INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

October 4, 2001

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CASE MIS No.: TAM-131600-01/CC:CORP:B3

Industry Director
Heavy Manufacturing, Construction & Transportation (LM:MCT)

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

Corp. X =

Corp. X's Sub =

Corp. A =

Corp. A's Affiliate 1 =

Corp. A's Affiliate 2 =

Target A =

Intermediate Parent A =

Merger Sub A =

LLC A	=	
Amount A-1	=	
Amount A-2	=	
Amount A-3	=	
Date A	=	
A Percent	=	
Corp. B	=	
Corp. B’s Affiliate	=	.
Target B	=	
Intermediate Parent B	=	
Merger Sub B	=	
LLC B	=	
Amount B-1	=	
Amount B-2	=	
Amount B-3	=	
Date X	=	
Date B	=	
3 Target B Subsidiaries	=	
Business F	=	
B Percent	=	

Issues:

(1) Do either of the two separate transactions (Transaction A and Transaction B, defined below) qualify as a tax-free reorganization under §§ 368(a)(1)(A) and 368(a)(2)(E) or under § 368(a)(1)(B) of the Internal Revenue Code?

(2) Do either Transaction A or Transaction B qualify for nonrecognition treatment under § 351?

(3) If § 351 or § 368 do otherwise provide nonrecognition treatment for Transaction A or Transaction B or both, does § 269 deny the benefit of those sections to the taxpayer?

Conclusions:

(1) Both Transaction A and Transaction B fail to qualify as tax-free reorganizations under §§ 368(a)(1)(A) and 368(a)(2)(E) and § 368(a)(1)(B) because the transactions are not the type of transactions Congress intended to be treated as reorganizations. Transaction B may also fail to satisfy the requirement of § 368(a)(2)(E) that the corporation surviving the merger continue to hold substantially all its properties, but the National Office has insufficient facts at this point to make that determination.

(2) Neither Transaction A nor Transaction B qualifies for nonrecognition treatment under § 351 because (i) the controlled transferee corporations (Intermediate Parent A in the case of Transaction A and Intermediate Parent B in the case of Transaction B) were investment companies within the meaning of § 351(e)(1), and (ii) neither Transaction A nor Transaction B is the kind of transaction intended to be covered by § 351.

(3) Section 269 denies any benefit of §§ 351 and 368 to the taxpayer.

Facts:

This technical advice memorandum responds to a request for technical advice filed by the field concerning two transactions (referred to in this memorandum as Transaction A and Transaction B) entered into and consummated in its taxable year ended Date X by Corp. X and its affiliates, a group of affiliated corporations filing consolidated Federal income tax returns. That consolidated group is the taxpayer that is under audit. This memorandum addresses both Transaction A and Transaction B because the Corp. X consolidated group was party to both transactions, because both transactions were very similar in form, and because both transactions occurred in the same taxable year of the Corp. X consolidated group. For purposes of this memorandum, a reference to “the Corp. X consolidated group” should be considered a reference to Corp. X or to Corp. X’s Sub, where and as appropriate.

The two transactions involved dispositions by members of the Corp. X consolidated group of all the stock of two wholly-owned members of the group, Target A in Transaction A and Target B in Transaction B. On its consolidated Federal income tax return for the taxable year ending on Date X, the Corp. X consolidated group treated both dispositions as tax-free reorganizations qualifying under §§ 368(a)(1)(A) and 368(a)(2)(E), and have suggested during the audit process that the transactions also qualified for nonrecognition treatment under §§ 351 and 368(a)(1)(B).

The steps of the two transactions are described below. All the steps were contemplated by the agreements between the parties, including the relevant members of the Corp. X consolidated group.

Transaction A described. Prior to Date A, the effective time of Transaction A, Corp. X owned all the outstanding stock of Corp. X's Sub, which owned all the outstanding stock of Target A. Prior to Date A, affiliates of Corp. A, Corp. A's Affiliate 1 and Corp. A's Affiliate 2 (the "Corp. A affiliates") established Merger Sub A. The Corp. A affiliates paid an amount of cash equal to the difference between Amount A-1 and Amount A-2 for all the outstanding stock of Merger Sub A, which stock consisted of three classes: common stock, carrying 20 percent of the voting power of Merger Sub A; voting preferred stock, carrying the remaining 80 percent of the voting power of Merger Sub A; and non-voting preferred stock. Also, Merger Sub A borrowed an amount equal to Amount A-2 from an affiliate of Corp. A. Thus, the initial capitalization (equity and debt) of Merger Sub A totaled Amount A-1.

Immediately prior to the effective time of Transaction A, the Corp. A affiliates transferred all their outstanding Merger Sub A voting and non-voting preferred stock to Intermediate Parent A, another newly established corporation, in exchange for all of Intermediate Parent A's single class of preferred stock, voting preferred stock, which carried 80 percent of the voting power of Intermediate Parent A. At or about the same time, Merger Sub A acquired all of Intermediate Parent A's common stock, which carried 20 percent of the voting power of Intermediate Parent A, in return for cash consideration equal to Amount A-1. Thus, at this moment, the Corp. A affiliates owned all the outstanding voting preferred stock of Intermediate Parent A and all the common stock of Merger Sub A. Intermediate Parent A owned all the voting preferred and non-voting preferred stock of Merger Sub A, and Merger Sub A owned all of the common stock of Intermediate Parent A. Although the Intermediate Parent A voting preferred stock issued to the Corp. A affiliates carried 80 percent of the voting power of Intermediate Parent A, the aggregate value of such stock was only approximately Amount A-3 (a small percentage of Amount A-1). The Corp. X consolidated group has itself guaranteed that the Corp. A affiliates will ultimately receive an amount equal to Amount A-3 for their preferred stock even if Intermediate Parent A itself cannot pay it.

Next, Intermediate Parent A established a single-member limited liability company, LLC A. Intermediate Parent A was the sole member of LLC A, which is an entity that is disregarded as an entity separate from its owner for Federal income tax purposes. This memorandum assumes such treatment to be valid.

At the effective time, Merger Sub A was merged into Target A, in a reverse subsidiary merger, with Target A the surviving corporation. As a result of the merger:

(i) All the Target A stock owned by Corp. X's Sub was converted into all the common stock of Intermediate Parent A, which Intermediate Parent A had previously issued to Merger Sub A, which stock carried 20 percent of the voting power of Intermediate Parent A;

(ii) The voting and non-voting preferred stock of Merger Sub A owned by Intermediate Parent A was converted into voting preferred stock and non-voting participating preferred stock of Target A (the participating feature being very small), with the voting preferred stock carrying 80 percent of the voting power of Target A; and

(iii) The common stock of Merger Sub A owned by the Corp. A affiliates was converted into common stock of Target A, which stock carried 20 percent of the voting power of Target A.

Immediately after the effective time of Transaction A, Intermediate Parent A contributed an amount of cash equal to Amount A-1 to the capital of LLC A, and Corp. X was appointed manager of LLC A.

In summary, the corporate structure that resulted from Transaction A was as follows. All the Intermediate Parent A common stock (20 percent of vote) is owned by Corp. X's Sub; and all the Intermediate Parent A voting preferred stock (80 percent of vote) is owned by the Corp. A affiliates. All the Target A voting preferred stock (80 percent of vote) and non-voting participating preferred stock is owned by Intermediate Parent A; and all the Target A common stock (20 percent of vote) is owned by the Corp. A affiliates. The Intermediate Parent A preferred stock and the Target A preferred stock represent, however, a very small percentage of the value in those two corporations.

The Transaction A agreements provided that if closing of Transaction A could not be accomplished because Corp. X did not receive an opinion of legal counsel that Transaction A would constitute a reorganization under § 368, then the parties would negotiate to determine whether the transaction could be restructured to replicate the economic benefits to the parties of Transaction A. If the parties could not, after 45 days' negotiations, agree on such a substitute transaction, the agreements provided that the Corp. A affiliates would purchase from the Corp. X consolidated group all the stock of Target A for a cash purchase price equal to Amount A-1. As Transaction A, as originally planned, was in fact consummated, the provisions described in this paragraph never became operative.

Transaction B described. The facts of Transaction B are substantially the same as those of Transaction A, with the following exceptions.

1. The names of some of the parties and the amounts involved are changed. That is, Target B, Corp. B, Intermediate Parent B, Merger Sub B, LLC B, Amount B-1, Amount B-2, Amount B-3, Date B, B Percent, and Corp. B's Affiliate are substituted for Target A, Corp. A, Intermediate Parent A, Merger Sub A, LLC A, Amount A-1, Amount A-2, Amount A-3, Date A, A Percent, and the Corp. A affiliates, respectively.

2. Target B was a wholly owned subsidiary of Corp. X, rather than a second tier subsidiary of Corp X.

3. Initially, the Transaction B plan contemplated that Corp. B, rather than Corp. B's Affiliate, would itself be a party to the steps undertaken pursuant to Transaction B. On Date B, however, Corp. B transferred all its rights and obligations under the Transaction B plan to Corp. B's Affiliate, a wholly-owned subsidiary of Corp. B. Prior to the effective time of Transaction B, Corp. B or Corp. B's Affiliate, or both, established Merger Sub B.

4. At some time prior to the merger of Merger Sub B into Target B, Target B distributed to Corp. X: (i) all the stock of 3 Target B Subsidiaries, and (ii) certain other assets relating to Business F. In other words, Target B no longer owned those assets by the time Merger Sub B merged into Target B. The request for technical advice does not address the value of the distributed assets, apparently because the field has not yet been able to develop sufficient facts on the issue.

The LLC management agreements described. Part of both Transaction A and Transaction B were LLC management agreements, which agreements were very similar to each other. Although (Transaction A) Intermediate Parent A is the sole member of LLC A and (Transaction B) Intermediate Parent B is the sole member of LLC B, virtually all management control over the cash equal to Amount A-1 contributed to the capital of LLC A and the cash equal to Amount B-1 contributed to the capital of LLC B is vested in Corp. X as manager of both LLCs. The LLC management agreements provide that LLC A's and LLC B's member (Intermediate Parent A and Intermediate Parent B, respectively) have no right or power respecting the LLCs, including the right to approve or vote on any action taken by the LLC, except as expressly required by law. The LLC agreements give the manager the sole right to manage the assets and activities of the LLC. Corp. X in fact had LLC A expend substantial portions of its Amount A-1 of cash to repurchase outstanding Corp. X stock, which Corp. X then reported for financial reporting purposes as treasury stock. Distributions of cash or other assets from the LLCs are to be made in the sole discretion of the manager, provided only that each LLC must make distributions to its member sufficient (i) to enable the member to meet its obligations and (ii) to enable the member to make payments on or distributions with respect to the member's outstanding preferred stock.

The agreements between the parties in the two transactions provide (i) that Corp. A and its affiliates (Transaction A) and Corp. B and its affiliates (Transaction B) will not assert that the LLC agreements are unenforceable, at least other than in the case of fraud; and (ii) that

> to the fullest extent permitted by law, . . . to the extent the Manager [of the LLC in question] owes any fiduciary duties or similar obligations to [its member] under any principles of law or equity or otherwise, such duties and obligations shall be owed solely to the holders of the [member's] common equity [that is, to the Corp. X consolidated group] and not to the holders of any other class of the [member's] equity [that is, not to the Corp. A affiliates in the case of Transaction A or to Corp. B's Affiliate in the case of Transaction B].

The agreements in Transaction B provide that each of the LLC member's directors (those of Intermediate Parent B), in discharging his or her fiduciary duties under applicable law, shall be permitted to consider only the interests of the stockholders who elected him or her.

Future unwinding of Transaction A and Transaction B described. In the case of both Transaction A and Transaction B, provisions contained in the agreements and corporate certificates grant the various parties to the transaction in question, at certain points in time, the right to cause redemptions or purchases (or they have sufficient corporate voting power to do so) of all the Intermediate Parent A preferred stock and all the Target A preferred stock (Transaction A) and all the Intermediate Parent B preferred stock and all the Target B preferred stock (Transaction B). Specifically, Corp. A (or its affiliates) (Transaction A) and Corp. B (or its affiliate) (Transaction B) can cause these redemptions or purchases to take place approximately five years after the effective time of the transaction, and the Corp. X consolidated group can cause these redemptions or purchases to take place approximately twenty years after the effective time of the transaction, assuming that the redemptions or purchases have not already occurred. The effect of these redemptions or purchases would be that the Corp. A affiliates (Transaction A) or Corp. B's Affiliate (Transaction B) would end up as the sole shareholders of Target A (Transaction A) or Target B (Transaction B), respectively, and the Corp. X consolidated group would end up as the sole owner of Intermediate Parent A (Transaction A) or Intermediate Parent B (Transaction B), whose sole asset would be LLC A (Transaction A) or LLC B (Transaction B), and their cash.

Law and Analysis:

Section 368. The taxpayer asserts that Transaction A and Transaction B both qualify as tax-free reorganizations under §§ 368(a)(1)(A) and 368(a)(2)(E) and under § 368(a)(1)(B). Section 368(a)(1)(A) defines a reorganization as including "a statutory merger or consolidation." The mergers the taxpayer refers to are those of Merger Sub

A into Target A in Transaction A and of Merger Sub B into Target B in Transaction B. The taxpayer maintains that the mergers satisfied the requirements of § 368(a)(2)(E), which provides:

> Statutory merger using voting stock of corporation controlling merged corporation. A transaction otherwise qualifying under [§ 368(a)(1)(A)] shall not be disqualified by reason of the fact that stock of a corporation (referred to in this subparagraph as the "controlling corporation") which before the merger was in control of the merged corporation is used in the transaction, if (i) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction); and (ii) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of such corporation.

A reorganization under § 368(a)(1)(B) is defined as:

> The acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition) . . . .

The acquiring corporation in Transaction A would be Intermediate Parent A and the acquired corporation Target A; the acquiring corporation in Transaction B would be Intermediate Parent B and the acquired corporation Target B. The applicable control standard is that set forth in § 368(c).

Generally, § 1.368-1(b) provides that:

> the purpose of the reorganization provisions of the Code is to except from [gain or loss recognition] certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms. . . . Both the terms [of the reorganization provisions] and their underlying assumptions and principles must be satisfied in order to entitle the taxpayer to the benefit of the exception from [gain or loss recognition]. . . . [A] sale is nevertheless to be treated as a sale even though the mechanics of a reorganization have been set up.

Section 1.368-1(c) provides that “a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization.”

Section 1.368-1(e) describes the judicially-created requirement for a good reorganization under § 368(a)(1) that there be continuity of interest. Section 1.368-1(e)(1) provides, in part, “The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. . . . All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved.”

In Transaction A, the Corp. X consolidated group exchanged its interest in Target A for a stock interest in Intermediate Parent A. But as part of the integrated transaction, Intermediate Parent A in effect disposed of the bulk of the interest in Target A that it acquired in the reverse subsidiary merger by allowing that interest to pass to the Corp. A affiliates through the ownership of the common stock of Target A, in exchange for the cash that funded LLC A owned by Intermediate Parent A.

Thus, the vast majority of the assets of Intermediate Parent A consisted, immediately after completion of Transaction A, of its member interest in LLC A, and thus in the Amount A-1 of cash possessed by disregarded entity LLC A. Only a small portion of Intermediate Parent A's assets, by comparison, consisted of its preferred stock interests in Target A. On the other hand, the vast majority of the Corp. A affiliates’ interests following completion of Transaction A was in Target A, in other words their ownership of the Target A common stock. Only a small portion of their interests, by comparison, was in their preferred stock interest in Intermediate Parent A. In economic substance, therefore, the Corp. X consolidated group disposed of almost all its interest in Target A in return for an equivalent interest in Intermediate Parent A, which holds, through LLC A, mostly cash. Under the terms of the LLC A management agreement, Corp. X, as manager, determines how LLC A's cash is invested, and appears generally not to be liable to the Corp. A affiliates for the results of such management, absent fraud. What amount the Corp. A affiliates might ultimately receive in redemption of their Intermediate Parent A voting preferred stock is limited to that stock's stated value, which equals Amount A-3. Thus, if Corp. X, as the manager of LLC A, invests LLC A's cash wisely, Corp. X will ultimately harvest the benefit.

To elaborate, Amount A-3 was only A Percent of Amount A-1 (a very small percentage), and thus a very small percentage of the total value of Intermediate Parent A’s assets. The Intermediate Parent A preferred stock held by the Corp. A affiliates is not participating, but instead carries the fixed redemption price noted above. Thus, on any redemption of that stock, the Corp. A affiliates would receive only the fixed Amount A-3, even if Corp. X, in its capacity as manager of LLC A, had through wise investment greatly increased Intermediate Parent A's value. Likewise, if Corp. X had lost money through unwise investment, or through simply using the money for whatever purposes it chose, remunerative to LLC A or not, the preferred stock redemption price the Corp. A affiliates would receive presumably would not be impaired, as the Target A preferred stock owned by Intermediate Parent A might provide sufficient redemption monies, and at any rate the Corp. X consolidated group has itself guaranteed that the Corp. A affiliates will ultimately receive an amount equal to Amount A-3 for their preferred stock.

Thus, by entering into Transaction A, the Corp. X consolidated group obtained current control over an amount of money equal to Amount A-1, to use for any purpose it sees fit, with a waiver of fiduciary obligation to the Corp. A affiliates, except to such extent as relevant state corporate law may limit that waiver. (The taxpayer has supplied no statement or evidence suggesting that state law does in fact limit that waiver to any extent.) Corp. X also got the ability ultimately to possess that money, along with any increase Corp. X might produce in it as its manager, subject only to its obligation to ensure that the Corp. A affiliates ultimately receive a fixed amount equal to Amount A-3 for their Intermediate Parent A stock, plus any preferred dividends.

Viewing all of the steps of the transaction, what was actually done, in substance, was the exchange by the Corp. X consolidated group of the bulk of its interest in Target A for interest in Intermediate Parent A, a corporation holding almost exclusively cash, disguised as a reorganization. As said in Helvering v. Gregory, 69 F.2d 809 (2d Cir., 1934) (Learned Hand, J.), aff'd, Gregory v. Helvering, 293 U.S. 465 (1935), "[a]ll these steps were real, and their only defect was that they were not what the statute means by a 'reorganization,' because the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham, though all the proceedings had their usual effect."

As stated in § 1.368-1(b), quoted above,

> the purpose of the reorganization provisions of the Code is to except from [gain or loss recognition] certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms. . . . Both the terms [of the reorganization provisions] and their underlying assumptions and principles must be satisfied in order to entitle the taxpayer to the benefit of the exception from [gain or loss recognition]. . . . [A] sale is nevertheless to be treated as a sale even though the mechanics of a reorganization have been set up.

And, as stated in § 1.368-1(c), also quoted above, "a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization."

For instance, in Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir.), cert. denied, 288 U.S. 599 (1932), substantially all the properties of one corporation were acquired by another corporation in exchange for cash and short-term promissory notes. Although the transaction came within the literal language of the reorganization provisions, the court held that the term reorganization assumes "a continuance of interest on the part of the transferor in the properties transferred" and that the transaction before the court was too much like a sale to qualify. In the instant case, in substance, all the Corp. X consolidated group got was a basket of cash over which it has complete control. Thus, the transaction was not the type that Congress intended to be treated as a reorganization.

As further evidence that this transaction was not a reorganization, but merely a sale, the Corp. X consolidated group's continuing interest in Target A is minimal at best. While a corporation may satisfy the continuity of interest requirement through ownership of preferred stock, see Rev. Rul. 71-233, 1971-1 C.B. 113, the Corp. X consolidated group's interest in Target A through its ownership of the common stock of Intermediate Parent A exists in form only, that is, for the sole purpose of trying to satisfy the requirements for a tax-free reorganization. As stated in § 1.368-1(e)(1)(i), "all facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved." In the facts of this case, however, the preferred stock (voting and non-voting) owned by Intermediate Parent A in Target A is of such little value that only in the most extreme circumstances will the value of Intermediate Parent A's assets, and thus the Corp. X consolidated group's value, be impacted whatsoever. Under these circumstances, we cannot conclude that the Corp. X consolidated group has a true continuing interest in Target A. Thus, the continuity of interest requirement is not satisfied.

Everything stated in the preceding paragraphs concerning Transaction A is also true of Transaction B. Accordingly, for the reasons discussed above, neither Transaction A nor Transaction B qualifies as a reorganization under §§ 368(a)(1)(A) and (a)(2)(E) or under § 368(a)(1)(B).

Owing to Target B's distribution of some of its properties to the Corp. X consolidated group before the conduct of Transaction B, Transaction B may also separately have failed to satisfy the requirement of § 368(a)(2)(E) that the corporation surviving the merger, Target B, continue holding substantially all of its properties. The National Office does not have enough facts to make this determination.

Section 351. Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the corporation. It has been asserted that § 351 applies to Transaction A, as Corp. X's Sub transferred the stock of Target A and the Corp. A affiliates transferred other property to Intermediate Parent A in exchange for stock of Intermediate Parent A, and Corp. X's Sub and the Corp. A affiliates are in control of Intermediate Parent A immediately after the exchange. The appreciated property for which the Corp. X consolidated group asserts the nonrecognition protection of § 351 is the stock of Target A.

However, for the reasons discussed below, § 351 does not apply to Transaction A. First, § 351(e) provides that § 351 does not apply to a transfer of property to an investment company. Section 351(e)(1) provides that the determination of whether a company is an investment company shall be made by taking into account all stock and securities of the company and by treating money as stocks and securities. Section 1.351-1(c)(1) provides, in part, that a transfer of property will be considered to be a transfer to an investment company if (i) the transfer results in the diversification of the transferors' interests, and (ii) the transferee is a corporation more than 80 percent of the value of whose assets are held for investment and are readily marketable stocks or securities.[1] Since LLC A is treated as a disregarded entity for Federal income tax purposes, its assets, that is, the Amount A-1 in cash, is treated as directly held by Intermediate Parent A. Hence, Intermediate Parent A's assets being almost all cash (well over the 80% threshold of §1.351-1(c)(1)(ii)), § 351 is not available to the Corp. X consolidated group for the transfers to Intermediate Parent A. (Even if LLC A was not a disregarded entity for Federal income tax purposes, Intermediate Parent A's interest in LLC A would be treated as stocks and securities of an entity substantially all of whose assets consist of cash, and Intermediate Parent A would still be an investment company. Section 351(e)(1)(B)(vi).)

Second, as discussed above in the reorganization context, Transaction A represented in substance a sale by the Corp. X consolidated group of its interest in Target A, and hence was not the kind of transaction § 351 was intended to cover. Section 351 is meant to cover mere changes in form of doing business, not what is effectively a sale of the asset transferred.

> It is the purpose of [§ 351] to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a

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[1] Section 1.351-1(c)(1)(ii), which states that cash is excluded in determining whether more than 80 percent of a corporation's assets are held for investment and are readily marketable stocks or securities, was overridden, in relevant part, by § 351(e). See Staff of Joint Committee on Taxation, 105th Cong., 2nd Sess., General Explanation of Tax Legislation Enacted in 1997 (comm. print 1997).

> mere change in the form of ownership and the taxpayer has not really "cashed in" on the theoretical gain, or closed out a losing venture.

Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940), cert. denied, 310 U.S. 650 (1940). Thus, for this reason, too, § 351 does not apply.

All of what has been said above about Transaction A and § 351 applies equally to Transaction B, as Transaction B was, for purposes of applying § 351, substantively identical to Transaction A.

Section 269. Section 269(a) provides:

> If (1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or (2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means 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 shares of all classes of stock of the corporation.

Section 1.269-1(a) provides:

> The term "allowance" refers to anything in the internal revenue laws which has the effect of diminishing tax liability. The term includes, among other things, a deduction, a credit, an adjustment, an exemption, or an exclusion.

Section 1.269-2(b) provides:

> The principle of law making an amount unavailable as a deduction, credit, or other allowance in cases in which the effect of making an amount so available would be to distort the liability of the taxpayer has been judicially recognized and applied in several cases. Included in these cases are Gregory v. Helvering . . . .

Section 269(a) disallows the benefit of a deduction, credit, or other allowance to a person or corporation if that person or corporation acquired control of another corporation with the principal purpose of evasion or avoidance of Federal income tax. Section 1.269-1(a) defines an “allowance” as anything in the Internal Revenue Code that has the effect of diminishing tax liability. The nonrecognition treatment provided by §§ 368 and 351 is therefore an allowance. Furthermore, in Transaction A and Transaction B, the Corp. X consolidated group acquired control (measured by value) of Intermediate Parent A and Intermediate Parent B, respectively, and Intermediate Parent A and Intermediate Parent B acquired control (measured by vote) of Target A and Target B, respectively. Thus, if Transaction A and Transaction B were undertaken with the principal purpose of evading or avoiding Federal income tax, § 269 can apply to deny the nonrecognition treatment of §§ 368 and 351 to the Corp. X consolidated group.

This taxpayer's attempted abuse of §§ 368 and 351 is the sort of abuse found by the Court in Gregory v. Helvering. The Corp. X consolidated group employed the artifices of having Intermediate Parent A and Intermediate Parent B created in the two transactions and then acquired control of them (having acquired stock in the two corporations representing at least 50 percent of the total value of all their outstanding stock) for the principal purpose of securing the benefit of §§ 368 and 351. Furthermore, Intermediate Parent A and Intermediate Parent B obtained control (more than 50 percent of the combined voting power of all classes of stock entitled to vote) of Target A and Target B, respectively, as part of the same tax-reduction scheme. It is clear from the facts of this case that the principal purpose, if not the sole purpose, for the formation of Intermediate Parent A and Intermediate Parent B, the acquisition of control of these two corporations by the Corp. X consolidated group, and Intermediate Parent A’s and Intermediate Parent B’s acquisition of control of Target A and Target B, respectively, was to evade or avoid Federal income tax. There was no intention to readjust corporate structures as required under § 368 or similar readjustment as necessary under § 351, as is evidenced by the minimal continuing interest of the Corp. X consolidated group in Target A and Target B. The intention was merely to dispose of the Target A and Target B stock, and the complex transactions were undertaken for the principal purpose of avoiding taxation on this disposition. This intention is demonstrated by the taxpayer’s own agreements, which provide that if the transactions could not be carried out by means of a transaction qualifying under § 368, then a direct sale would take place. The Corp. X consolidated group could, and if not for tax evasion or avoidance purposes would, in a much simpler transaction, simply have sold its interests in Target A and Target B. In summary, while the Corp. X consolidated group presumably had legitimate business purposes for disposing of Target A and Target B, it clearly had a tax evasion or avoidance purpose for structuring the disposition transactions as it did. Section 269 thus disallows the Corp. X consolidated group's use of §§ 368 and 351 in both Transaction A and Transaction B.

The Service recognizes the existence of counter authorities to the use of § 269 to prevent nonrecognition treatment. In Cherry v. U.S., 264 F. Supp. 969 (C.D. Cal. 1967), the Service attempted to use § 269 to stop the taxpayer's receiving nonrecognition treatment under §§ 336 and 453. The court noted that under § 336 no gain or loss is to be "recognized" to a corporation when it distributes property to its shareholders in liquidation, and under § 453(d)(4)(A) no gain or loss is to be "recognized" on the distributions of installment obligations in the liquidation of subsidiary corporations. The court stated that the term "recognized," like the term "realized," is a technical term used in the Internal Revenue Code; and that likewise the terms "deduction," "credit," and "allowance," as used in § 269, are technical terms, each having its precise meaning in the Internal Revenue Code. The court held that statutory provisions dealing with nonrecognition of gain, as in §§ 336 and 453(d)(4)(A), are not encompassed by the terms "deduction," "credit," or "allowance" and that § 269 does not deal with nonrecognition concepts. See also Bijou Park Properties, Inc. v. Commissioner, 47 T.C. 207 (1966). Such reasoning, if correct, might also block the Service's using § 269 to deny the use of §§ 351 and 368 to taxpayers in otherwise appropriate cases.

The Service disagrees with these authorities. As stated above, § 1.269-1(a), promulgated in 1962, provides that the term "allowance" refers to anything in the Internal Revenue Code that has the effect of diminishing tax liability. Certainly, the nonrecognition of gain on a “sale” of stock has the effect of diminishing tax liability. Thus, it is the Service’s position that such nonrecognition is an allowance within the meaning of § 269 and thus § 269 can apply to deny nonrecognition treatment.

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

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