 294 F.2d 82 (5th Cir. 1961), aff'g, 32 T.C. 390 (1959), acq., 1959-2 C.B. 4 (referring to Reg. 111 § 29.45-1). The regulations also state that control may exist as a result of the actions of "two or more Taxpayers acting in concert with a common goal or purpose." § 1.482-1(i)(4). Accord DHL Corp. v. Commissioner, T.C. Memo. 1998-461 ("[W]hen the interests controlling one entity and those controlling another have a common interest in shifting income from the former to the latter, entities may be considered commonly controlled [in determining whether the control requirement under the 1968 regulations is satisfied]."). Thus, under the regulations, joint, legal ownership, or overlapping ownership, is not required for unrelated corporations to come within the purview of § 482 if income or deduction shifting is present, or if there is a common goal to shift income or deductions. But see Lake Erie & Pittsburgh Railway Co. v. Commissioner, 5 T.C. 558 (1945), acq., 1945 C.B. 5, acq. withdrawn and substituted for nonacq., Rev. Rul. 65-142, 1965-1 C.B. 223.

Where the Service seeks to establish common control due to the presence of an artificial shifting of income and deductions, it is the Service's burden to prove the applicability of § 482 by establishing a shifting of income and deductions. Dallas Ceramic Tile Co., at 1390. We believe this burden is met by the LLCs and the Parent group acting in concert to intentionally create a noneconomic gain in the LLCs (which are not subject to U.S. taxation) and a corresponding noneconomic unrealized loss in Sub 2 through the transfer of the Currency b from the LLCs to Sub 2 in the § 351 transaction. See Notice 95-53, 1995-2 C.B. 334 (stating that for purposes of § 482, the parties in a stripping transaction, as defined in the Notice, generally are "controlled . . . by the same interests" because they act in concert with the common goal of arbitrarily shifting income or deductions between the transferor and the transferee). Although this transaction may not technically fit into the definition of a stripping transaction, this transaction is similar to the stripping transactions since as a result of the § 351 transaction the LLCs realized noneconomic income, and the LLC's recognition of gain directly resulted in Sub 2's unrealized loss. In this vein it must be noted that in fact Sub 2 had no business need or use for the Currency b; in fact it sold the Currency b on the following day. Accordingly, a presumption of control arises since the loss on the Currency b had been arbitrarily shifted. See § 1.482-1(i)(4).

c. Legal Standard for "Same Interests"

A controlled group or controlled Taxpayer is defined to mean the entities owned or controlled by the "same interests," and includes the Taxpayer that owns or controls other Taxpayers. §§ 1.482-1(i)(5), (6). Unlike the term "control," the phrase "same interests" is not defined in the § 482 regulations. Case law as well as the legislative history of § 482 provide guidance, however.

Section 482 was enacted to prevent the artificial shifting of income between controlled taxpayers to avoid Federal taxes, and thereby "milk" a taxable entity, i.e., moving losses to a taxable entity. Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979), citing, H. Rept. No.2, 70th Cong., 1st Sess. (1927), 1939-1 C.B. (Part 2) 384, 395; S. Rept. No. 960, 70th Cong., 1st Sess. (1928), 1939-1 C.B. (Part 2) 409, 426. See also H. Rept. No. 350 and S. Rept. No. 275, 67th Cong., 1st Sess. (1921); Ach v. Commissioner, 42 T.C. 114, 125 (1964), aff'd, 358 F.2d 342 (6th Cir.), cert. denied, 385 U.S. 899 (1966). In using the term "same interests," Congress intended to include more than "the same persons" or "the same individuals." Brittingham, at 1379; South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-5 (5th Cir. 1966), aff'g, 43 T.C. 540 (1965), cert. denied, 386 U.S. 1016 (1967); Appeal of Rishell Phonograph Co., 2 B.T.A. 229, 233 (1925). See also LXI-Part 6 CONG. REC. 5827 (1921) (statement of Sen. King referring to the "same forces" controlling a number of corporations). Different persons with a common goal or purpose for artificially shifting income can constitute the "same interests" for the purposes of the statute. South Texas Rice Warehouse,

at 894-5. See also Brittingham, at 1378-9, citing, Ach, 42 T.C. at 125-6 (The phrase, "same interests," should not be narrowly construed to frustrate the intent of § 482); Appeal of Rishell Phonograph Co., at 233 ("If `the same interests' was intended to mean only `the same persons,' it would have been easy for Congress, by using the latter term, to have avoided all ambiguity."). Accord Grenada Indus., supra.

Thus, it is not necessary that the same person or persons own or control each controlled business before § 482 can be applied, but there must be a common design for the shifting of income in order for different entities to constitute the "same interests." Indeed, this definition of same interest is identical to the definition of control (and the presumption relating thereto) in the regulations and case law. Thus, if there is a common design for shifting income or deductions, then the requirements for control and same interests will be met. See Hall v. Commissioner, supra, 32 T.C. at 409-10 (An arbitrary shifting of income coupled with the ability to direct the actions of an entity establishes control for the purposes of § 482 -- whether or not ownership exists.).

d. Control by the same interests in the Transaction

Based on the facts as presented, we believe the parties to the Transaction acted pursuant to a common plan to shift the unrealized loss on the Currency b to Sub 2, through the § 351 transaction. First, the LLCs, the owners of which are not subject to U.S. taxation, had no business other than to act as an accommodation party to accept the gain on Sub 2's assuming the full Amount x Currency b loan as co-obligor, so that Sub 2 will take the Currency b with an inflated basis. Indeed, the LLCs were created immediately prior to the transactions at issue, and conducted no other transactions. Secondly, Sub 2 had no need for the LLCs investment. Sub 2 was a corporation with no viable long term business or anticipated growth. According to one of Parent's internal memoranda, the only reason Sub 2 (rather than another subsidiary) engaged in the transaction was so that the loss could be used in a high tax state.

Furthermore, Parent states that the LLCs' loan obligation was assumed as co-obligor by Sub 2 since Foreign Bank required another party other than the LLCs to assume the loan when the original Securities collateral matured, and the LLCs purchased the Currency b denominated mortgage pool from F Sub. According to Parent, F Sub sold the mortgage pool to the LLCs since there was no active market for the securitization of Country B assets. However, the fact that Sub 2, an entity with no need for Currency b, no use for capital, and no ability to assume the loan as co-obligor, but for the guarantee from Sub 1, engaged in this transaction, further supports the conclusion that the LLCs and the Parent group, including Sub 2, were acting in concert to create gains in the tax indifferent LLCs and losses in Sub 2, which was subject to tax in a high tax state.

e. Section 482's Application to the Transaction — In General

Once the Secretary has proven that the parties are controlled by the same interests, he "may distribute, apportion, or allocate . . . deductions . . . between or among such organizations, trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses." Section 482. Generally, the Commissioner's determinations under § 482 must be sustained absent an abuse of discretion. G.D. Searle and Co. v. Commissioner, 88 T.C. 252, 358 (1988). The taxpayer must meet a heavier than normal burden of proof and demonstrate that Commissioner's determinations are arbitrary, capricious, or unreasonable in order for the courts to set aside the Commissioner's determinations. Id.

Under § 1.482-1(f)(1)(iii)(A), the Commissioner has specific regulatory authority to allocate to the transferor with respect to a nonrecognition transaction, the loss from a sale of property which had previously been transferred in a nonrecognition transaction to the extent the taxpayer's basis upon receipt of the property exceeded the property's fair market value. Courts have sustained the Commissioner's reallocation in the context of § 351 transactions in order to clearly reflect income in cases when the income was recognized by one party and the expenses incurred in producing the income were deducted by another related party, even if there was no finding that tax avoidance was a principal motive of the taxpayer. See, e.g, Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); Central Cuba Sugar Co., 198 F.2d 214 (2d Cir. 1952). Section 482 has also been applied, where the transfer of property in a § 351 transaction was found to have been made with a tax avoidance purpose. National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943). However, by its terms, §1.482-1(f)(1)(iii)(A) does not require that a tax avoidance motive be present. The regulation provides:

> [I]f necessary to prevent the avoidance of taxes or to clearly reflect income, the district director may make an allocation under § 482 with respect to transactions that otherwise qualify for nonrecognition of gain or loss under applicable provisions of the Internal Revenue Code (such as § 351 or 1031).

Id.

The example to the regulation illustrates a reallocation of loss incurred with respect to contributed property that had a built in loss. However, we do not read §1.481-1(f)(1)(iii) to be limited to or require a transfer of property that includes a built in loss in a nonrecognition transaction. What is relevant, is that a nonrecognition provision is necessarily used incident to the transaction. Accordingly, the fact that gain may be recognized incident to the contribution of property does not remove the condition that § 351 qualification was necessary to

provide the uneconomic inflation of Sub 2's basis in the foreign currency received in the contribution. Absent the application of § 351, Sub 2's tax basis in the foreign currency would not have been increased under § 357(c).

In applying §1.482-1(f)(1)(iii), we believe the facts of the current case demonstrate a plan to transfer property solely with a tax avoidance purpose because the amount of the loss claimed far exceeded the fair market value of the property on the day it was acquired and the property was held for one day prior to its ultimate disposition giving rise to the claimed loss.

In the present case the LLCs transferred Currency b in a § 351 transaction in exchange for Sub 2's preferred stock and Sub 2 assuming as co-obligor the LLCs' obligation under the loan to Foreign Bank. Under § 357(c) the LLCs were required to recognize gain on Sub 2's assumption of the LLCs' obligations to the extent the liabilities assumed exceeded their basis in the Currency b. Under § 362(a) Sub 2 took a carryover basis in the Currency b, increased by the amount of the LLCs' recognized gain. Economically, the exchange was an even exchange, in that the value of the Currency b transferred equaled the present value of Sub 2's primary liability to pay the loan's principal in thirty years at maturity, and the value of Sub 2's preferred stock. Nonetheless, because the amount of the loan, the Currency b equivalent of $Amount k, far exceeded the value of the Currency b which was also the LLCs' basis in the Currency b, transferred to Sub 2, the LLCs recognized a (noneconomic) gain. As a result of § 362(a), Sub 2 had a step up in basis in the amount of the LLCs' gain, so that Sub 2's basis in the Currency b far exceeded the fair market value of the Currency b. In fact, Sub 2 sold the Currency b the day after it received the Currency b in the § 351 transaction at a loss of approximately $Amount r, which loss is totally due to the increase in basis resulting from the LLCs' gain. Neither Sub 2's loss, nor the LLCs' gain was economic. Accordingly, under the clear reflection of income application of § 482, Sub 2's loss should be allocated to the LLCs.

In addition, courts have sustained the Commissioner's reallocation of gain or loss on taxable dispositions to the transferor with respect to the previous nontaxable transfer of the property under §§ 351 or 311 (as then in effect), when the purpose of the transaction was tainted by tax avoidance motives, e.g., when the transferee was better able to use the loss, absorb the capital gain, or use the deduction for charitable contributions. Northwestern National Bank v. United States, 556 F.2d 889 (8th Cir. 1977) (Commissioner's reallocation of charitable contribution deduction to the wholly owned subsidiary was sustained when the subsidiary distributed the appreciated stock to the parent corporation, and the parent contributed the stock to a charitable organization, so that the parent corporation could make use of the charitable deduction); National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943) (sustaining Commissioner's reallocation of capital loss to the parent corporation when the parent corporation

contributed built in loss stock to its wholly owned subsidiary in a transaction tax free under the predecessor of current § 351, so that ten months later upon sale of the stock, the subsidiary can make use of the capital loss deduction); Ruddick Corp. v. United States, 3 Cl. Ct. 61, 83-2 U.S.T.C. P 9480 (1983), on remand from 643 F.2d 168 (Ct. Cl. 1981), aff'd, 732 F.2d 168 (Fed. Cir. 1984) (Commissioner's reallocation of capital gain to the subsidiary-transferor was sustained when a wholly owned subsidiary distributed appreciated stock to its parent in a tax free distribution under § 311 as then in effect so that the parent could offset the capital gain from the disposition of the stock with its net operating loss); Southern Bancorp. v. Commissioner, 67 T.C. 1022, 1027 (1977). In this regard it is particularly noteworthy that in Southern Bancorp. v. Commissioner, the Commissioner's allocation of gain to the distributing Foreign Bank subsidiary was sustained notwithstanding that the court noted that the dividend had a business purpose, since the primary purpose for the dividend was tax avoidance. In Southern Bancorp. a bank under § 581, distributed appreciated U.S. Treasury notes as a dividend to its nonbank parent, and a few days later the parent sold the notes and realized capital gain. Had the subsidiary sold the Treasury notes, it would have realized ordinary gain. Although the court recognized that "admittedly the payment of a dividend . . . had a business purpose . . . to provide [the parent corporation] with the funds necessary to carry on its business", 67 T.C. at 1027, the court sustained the Commissioner's reallocation, since the subsidiary's primary business purpose for distributing the Treasury notes as a dividend in kind was tax avoidance. Id. See also, Ruddick Corp. v. United States, 643 F.2d 747 (Ct. Cl. 1981) at 751-52 (stating that the tax evasion prong of § 482 was applicable when a significant element of tax avoidance existed).

The present transaction is not one in which the property was held for use in the taxpayer or its affiliate's trade or business. Cf. Eli Lilly and Co. v. Commissioner, 84 T.C. 996 (1985), aff'd in part, rev'd in part, 856 F.2d 855 (7th Cir. 1988), at 1117, 1119 (stating that the tax evasion prong of § 482 only applies in situations when the sole purpose of the nonrecognition transfer was for tax avoidance); G.D. Searle and Co. v. Commissioner, 88 T.C. 252, 365 (1987) (same).

We believe that the principal purpose for Sub 2 to engage in the § 351 transaction was for tax avoidance. First, Sub 2 engaged in a series of transactions, which at the end of thirty years results in it being in the exact same position as it was originally, without any risk, and would incur a $Amount r tax loss. Furthermore, Sub 2 did not have a long term business or growth potential, and had no need or use for the Currency b, or its proceeds, (other than to hedge its primary liability to repay the principal on the loan to Foreign Bank). In addition, Parent's internal memorandum states that Sub 2 was selected to "house" this loss transaction since it is subject to tax in a high tax state. Accordingly, based on § 1.482-1(f) and the above cited cases, the Commissioner may reallocate Sub 2's

loss on the Currency b, to the extent it was unrealized when Sub 2 acquired the Currency b, i.e., its total loss, to the LLCs.

5. Economic Substance

Section 165(a), under which losses are allowed, requires that losses be bona fide in substance, and not merely in form. Section 1.165-1(b). As a result, for a loss to be deductible, the taxpayer must suffer a financial detriment and be left poorer in a material sense. Horne v. Commissioner, 5 T.C. 250, 254 (1945). See Shoenberg v. Commissioner, 77 F.2d 446 (8th Cir. 1935), cert. denied, 296 U.S. 586 (1935). The purpose of analyzing the economic substance of a transaction is to determine if a loss was sustained.

In order for a transaction to be given effect for federal tax purposes, it must have economic substance, i.e., generally that the transaction has economic significance beyond expected tax benefits. Lerman v. Commissioner, 939 F.2d 44, 45, and 49 n.6 (3d Cir. 1991). In determining whether the transaction has economic substance the transaction must be viewed "as a whole, and each step, from the commencement . . . to the consummation . . . is relevant." ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998) at 247 (quoting Weller v. Commissioner, 270 F.2d 294, 297 (3d Cir. 1959)). "The inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the objective economic substance of the transactions and the subjective business motivation behind them." Id. However, circuit courts of appeal, in affirming the Tax Court, have often stated that inquiries into the economic substance and business purpose of the transaction do not constitute discrete prongs of a two-step analysis, but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247, and cases cited.

A transaction or group of transactions that have no non-tax economic effect on the taxpayer other than to generate deductions will not be respected. Jacobson v. Commissioner, 915 F.2d 832, 837 (2d Cir. 1990). In this case Sub 2 in a purported § 351 transaction received Currency b with a fair market value of $Amount p in exchange for preferred stock and assuming the LLCs' loan of Amount x Currency b, equivalent to $Amount k, as co-obligor. As between the LLCs and Sub 2, Sub 2 was primarily liable to pay the principal in thirty years, and secondarily liable to pay the interest. Parent claims the present value of Sub 2's obligation to pay the principal was worth $Amount o, and the preferred stock was worth the remainder; for financial accounting purposes Parent booked the loan at its claimed present value. Sub 2 then sold all its Currency b, and solely for tax purposes recognized a loss of $Amount r based on its overstated -- and uneconomic -- basis in the Currency b derived under § 362(a). The high basis resulted from Sub 2's

assumption of the Amount x Currency b Loan as co-obligor. (We note that the assumption of the interest component of the note has no substance, since Sub 2 could not fulfill its obligation other than through Sub 1's guarantee.) With the proceeds it received for assuming the Loan Sub 2 purchased a zero coupon U.S. dollar denominated bond issued by Sub 1 which at maturity in thirty years will pay $Amount w, and entered into a forward contract with Sub 1 that will require Sub 2 to pay $Amount w in thirty years and receive a payment of Amount x Currency b. Accordingly, at the end of thirty years, after Sub 2 receives payment on its zero coupon bond, and fulfills its obligation under the forward contract, it will have exactly the amount of Currency b necessary to repay the principal of the loan to Foreign Bank. Consequently, other than the counter-party credit risk[10] on the zero coupon bond and the forward contract, Sub 2 had no risk of loss resulting from its assumption of the obligation to repay the loan principal. In addition, Sub 2 will have used all the funds it received for assuming the principal payment on its hedge of its assumed obligation.

Since Sub 2 had no ability to profit from the proceeds of the assumption, and had no risk of loss from its obligation to pay the principal, the § 351 transaction, to the extent of its assumption of the LLC's obligation, and its receipt of Currency b in exchange, had no economic substance. This case resembles Knetsch v. United States, 364 U.S. 361 (1960), in that here, as in Knetsch, after an elaborate set of transactions, the taxpayer was to end up in the exact same position as it was in the beginning of the transaction. In Knetsch the taxpayer purchased a single premium annuity contract for a nominal amount of cash; the remainder of the premium was paid through the issuance of nonrecourse debt. The taxpayer prepaid the interest due on the nonrecourse note. A few days later the taxpayer borrowed the excess of the following year's expected cash surrender value over the amount of the nonrecourse debt, and again prepaid the interest on that borrowing. Similarly, in the second year the taxpayer prepaid the interest on the outstanding debt, and shortly afterwards borrowed the second year's expected increase in the cash surrender value of the annuity. In this manner, the taxpayer kept the net cash value of the annuity at a nominal amount. The Supreme Court, holding that the taxpayer was not entitled to deduct the interest he paid, stated:

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[10] Sub 2 alone does not have the assets or growth prospects to make the loan payment should Sub 1 default on the zero coupon note it issued to Sub 2 or the forward contract it entered into with Sub 2. Sub 2's performance under the assumption agreement was also guaranteed by Sub 1. Should Sub 1 default on any of its agreements with Sub 2, as a practical matter Foreign Bank would probably not receive payment of the loan at maturity. Accordingly, it is apparent that the parties did not view the counter party (Sub 1) credit risk as significant.

> What did [Taxpayer] get for the out-of-pocket difference of $91,570? In form he had an annuity contract with a so-called guaranteed cash value at maturity of $8,388,000 . . . . This, as we have seen, was a fiction, because each year [Taxpayer's] annual borrowings kept the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of $1,000. [footnote omitted] Plainly, therefore, [Taxpayer's] transaction with the insurance company did not appreciably affect his beneficial interest except to reduce his tax. For it is patent that there was nothing of substance to be realized by [Taxpayer] from this transaction beyond a tax deduction.

364 U.S. at 365 (citations omitted).

Similarly, here Sub 2's assumption of the principal payment on the loan for $Amount o of Currency b could not in any way affect Sub 2's economic situation, since Sub 2 immediately hedged its obligation with Sub 1. See also Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966) (transaction had no economic substance when taxpayer borrowed at 4% to invest in property that returned less than 2%, since the transaction ha[d] no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction); Yosha v. Commissioner, 861 F.2d 494, 500 (7th Cir. 1988) (holding there was no economic substance in option straddles when the broker guaranteed the investor that the only consequences of the straddle would be tax consequences).

We note that Parent arranged the assumption transaction (for tax purposes) as part of a § 351 transaction in which the LLCs invested approximately $Amount bb in exchange for preferred stock. We believe that the § 351 transaction was arranged as window dressing for the assumption transaction. The LLCs' investment in preferred stock merely entitled the LLCs to a y% yield with no possibility of capital appreciation. Similarly, Sub 2 had no need or use for the proceeds of the investment. It was a corporation which had no viable long term business, and no expectation of growth. Accordingly, the only reason this transaction occurred was for Parent to benefit from the expected tax benefits of the tax loss. Indeed, Sub 2 was selected for this transaction merely because it was subject to tax in a high tax state.

The fact that the assumption transaction was arranged as part of a § 351 transaction does not imbue the assumption transaction with economic substance. In substance the assumption should be viewed separately from the remaining § 351 transaction. Indeed, for financial accounting purposes, Parent booked the assumption transaction as a liability at the present value amount.

Parent may argue that in fact Sub 2 earned $Amount y arbitrage profit by assuming the principal amount of the debt and hedging its liability. First, we note that all the hedging was done with its parent, Sub 1, and do not believe that arm's length dealing could result in such an arbitrage profit. Nevertheless, even if Sub 2 did earn an $Amount y profit, we believe the transaction had no economic substance, since the profit was *de minimis* compared to the expected $Amount r tax loss on the transaction. Sheldon v. Commissioner, 94 T.C. 738 (1990) held that a transaction did not have economic substance when the potential for gain was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions" so that the taxpayer was indifferent as to whether it would recognize pretax gain or loss. Id. at 768. Similarly, in Saba Partnership v. Comm'r, T.C. Memo 1999-359 (1999), the court stated

> Relatively modest profits are insufficient, standing alone, to clothe the disputed . . . transactions with economic substance. In particular, even assuming for the sake of argument that the partnerships reasonably could have expected profits of up to $10,800,000 on a 5-year investment in the . . . notes, such profits would be inconsequential when compared with the capital losses of approximately $170,000,000 that the . . . transactions were designed to generate for [Taxpayer].

78 T.C.M. 684, 721 (citations omitted).

It should be noted that Sub 2's ratio of expected tax losses to real profit far exceeds the ratio of expected tax losses to real profits of the transaction in Saba Partnership. Furthermore, unlike the taxpayer in Saba Partnership, Sub 2 is attempting to deduct ordinary losses. Accordingly, even if Sub 2 did earn an arbitrage profit through arm's length transactions, we do not believe the transaction had economic substance.

Parent may argue that the transaction had economic substance in that it had a business purpose for the transaction. Parent claims that Sub 2 assumed the loan as co-obligor since the transaction as a whole enabled F Sub to securitize its mortgage pool. F Sub sold the LLCs its mortgage pool; consequently, the LLCs switched the collateral for Foreign Bank's loan from short term high quality bonds, such as the Securities, to F Sub's Currency b denominated mortgage pool. The loan agreement required in the event that the collateral was changed that another party satisfactory to Foreign Bank become a co-obligor. Accordingly, Sub 2, through the § 351 transaction, became co-obligor on the Loans.

First, we do not believe that Sub 2 alone, without the Sub 1 guarantee, could have provided Foreign Bank with sufficient comfort by becoming co-obligor since

Sub 2 prior to the § 351 transaction had a book value of a mere $Amount bb. Indeed, assuming that the appropriate discount rate was used to present value the principal amount of the Loan, had Foreign Bank lent the LLCs $Amount o less, and Foreign Bank merely received Sub 1's guarantee, Foreign Bank would be in the same economic position as it was with Sub 2's guarantee. Accordingly, we do not believe Sub 2 assumed the loan, and then hedged that assumption, for any purpose other than tax avoidance.

Since we do not believe Sub 2's assumption and hedge transactions had economic substance, Sub 2's § 988 loss should not be allowed. See Lerman v. Commissioner, 939 F.2d 44, 45 (1991) (a transaction devoid of economic substance cannot be the basis of a deductible loss). As an economic matter, no loss was sustained in this transaction. See § 165(a).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

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This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions, please call CC:CORP:B03 at (202) 622-7790.

Sincerely,
Richard E. Coss
Assistant to the Branch Chief, Branch 3
Office of Associate Chief Counsel (Corporate)