DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
May 15, 2001

OFFICE OF
CHIEF COUNSEL

Number: **200134008**
Release Date: 8/24/2001
CC:CORP:B03
TL-N-2028-99
UILC: 351.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR MATTHEW J. FRITZ
ASSOCIATE AREA COUNSEL (LMSB)
CC:LM:MTC:CIN:2:LOU

FROM: Filiz A. Serbes, Branch Chief, CC:CORP:B03

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated February 14, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Parent =

Sub 1 =

Sub 2 =

Sub 3 =

Subsidiary =

New Name =

Benefits =

Products =

Insurance Company =

Third Party =

Fiscal Tax Year 1	=
Fiscal Tax Year 4	=
Date 1	=
Date 2	=
Date 3	=
<u>a</u>	=
<u>b</u>	=
<u>c</u>	=
<u>d</u>	=
<u>e</u>	=
<u>f</u>	=
<u>g</u>	=
<u>h</u>	=
<u>m</u>	=
<u>n</u>	=
<u>o</u>	=
<u>x</u>	=
<u>y</u>	=

<u>ISSUES</u>

1. Does the transaction described herein qualify as an exchange under I.R.C. § 351 of the Internal Revenue Code?

2. Is the transferee corporation entitled to deduct payments made on the assumed liability?

CONCLUSIONS

1. This transaction does not qualify as an I.R.C. § 351 exchange for numerous reasons, as discussed below.

2. The transferee corporation is not entitled to deduct any payments made on the assumed liability.

FACTS

This request for Field Service Advice concerns an affiliated group of corporations that did not file consolidated returns in Fiscal Tax Year 1 through Fiscal Tax Year 4. Below, we have summarized the relevant facts as submitted by Area Counsel.

At the time of the transaction, described below, Parent owned all the outstanding stock of three operating subsidiaries, Sub 1, Sub 2, and Sub 3. Prior to the transaction, Sub 1 owned all of the outstanding stock of Subsidiary,[1] which prior to the transaction was an inactive shell corporation. The outstanding stock of Subsidiary consisted of x voting common shares and y nonvoting common shares.

Parent and its subsidiaries had been experiencing rising costs for certain Benefits for their employees and, by Fiscal Tax Year 4, collectively had such Benefits liabilities recorded on their books in an amount in excess of $g. Of this amount, $b was attributable to Benefits for eligible employees of Parent and Sub 2.[2] Parent asserts that it undertook the transaction to control rising Benefits costs.

On Date 1, near the end of Fiscal Tax Year 4, Sub 3 formalized a portion of its outstanding debt to Parent by issuing an unsecured promissory note to Parent in the principal amount of $c. On the next day, Date 2, Subsidiary amended and restated its certificate of incorporation to authorize the issuance of a shares of voting, participating, noncumulative preferred stock with an “optional redemption” provision and a put provision. Also on Date 2, Parent subscribed to purchase the a newly authorized preferred shares by contributing the $c promissory note to Subsidiary in exchange for the a shares and Subsidiary’s assumption of $b of

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[1] Shortly before the transaction was undertaken, the name of Subsidiary was changed to New Name. Shortly after the transaction was completed, its name was changed back to Subsidiary. References to Subsidiary are references to such corporation regardless of its name at the particular time.

[2] Under applicable tax accounting rules, neither Parent nor any other member of its affiliated group had yet been able to take a deduction for these Benefits.

Parent’s and Sub 2's Benefits liabilities. These a shares of preferred stock of Subsidiary represented approximately e percent of Subsidiary’s value and an f percent voting interest in Subsidiary.

Effective Date 2, Parent and Subsidiary entered into an agreement under which Parent agreed to provide “the services necessary to handle all matters relating to the administration of the Contingent Liabilities [defined as the Benefits costs] for [Subsidiary]”. In addition, according to Area Counsel, Parent agreed to provide services concerning “insurance (including risk management services).”

A few days later, on Date 3, Parent entered into an arrangement with Insurance Company, in accordance with which Parent sold the a preferred shares to Insurance Company for $d, an amount equal to the difference between the face amount of the $c promissory note and the $b Benefits liabilities assumed by Subsidiary. On its Federal tax return for Fiscal Tax Year 4, Parent claimed a capital loss on its sale of the a shares of Subsidiary preferred stock, asserting that its basis in that stock was an amount equal to $c, the full face amount of the promissory note contributed to Subsidiary, not reduced by the amount of liabilities assumed by Subsidiary. Parent’s reporting position was that Subsidiary's assumption of the $b of Benefits obligations was not a liability for purposes of I.R.C. § 358(d)(1) and (a)(1)(A)(ii) because of the contingent character of these obligations.

Area Counsel asserts that this transaction has no economic basis and was undertaken merely to create a capital loss carryback to offset capital gains Parent recognized in Fiscal Tax Year 1.

Parent asserts that the purpose of the transaction was to give Insurance Company a new incentive to help control Benefits costs. Insurance Company had for some time leading up to the transaction administered Parent's Benefits program, receiving a flat per capita fee. The purported new incentive derived from Insurance Company's purchase of the a shares of Subsidiary preferred stock. Under the put provision associated with the stock, Insurance Company could sell the a preferred shares back to the Parent affiliated group at a formulaic put price tied to the level of Subsidiary's retained earnings at the time of exercise of the put. The put price is capped at an aggregate $n for all the a shares together. The contractual documents underlying the transaction, however, contained what Area Counsel characterizes as two conflicting formulas for calculating the put price. Also, at the time Insurance Company bought the a shares, Parent's executive committee had, without any request from Insurance Company to do so, increased the aggregate price cap from an initially-drafted $m figure to the $n noted above. In sum, no evidence has been shown that Insurance Company bargained over the terms of the transaction.

Furthermore, Parent officials maintain that they first determined that an incentive should be created for some qualified third party to minimize the Benefits paid and that only then did they consult Parent's tax personnel as to how to structure such incentive so as to reduce corporate taxes. Parent tax officials designed and recommended the above-outlined deal structure for the large capital loss carryback it would generate. Parent officials maintain, however, that a majority of its executive committee voted to approve the incentive deal with Insurance Company at a time when less than a majority of the executive committee members were aware of the tax reduction benefits of the transaction.[3]

At or prior to the time Parent agreed to the transaction with Insurance Company, Parent created a task force dedicated to devising ways to control Parent's Benefits costs. Though there were other representatives on the task force, once Insurance Company purchased the a preferred shares, it provided its own representative.

Area Counsel disputes the effectiveness of this task force in reducing Benefits costs and Insurance Company's role as part of the task force. There is evidence that, prior to the transaction, Insurance Company did participate in discussions about cost-saving ideas, but never in a forum like the task force meetings where representatives of an actuarial firm were also present. Furthermore, in Parent's actuarial report for the year ended approximately three years after Date 3, Benefits costs were down only $o less than the amount actuarially projected for that date at the time the transaction was undertaken. Although Parent argues that $o does not reflect the unusually high inflationary increase in certain Benefits costs and that the actual savings have been greater than $o, Parent appears to concede that most of the $o savings came from the introduction of Products, of which the task force members were generally aware prior to the transaction and using them cannot be credited solely to Insurance Company. The ideas that have produced savings have all come from the task force, which included one Insurance Company employee among its members, and Parent cannot identify which saving ideas, if any, may have originated with Insurance Company representatives.

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[3] Area Counsel states that Parent's tax personnel advised at least some members of the executive committee that the worst case scenario was that the Service might determine that the transaction lacked a bona-fide business purpose and deny the loss deduction even though the transaction may "satisfy the technical requirements." The worst case scenario was described to at least the top four members of the executive committee by the tax department as "Parent's cost would be the interest on the repaid amount, calculated from the date the refund was received . . . . [for] a total cost of approximately $h."

Area Counsel states that Insurance Company sold its Benefits business to Third Party approximately a year and a half after Date 3. Insurance Company retained its a shares of Subsidiary preferred stock, and Area Counsel says "[the Third Party] does not have any 'partnership' incentive to produce cost savings since Insurance Company retained the [Subsidiary] stock."

LAW AND ANALYSIS

As noted by Area Counsel, the subject transaction is substantially the same as that described in Notice 2001-17, 2001-9 I.R.B. 730 (February 26, 2001). Accordingly, although the subject transaction was completed before Notice 2001-17 was issued, the loss claimed on the disposition of the Subsidiary stock is disallowed for reasons set forth in Notice 2001-17, including the following:

1. Parent's acquisition of Subsidiary stock does not qualify under I.R.C. § 351 and is therefore a taxable exchange subject to I.R.C. § 1001.

   a. The acquisition failed to satisfy the technical requirements of I.R.C. § 351.

I.R.C. § 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for stock, and, immediately after the exchange, the transferor or transferors are in control of the corporation. "Control" is defined in I.R.C. § 368(c), which provides that control requires ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. For this purpose, ownership must be direct, not by attribution. See Rev. Rul. 56-613, 1956-2 C.B. 212; Rev. Rul. 78-130, 1978-1 C.B. 114.

Under the facts presented, Sub 1 owned all of the outstanding stock of Subsidiary immediately prior to the transaction. In the transaction, Parent acquired a shares of newly-authorized Subsidiary preferred stock, representing significantly less than 80 percent of the vote (approximately f percent). Parent directly owned no other shares of any other classes of Subsidiary stock.[4] Accordingly, Parent did

[4] Since Parent and its subsidiaries do not file consolidated returns, Treas. Reg. § 1.1502-34 of the Income Tax Regulations, which provides that, "... for purposes of determining the application of ... section 351(a) ..., in a consolidated return year, there shall be included stock owned by all other members of the group in the issuing corporation[,]" is not available to raise Parent's ownership of Subsidiary stock to the requisite 80 percent level.

not have control of Subsidiary immediately after the exchange and so failed to satisfy the technical requirements of the I.R.C. § 351.

If facts are developed that indicate Sub 1 joined with Parent in transferring property to Subsidiary, the exchange may or may not satisfy the control requirement of I.R.C. § 351(a). See Treas. Reg. § 1.351-1(a)(1)(ii) (negating transfers by a pre-existing owner of transferee stock if the value of the new stock issued to that transferor is relatively small compared to the value of the old stock owned by that transferor and the primary purpose of the transfer by that transferor was to qualify other transferors for I.R.C. § 351 treatment). See also Rev. Proc. 77-37, § 3.07, 1977-2 C.B. 568, 570.

b. The transaction lacks a bona fide business purpose.

Even if the subject transaction were found to satisfy the technical requirements of I.R.C. § 351, it must also have a bona fide business purpose in order to qualify as an I.R.C. § 351 exchange. See Rev. Rul. 55-36, 1955-1 C.B. 340; see also Caruth v. United States, 688 F.Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989), and the cases cited therein. Determining whether a bona fide non-tax business purpose motivated, at least in part, the I.R.C. § 351 transaction requires intensive factual development of the motives and intent of the parties, as gleaned through their written communications, contracts and agreements, and their expertise on tax matters in general, as well as their conduct throughout the transaction. The Service and the various courts have distilled several factors that aid in determining whether a valid non-tax business purpose is present in a purported I.R.C. § 351 transaction. These factors include:

- whether the transfer achieved its stated business purpose;
- whether the transfer primarily benefitted the transferor or the transferee;
- the amount of potential non-tax benefit to be realized by the parties;
- whether the transferee corporation is a meaningless shell;
- whether the transferee's existence is transitory;
- whether the transferee corporation has any other assets of the type transferred;
- the number of times the property was transferred, both prior to and after the I.R.C. § 351 transaction;
- the amount of time each party held the property, both prior to and after the I.R.C. § 351 transaction;
- whether there were any pre-arranged plans concerning future dispositions of the property; and
- whether there were independent parties (such as creditors) that requested a specific structure for the transaction.

Based on the facts as we understand them, it appears there was no real purpose for the transaction apart from the creation of an asset (the Subsidiary preferred stock) with a basis far in excess of its value in order to generate a substantial tax loss to offset Parent's previously-recognized substantial capital gain. Parent argues that it sold its a shares of Subsidiary preferred stock to create an incentive for Insurance Company to find ways to reduce Benefits costs. But those cost reductions were de miminis compared to the tax savings Parent generated through the transaction. In addition, there is evidence that the means to reduce costs already were known to Parent without significant participation by Insurance Company.

Taking all of the facts and circumstances of the transaction into account, there is no apparent bona fide business purpose to support the steps taken by Parent. Although courts have generally not imposed an exceptionally high standard in making this business purpose determination, the present transaction nevertheless presents a very strong case for disqualification on the grounds that taxpayer failed to satisfy the business purpose requirement. Accordingly, the transfer does not qualify as an I.R.C. § 351 exchange.

Note that, if the transaction fails to qualify as an I.R.C. § 351 exchange, it is a taxable I.R.C. § 1001 exchange, and, under I.R.C. § 1012, Parent takes a reduced basis in the Subsidiary preferred stock in an amount equal to the fair market value of the note transferred, which might reasonably be argued to equal the face value of the note, reduced by the liabilities assumed.

2. Even if the transaction is treated as qualifying under I.R.C. § 351, Parent is not entitled to deduct its purported stock loss.

   a. If Parent acquired control of Subsidiary in the transaction, the loss is disallowed under I.R.C. § 269(a).

I.R.C. § 269(a) states that if control of a corporation is acquired for the principal purpose of securing the benefit of a deduction, credit, or other allowance, then the Secretary may disallow such deduction, credit, or other allowance. I.R.C. § 269(a) thus requires the presence of three elements: (1) an acquisition of control of a corporation, (2) the principal purpose of avoiding Federal income tax, and (3) securing the benefit of a deduction, credit or other allowance which would not otherwise be enjoyed. See Cromwell Corp., et. al. v. Commissioner, 43 T.C. 313, 318 (1964).

The first element will be present only if the facts are ultimately found to be significantly different than described above. But, if in fact Parent acquired control of Subsidiary in the exchange, while Parent's I.R.C. § 351 problems will be solved, it will be brought squarely within the scope of I.R.C. § 269, inasmuch as the other elements are satisfied here. Control for the first element is the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of the shares of all classes of stock of the corporation. Acquisition of control can be the formation of a controlled corporation. James Realty Co. v. U.S., 280 F.2d 394 (8th Cir. 1960). A litigating hazard with this argument is that Subsidiary was not newly created; Parent's control of Subsidiary was achieved by a transfer of a newly created class of stock of Subsidiary to Parent. Challenger Inc. v. Commissioner, T.C. Memo 1964-338, suggests that § 269(a) does not apply to the use of existing subsidiaries. In Challenger, the subsidiary was created with a business purpose, then had fallen dormant because the majority of its business operations (slot machines) were outlawed. The court concluded that the use of these corporations did not fall within the definition of an acquisition of control for purposes of the application of § 269. Id.

However, the facts in Challenger can be distinguished from the facts in this case. The mere fact that a subsidiary used for tax avoidance reasons was in existence at the time the transaction took place to evade tax should not be allowed to circumvent § 269. Here, Subsidiary was an inactive shell corporation having no earnings and profits and not engaged in any business (not even after the transaction) until Parent transferred the note to it. Subsidiary therefore had no value until it engaged in this scheme. The relative value of the acquired tax benefit of the eventual sale of the Subsidiary stock that duplicates the deductions for payment of contingent liabilities is enormous when compared to the economic profit of Subsidiary, which is literally nothing. The Senate Report for § 129, the pre-1954 predecessor to § 269, states that the aim of § 129 is to prevent "perverting deductions ... so that they no longer bear a reasonable business relationship to the interest or enterprises which produced them and for the benefit of which they were provided." S. Rep. No. 627, 78th Cong., 1st Sess. 58 (1943). The original investment into Subsidiary by Parent is made with the end goal of duplicating a loss, which may satisfy both the first and second prongs of the § 269 test.

Specifically, I.R.C. § 269(a) requires that tax evasion or avoidance is the principal purpose for the acquisition. In the context of I.R.C. § 269, "principal purpose" means that the evasion or avoidance purpose must outrank, or exceed in importance, any other purpose. Capri Inc. v. Commissioner, 65 T.C. 162, 178 (1975). That element is clearly satisfied here. Although Parent argues that the transaction was engaged in for legitimate business purposes, as discussed above, Parent has not provided sufficient evidence to establish such a business purpose. In addition, the resultant magnitude of evasion or avoidance of federal income taxes in this transaction exceeds any purported business purpose.

We believe that the third requirement, that the deduction would not have otherwise been enjoyed, is also present in this case. Although Parent may have, at some time, become entitled to a deduction by reason of payments on its Benefits obligations, Parent was not, at the time of the stock sale, entitled to any such deduction. The reason is that Parent had not satisfied the tax accounting requirements governing deductions, inasmuch as Parent's Benefits obligation appears not to have been fixed in fact or reasonably determinable in amount, economic performance had not been performed, and it was subject to other restrictions relating to employee benefits provisions. Therefore, Parent was merely attempting to take a potential future deduction, duplicate the economic loss attributable to that amount into the basis of Subsidiary stock, and thereby obtain the benefit of the deduction at a time when it was not entitled to any deduction.

We note that I.R.C. § 269 has generally been used for the disallowance of deductions for losses that occurred before the acquisition of the loss corporation. See, e.g., Collins v. U.S., 303 F.2d 142 (1st Cir. 1962) (where a parent corporation acquired a corporation with significant operating losses was denied deductions for those losses under I.R.C. § 269 because the parent was found to have acquired control of the loss corporation with tax avoidance motives). Nevertheless, nothing in the language of I.R.C. § 269 precludes the application of I.R.C. § 269 to pre-acquisition losses that could not be taken into account for tax purposes until post-acquisition tax years. Thus, in Treas. Reg. § 1.269-3(b)(1), the Service states that I.R.C. § 269 applies, assuming the other requirements are satisfied, if a corporation acquires control of another with "current, past, or *prospective* credits, deductions, net operating losses or other allowances (emphasis added)."

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

The Benefits liability is a liability the assumption of which would be taken into account in amount realized in an I.R.C. § 1001 transaction. As a result, under a straightforward application of I.R.C. § 358(d)(1), the liability assumption reduces the basis of the stock received in the exchange.

Parent claims that, because the liability is one that will give rise to a deduction, it is a liability described in I.R.C. § 357(c)(3) and that, therefore, I.R.C. § 358(d)(2) prevents the basis reduction required under I.R.C. § 358(d)(1). Under these facts, however, the liabilities are not within the intended scope of I.R.C. § 357(c)(3) and thus I.R.C. § 358(d)(2) is inapplicable. Accordingly, I.R.C. § 358(d)(1) requires the reduction of stock basis by the amount of the assumed liability.

The rationale for this position is that, although authorities such as Rev. Rul. 95-74,1995-2 C.B. 36, permit a corporate transferee to claim deductions accruing upon payment of assumed liabilities, such authorities only apply if there is a transfer of a trade or business and the taxpayer has no plan to dispose of the stock received. In cases described in Notice 2001-17, and under the facts as presented by Area Counsel in this case, there is no transfer of a trade or business and there is a plan to dispose of the stock immediately after the purported I.R.C. § 351 exchange. These transactions therefore are not within the scope of Rev. Rul. 95-74. As a result, the taxpayers in these cases are subject to the rule in Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946), that the assumption of the liability is part of the cost of acquiring the transferred asset, and so the payment of the liability does not give rise to a deductible expense for the transferee, as will be discussed further below. Consequently, the transferee's basis in the assets received is determined under I.R.C. § 362; therefore, the later payment of the liability gives rise to no additional basis to the transferee. In such a case, the deduction upon payment should accrue to the transferor, and thus there is no need to preserve the loss in the stock basis. Under the circumstances, the liability is not within the scope of I.R.C. § 357(c)(3)(A)(i), its assumption is therefore not within the scope of I.R.C. § 358(d)(2), and the general rule of I.R.C. § 358(d)(1) applies to reduce the stock basis by the amount of the liability.

c. The liability assumption is treated as a distribution of money under I.R.C. § 357(b).

Even if the liabilities may be considered liabilities described in I.R.C. § 357(c)(3), with the result that I.R.C. § 358(d)(2) would prevent the reduction of stock basis otherwise required by I.R.C. § 358(d)(1), in the cases described in Notice 2001-17, the principal purpose of the liability assumption is to facilitate the creation of high basis, low value stock the disposition of which could accelerate and, in some cases, duplicate the deduction of the underlying liability. This is not a bona fide business purpose and, therefore, under I.R.C. § 357(b), the assumption of the liability is treated as a distribution of money. Under I.R.C. § 358(a), that deemed distribution of money reduces stock basis.

Note that, unlike the requirement in I.R.C. § 351 (which is only that the taxpayer have *a* business purpose), I.R.C. § 357(b) applies if the taxpayer's *principal* purpose is not a bona fide business purpose. Thus, I.R.C. § 357(b) can apply even if the taxpayer in fact has a business purpose.

3. Parent's purported stock loss is also disallowed because the transaction lacks economic substance.

In addition to the reasons set forth above, the facts of this case require the disallowance of Parent's purported stock loss because the overall transaction lacks a business purpose, was engaged in solely for tax avoidance purposes, and is lacking in economic substance. See ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999); United Parcel Service v.

Commissioner, T.C. Memo. 1999-268, appeal pending; Compaq Computer Corporation and Subsidiaries v. Commissioner, 113 T.C. 214 (1999).

As discussed throughout this memorandum, although Parent has offered its business purpose of reducing Benefits costs for the transaction, there is sufficient evidence in this case that this business purpose is not bona fide, that it does not outweigh the significant tax-motivated nature of the transaction, and that the form chosen by Parent does not reflect the true substance of the transaction.

The facts provided by Area Counsel certainly provide grounds for arguing under general tax principles that there is no economic substance to this transaction. For instance, there is no evidence that there was much, if any, negotiation between Parent and Insurance Company for the incentive scheme before it was entered into. Parent raised the cap on the put price from $m to $n without any request from Insurance Company to do so. The two formulas in the transaction documents for the put price were arguably inconsistent, a sign that neither side considered the put very important. When Insurance Company sold its Benefits business, Parent apparently did not create a similar replacement incentive for its new insurer. Finally, Parent entered into the incentive deal just as the period for carrying back a capital loss to its large capital gain three years earlier was about to expire.

Furthermore, although Subsidiary assumed the Benefits liabilities, all aspects of Benefits claims management were contracted by Subsidiary back to Parent, and Parent remained primarily liable for the obligations after transfer to Subsidiary. This arrangement simply constituted Parent's attempt to accelerate its deduction for payment of these liabilities through the creation of a stock loss. It appears that Parent was aware that the anticipated Benefits costs savings were relatively de miminis in light of the large tax savings generated, which only serves to evidence further Parent's lack of any business purpose beyond tax avoidance.

Frank Lyon Co. v. United States, 435 U.S. 561 (1978), sets forth several factors indicating that a transaction has no economic substance. These factors also are discussed in Newman v. Commissioner, 902 F.2d 159, 163-164 (2d Cir. 1990). One factor is the economic independence of the contracting parties. Insurance Company may have been independently owned, but because it presumably desired to continue its pre-existing business relationship with Parent, it appears to have been willing to accommodate Parent in what was purely a tax savings scheme. Parent has not established that Insurance Company truly negotiated, as an unrelated party would, over the terms of its incentive. See also, Helba v. Commissioner, 87 T.C. 983 (1986), aff'd without opinion, 860 F.2d 1075 (3d Cir. 1988) (where partnerships' purported purchase of videotapes was held a sham partly because the transactions were made on terms unilaterally established by the sellers, suggesting a lack of arm's length bargaining); Rose v. Commissioner, 88 T.C. 386 (1987) (where the court cited as one factor typically indicative of a lack of economic substance the fact that the opposite party accepted the terms of the transaction without price negotiation).

A second factor is whether the parties disregarded the form of their transaction. Subsequent to Parent's sale of the Subsidiary preferred stock to Insurance Company, Subsidiary conducted no or virtually no activities of its own. It reimbursed Parent for work done by Parent's employees. In other words, Parent's deal with Insurance Company resulted in no operating changes at Subsidiary. Subsidiary was merely a shell corporation used to assume a liability and then provide a stock incentive compensation vehicle for Insurance Company. Since Parent had no real expectation that its incentive deal with Insurance Company would produce a significant reduction in claims costs, the transaction with Insurance Company should be disregarded for tax purposes, denying Parent its claimed capital loss.

Even assuming, on the other hand, that Parent did have a real expectation that its incentive deal with Insurance Company would produce a significant reduction in claims costs, there are other, more direct forms for the transaction that Parent could have chosen. Parent could have entered into a direct cash contract with Insurance Company that would have provided Insurance Company with a contingent economic benefit identical to that constructed with the put option on the Subsidiary preferred stock. No reason has been suggested why it could not. In fact, the steps taken by Parent's management seemingly to obscure the tax benefits to be achieved by the transaction from the full executive committee (e.g., by not informing the full committee about the transaction's tax consequences until after a general decision to try to reduce Benefits costs had been made) strengthens the argument that this particular form of the transaction was chosen for tax-motivated reasons.

It was noted in Berry Petroleum Co. v. Commissioner, 104 T.C. 584 (1995), aff'd, 98-1 USTC ¶ 50,398 (9th Cir. 1998), that the presence of a third party with whom the taxpayer has bargained at arm's length fails to protect a tax-avoidance plan if the formalities employed by the taxpayer have no significant impact on the other contracting party and are tolerated or accepted as an accommodation rather than as an integral part of the basic transaction. It appears that Insurance Company's agreeing to cast the incentive deal as a purchase of Subsidiary preferred stock accompanied by a put option on the same stock was purely an accommodation to Parent and that, as noted, the same economic end could have been achieved much more directly.

As discussed throughout this memorandum, there would be enormous tax advantages to the position advocated by Parent. Under Parent's theory, it would be entitled to an immediate deduction of its purported loss on the sale of Subsidiary stock, and, presumably, under a misguided reading of Rev. Rul. 95-74, Subsidiary would be entitled to deduct that same amount again as payments are actually made on the Benefits claims. Also as discussed throughout this memorandum, there is neither a basis in the applicable regulations nor a compelling policy objective to support Parent's position. In fact, without a bona fide business purpose, and considering that the anticipated tax savings far exceeded the projected savings from the business objectives, we conclude that the transaction has no purpose other than inappropriate tax avoidance and should be disregarded.

Parent states that the purpose of the transaction was to isolate the Benefits costs and create an incentive for Insurance Company to manage and reduce rising Benefits costs, drawing on its experience and expertise in that area to make the administration of the claims significantly more efficient and economic. But, in fact, relatively de minimis savings were achieved, using Products already known to Parent without significant input from Insurance Company. It appears that the only true savings accomplished in the plan were those achieved through the plan's tax planning component: the creation and sale of high basis, low value stock to generate a large capital loss to offset a previously-experienced capital gain that Parent was on the verge of not being able to offset. Under the circumstances, we conclude that there was no economic substance, or at most insignificant economic substance, to the transaction apart from tax planning. Accordingly, the sale of the stock should be disregarded as lacking economic substance apart from tax avoidance.

4. <u>Subsidiary is not entitled to any deductions for payments on the assumed liabilities.</u>

In addition, any deduction claimed by Subsidiary for payments on the Benefits liability assumed in the transaction is subject to disallowance on one or more of several possible grounds, including that the payments are not for ordinary and necessary business expenses of the transferee corporation. Rev. Rul. 95-74, 1995-2 C.B. 36, which addresses the treatment of certain environmental liabilities assumed by a transferee of a manufacturing business, does not apply to the deductibility by the transferee of liabilities assumed in a transaction of the type described in Notice 2001-17 because Rev. Rul. 95-74 addresses liabilities assumed by a transferee corporation in connection with the transfer of substantially all the assets associated with the operation of a business to the transferee corporation in a transaction that qualified as an I.R.C. § 351 exchange. That is not the case here.

Furthermore, I.R.C. § 162 allows a deduction only for expenses paid or incurred in carrying on a trade or business. Although the term "trade or business" is not defined by the statute or the regulations, various litigated cases do offer some guidance. See <u>Purvis v. Commissioner</u>, 530 F.2d 1332 (9th Cir. 1976) (one factor in whether a taxpayer had a trade or business as a securities trader was the "frequency, extent, and regularity of the . . . transactions."); see also <u>Mayer v.</u>

United States, 32 Fed. Cl. 149 (1994) (taxpayer's securities trading was not a trade or business because the taxpayer delegated investment decision making to investment managers).

Subsidiary is not engaged in the conduct of a trade or business. The factual summary provided by Area Counsel indicates that it is but a shell corporation, the purpose of which was merely to assume a liability and then issue stock to act as a purported incentive compensation vehicle for Insurance Company. Any activities that Subsidiary otherwise might have conducted were instead conducted either by Parent, with expense reimbursement by Subsidiary, or by Insurance Company itself in its claims-minimizing role.

Rev. Rul. 95-74, discussed above, and Rev. Rul. 80-198, 1980-2 C.B. 113, both addressing I.R.C. § 351 exchanges, do not suggest otherwise, as the rulings in both were contingent on the transferee corporation's receiving substantially all the operating assets of the business in question; in other words, on the transferee corporation's thereafter operating the same business itself and deducting assumed liabilities in the context of operating that business.

For Subsidiary to take deductions with respect to the assumed Benefits liabilities while not also possessing the assets or operating the business in conjunction with which the liabilities were generated would violate the requirement in I.R.C. § 446 of a clear reflection of income and would call for reallocation of deductions or income under I.R.C. § 482.

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Please call if you have any further questions.

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