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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR JOSEPH F. MASELLI
AREA COUNSEL (HEAVY MANUFACTURING AND TRANSPORTATION) CC:LM:HMT:NEW:1

FROM: John M. Breen
Senior Technical Reviewer CC:INTL:6

SUBJECT: — Tax Year Ending

This Chief Counsel Advice responds to your memorandum dated March 1, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

<u>LEGEND</u>

Amount A =
Amount B =
Amount C =
Amount D =
Amount E =
Amount F =
Amount G =
Amount H =
Amount I =
Amount J =
Amount K =
Amount L =
Amount M =
Amount N =

City 1	=	
City 2	=	
City 3	=	
Company 1	=	
Country A	=	
Country A Co	=	
Country A Entity	=	
Country A Sub	=	
Country A Law	=	
Date 1	=	
Date 2	=	
Date 3	=	
Date 4	=	
Date 5	=	
Date 6	=	
Date 7	=	
Date 8	=	
Date 9	=	
Division 1	=	
Division 2	=	
Foreign Co	=	
Percent A	=	
Percent B	=	
Product A	=	
Taxable Year 1	=	
Taxable Year 2	=	
USCo	=	
X	=	
Y	=	
Z	=	

<u>ISSUES</u>:

1. Whether Country A Sub was a separate entity eligible to make an election effective on Date 7 under the check-the-box regulations (Treas. Reg. § 301.7701-3).

2. Whether section 382 limits, or eliminates, the amount of taxable income that can be offset by the loss recognized by USCo on its sale of the Division 1 assets to Foreign Co.

3. Whether section 269(b)(1) may apply to disallow USCo's loss on the sale of the Division 1 assets to Foreign Co.

4. Whether, under the authority of section 482, the Service may disregard Country A Co's check-the-box election and then reallocate to Country A Co, as a separate entity, the loss recognized by USCo on the sale of Country A Sub stock to Foreign Co.

<u>CONCLUSIONS</u>:

1. Based on the evidence presented, neither Country A Sub nor Country A Entity, Country A Sub's purported predecessor entity, was incorporated under the laws of Country A on Date 7. However, Country A Sub's check-the-box election should be effective on Date 6, the filing date of the Form 8832, provided the election otherwise complies with the check-the-box requirements.

2. Section 382 applies to limit the amount of taxable income that can be offset by the loss recognized by US Co on its sale of the Division 1 assets.

3. Section 269(b)(1) may apply to disallow US Co's loss on the sale of the Division 1 assets to Foreign Co.

4. Although section 482 would permit the Service to reallocate losses from USCo to Country A Co when such an allocation is necessary to clearly reflect income or to prevent the evasion of taxes, we do not believe it is appropriate, in the present factual context, to apply section 482 to disregard Country A Co's check-the-box election.

<u>FACTS</u>:

USCo, a United States corporation, is a major manufacturer of Product A. On Date 1, USCo purchased the worldwide business operations of Company 1. With a few exceptions (not relevant here), USCo purchased the assets of Company 1's United States businesses and the stock of Company 1's foreign businesses. USCo paid approximately $ Amount A for Company 1's worldwide business operations (this amount included approximately $ Amount B in cash and USCo stock worth $ Amount C). After the acquisition transaction, Company 1's shareholders owned, directly or indirectly a Percent A (<u>i.e.</u>, less than 50 percent) interest in USCo.

At the time of the purchase, USCo was a publicly traded corporation, and the majority of its stock was held by public shareholders, none of whom held a five percent or greater interest. USCo represents that, prior to the purchase of Company 1's worldwide business, USCo was not related to Company 1 in any way and Company 1's shareholders did not hold any interest in USCo.

The parties apportioned approximately $ Amount D of the total purchase price to the stock of the foreign businesses.[1] Of this amount, approximately $ Amount E was specifically apportioned to the purchase of the stock of a Country A corporation, Country A Co, which became a controlled foreign corporation (CFC) of USCo.

USCo filed a Form 5471 ("Information Return of U.S. Persons With Respect To Certain Foreign Corporations") for Country A Co with its Taxable Year 1 Federal income tax return. Schedule F ("Balance Sheet") of that Form 5471 states that, on Date 2, Country A Co's total asset value before liabilities was $ Amount F. USCo supplied an additional balance sheet for Country A Co as of Date 3. According to this balance sheet, Country A Co had assets before liabilities of $ Amount G. The adjusted basis of the assets of Country A Co exceeded their fair market value immediately before the sale to USCo. At present, no information indicates that Country A Co was engaged in a trade or business within the United States.

Prior to the purchase by USCo, Country A Co had two separately operated divisions, Division 1 and Division 2. The Division 1 facilities were located in City 1 and City 2 in Country A. The Division 2 facilities were located in City 3 in Country A. According to USCo's Taxable Year 1 annual report, at the time of purchase USCo did not intend to retain the Division 1 business because it did not fit well with USCo's core business. Examination determined that, of Country A Co's $ Amount G book value in assets, approximately $ Amount H was attributable to Division 1 assets, and $ Amount I of the liabilities were attributable to Division 1.

Less than two years after Date 1, the date of the acquisition of Company 1's worldwide business operations, the following occurred:

(i) <u>Country A Co established a new wholly owned entity in Country A, Country A Sub</u>.

The facts surrounding the formation of Country A Sub are unclear at this time. USCo represents that Country A Co had previously incorporated an entity called Country A Entity in Country A on Date 4. USCo claims that Country A Entity then changed its name to Country A Sub, which required a reincorporation in Country A.

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[1] USCo indicated it did not perform, nor did it have any other party perform, a valuation study of the foreign businesses it purchased.

A Country A certificate of incorporation dated Date 5 indicates that Country A Entity was incorporated on Date 5. This is the only Country A certificate of incorporation currently available for Country A Entity.

Country A Sub's Form 966 ("Complete Dissolution or Liquidation") lists the name of the corporation as "[Country A Sub] ([Country A Entity])." This Form 966 lists Date 4 as the date of incorporation.

(ii) <u>On Date 6, Country A Co and Country A Sub executed Forms 8832 ("Entity Classification Election") in which they "checked the box" electing to be treated as disregarded entities</u>.

Each Form 8832 stated that the election was to be effective on Date 7 (a date not more than 75 days before Date 6), and that the election was a change in the entity's current classification. The entity name on Country A Sub's Form 8832 is "[Country A Sub] (f/k/a [Country A Entity])." USCo did not specify an order of election.[2]

(iii) <u>On Date 8, USCo transferred the Division 1 assets and liabilities to Country A Sub</u>.

Country A Co agreed to transfer the Division 1 business to Country A Sub as a going concern. With certain exceptions, the transfer comprised all the assets and liabilities of the Division 1 business. USCo supplied a balance sheet for the Division 1 and Division 2 businesses as of Date 9. According to this balance sheet, the total asset value of the Division 1 business before liabilities was approximately $ Amount J. The total liabilities of the Division 1 business were approximately $ Amount K.

(iv) <u>On Date 9, Country A Co sold the stock in Country A Sub to Foreign Co, a Country A entity</u> (USCo represents that USCo and Foreign Co were unrelated).

Steps (ii) through (iv) occurred during the same month.

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[2] <u>See</u> Treas. Reg. § 301.7701-3(g)(3)(iii) (when check-the-box elections for a series of tiered entities are effective on the same date, the eligible entities may specify the order of the elections on Form 8832; if no order is specified for the elections, the transactions that are deemed to occur under Treas. Reg. § 301.7701-3(g) as a result of the classification change will be treated as occurring first for the highest tier entity's classification change, then for the next highest tier entity's classification change, and so forth down the chain of entities).

On its Federal income tax return for Taxable Year 2, USCo treated the sale of Country A Sub to Foreign Co as an asset sale. USCo reported an amount realized from the sale of
$ Amount L and an adjusted basis in the assets transferred of $ Amount M. USCo reported a $ Amount N loss on the sale.

LAW AND ANALYSIS:

Issue 1:

Section 7701 sets forth definitions to be used in determining the classification of an organization as a corporation or as a partnership for Federal tax purposes. Section 301.7701 of the Treasury Regulations, known as the “check-the-box regulations,” provides a regime for the classification of entities that generally is elective. The first issue presented is whether Country A Sub was a separate entity eligible to make an election effective on Date 7 under the check-the box regulations.

Section 301.7701-1(a)(1) of the Treasury Regulations clarifies that whether an organization is an entity separate from its owners for Federal tax purposes is a matter of Federal tax law and does not depend on whether the organization is recognized as an entity under local law. Under these regulations, an entity may elect the form that it takes for tax purposes, if that entity is considered an “eligible entity.” Section 301.7701-2(a) of the Treasury Regulations generally provides that a business entity is any entity recognized for Federal tax purposes that is not properly classified as a trust under Treas. Reg. § 301.7701-4, or otherwise subject to special treatment under the Internal Revenue Code. Section 301.7701-3(a) of the Treasury Regulations generally provides that a business entity that is not classified as a corporation under Treas. Reg. § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) is an entity eligible to elect its classification for Federal tax purposes. An eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. For purposes of this advice, we assume that Country A Co and Country A Sub are entities eligible to elect their classification for Federal tax purposes.

An election under the check-the-box regulations is made on a Form 8832, “Entity Classification Election.” Section 301.7701-3(c)(1)(iii) of the Treasury Regulations generally provides that an election will be effective on the date specified by the entity on the Form 8832, or on the date the form is filed if no such date is specified. The regulations further specify that the effective date on the Form 8832 cannot be more than 75 days prior to the date on which the election is filed, and cannot be more than twelve months after the date on which the election is filed.

The information that you submitted states that, under Country A law, a company is incorporated as of the date of incorporation listed on the certificate of incorporation. See Country A Law, section X. Furthermore, under Country A law, a company cannot commence operation as an incorporated entity before it has been incorporated. See Country A Law, section Y.

Based on the information we have been provided, it appears that neither Country A Sub nor Country A Entity was properly characterized as a business entity under Country A law on Date 7, the effective date specified on the Form 8832. Therefore, neither Country A Sub nor Country A Entity are eligible to make an election effective on Date 7. The check-the-box regulations provide no authority for the Service to use a date other than the filing date or the date specified on the Form 8832 as the effective date of the election. Consequently, the Service must use the filing date for the Form 8832 in the event that the specified date is unavailable to the entity. Based on the information provided, the filing date of the Form 8832, Date 6, is the effective date for the election, provided the election complies with the check-the-box requirements in other respects.

Issue 2:

The next issue is whether section 382 limits, or eliminates, the amount of taxable income that can be offset by the loss recognized by USCo on its sale of the Division 1 assets to Foreign Co.

Section 382 generally limits the amount of pre-change of ownership losses that can be used to offset the taxable income of any loss corporation. The section 382 limitation is triggered by the occurrence of an ownership change. An ownership change occurs if, immediately after any owner shift involving a 5-percent shareholder or any equity structure shift, the percentage of the stock of the loss corporation owned by one or more 5-percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of the loss corporation owned by such shareholders at any time during the 3-year testing period.[3] I.R.C. § 382(g)(1) and (2).

Based on the information submitted, we agree that Country A Co underwent an ownership change within the meaning of section 382(g). USCo held less than five

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[3] The "testing period" is generally defined in section 382(i) as the 3-year period ending on the day of any owner shift involving a 5-percent shareholder or equity structure shift.

percent of the stock of Country A Co prior to Date 1. A shift of owners involving a 5-percent shareholder occurred when the USCo shareholders (including the public shareholders as a single public group under Treas. Reg. § 1.382-2T(g)(1)) increased their ownership of Country A Co (by attribution under section 382(l)(3)(A) and Treas. Reg. § 1.382-2T(h)(2)) from zero to Percent B (i.e., by more than 50 percentage points over their former ownership of Country A Co, which was zero).

Section 382(k)(1) specifies that a loss corporation includes any corporation with a net unrealized built-in loss (NUBIL). Section 382(h)(3)(A)(i) defines a NUBIL, with respect to any “old loss corporation,” as the amount by which the fair market value of the assets of such corporation immediately before an ownership change is less than the aggregate adjusted basis of such assets at such time. The information submitted states that immediately before USCo’s acquisition of all the Country A Co stock, the adjusted basis of the assets of Country A Co exceeded their fair market value by an amount greater than the threshold under section 382(h)(3)(B).

Because the purchase of the Country A Co stock resulted in an ownership change, it follows that Country A Co had a NUBIL within the meaning of section 382(h)(3)(A)(i). Therefore, Country A Co was a loss corporation as defined in section 382(k)(1). Moreover, because Country A Co was a loss corporation immediately before the ownership change, Country A Co was an old loss corporation as defined in section 382(k)(2). Furthermore, because Country A Co was a loss corporation after an ownership change, it was also a new loss corporation as defined in section 382(k)(3).

Assuming that the check-the-box elections under Treas. Reg. § 301.7701-3(c) are valid, and also assuming that the deemed liquidations of Country A Co and Country A Sub that resulted under Treas. Reg. § 301.7701-3(g)(1)(iii) qualify under section 332, USCo was the successor to Country A Co. See Treas. Reg. §§ 1.382-2T(f)(4), 1.382-2(a)(5) (defining a successor corporation to include a distributee corporation that succeeds to items described in section 381(c) from a corporation as the result of an asset acquisition described in section 381(a)). As the successor to Country A Co, USCo and Country A Co are treated as one entity for purposes of applying section 382. I.R.C. § 382(l)(8).

USCo’s recognition of a loss upon the sale of the Division 1 assets resulted in a recognized built-in loss (RBIL) within the meaning of section 382(h)(2)(B). Thus, USCo is subject to the section 382 limitation in the same way as Country A Co. I.R.C. §§ 382(a) and 382(h)(1)(B).

Section 382(b)(1) provides that the section 382 limitation for any post-change year is an amount equal to the value of the old loss corporation, multiplied by the long-term tax-exempt rate. Under section 382(e)(1), the "value of the old loss corporation" is the value of the stock of such corporation (including any stock described in section 1504(a)(4)) immediately before the ownership change. A special rule under section 382(e)(3) provides that in determining the value of any old loss corporation that is a foreign corporation, only "items treated as connected with the conduct of a trade or business in the United States" are considered, except as otherwise provided in regulations. There are no regulations interpreting this provision.

It is our understanding that the Service presently does not have any information indicating that Country A Co was engaged in a trade or business within the United States. If, after further development of the facts, the Service concludes that Country A Co had no items connected (or which should be treated as connected) with the conduct of a trade or business in the United States, there may be an argument that the section 382 limitation is zero under section 382(e)(3). Alternatively, if the Service develops facts indicating that Country A Co had any items connected (or properly treated as connected) with the conduct of a trade or business in the United States, we recommend that you contact the National Office for further advice concerning the application of section 382(e)(3) for purposes of determining the section 382 limitation.

In addition to the requirements discussed above, we also note that section 382(c)(1) generally provides that if the new loss corporation does not continue the business enterprise of the old loss corporation at all times during the two-year period following the ownership change, then the section 382 limitation is zero. This test is the same as the continuity of business enterprise rule of Treas. Reg. § 1.368-1(d) that is generally applicable to reorganizations. See S. Rep. No. 99-313, 99th Cong., 2d Sess. 234 (1986), 1986-3 (Vol. 3) C.B. 234. To satisfy the continuity of business enterprise test, the new loss corporation must either continue the historic business of the old loss corporation, or use a significant portion of the old loss corporation's assets in the business of the new loss corporation. See Treas. Reg. § 1.368-1(d)(2) and (3). Since USCo continued the Division 2 business after the acquisition of Country A Co, we agree that the continuity of business enterprise requirement of section 382(c)(1) was satisfied.

Issue 3:

The third issue is whether section 269(b)(1) may apply to disallow USCo's loss on the sale of the Division 1 assets to Foreign Co.

Section 269(b)(1) allows the Service to disallow a deduction, credit, or other allowance if:

> (A) there is a qualified stock purchase by a corporation of another corporation,
> (B) an election is not made under section 338 with respect to such purchase, (C) the acquired corporation is liquidated pursuant to a plan of liquidation adopted not more than 2 years after the acquisition date, and
> (D) the principal purpose for such liquidation is the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which the acquiring corporation would not otherwise enjoy.

The terms "qualified stock purchase" and "acquisition date" have the same meanings as in section 338. I.R.C. § 269(b)(2).

The acquisition of Country A Co stock by USCo appears to be a qualified stock purchase as defined in section 338(d)(3). Assuming that it is a qualified stock purchase, section 269(b) potentially applies because the deemed liquidation of Country A Co (which occurred under Treas. Reg. § 301.7701-3(g)(1)(iii) if a valid disregarded entity election was made under Treas. Reg. § 301.7701-3(c)) was less than two years after Country A Co's acquisition by USCo. In addition, the fact that the loss sale of the Division 1 assets occurred only a period of Z days after the making of the disregarded entity elections may be evidence of a tax avoidance purpose. Although USCo and Country A Co may have a good business purpose for selling the division that was transferred to Country A Sub, USCo and Country A Co could have sold that division without first making elections to liquidate Country A Co and Country A Sub for tax purposes, and in effect transferring to USCo Country A Co's loss on the sale.

Section 269(b)(1), however, applies only if, as a factual matter, the liquidation of Country A Co was motivated by the principal purpose of tax evasion or avoidance by securing the benefit of a deduction that USCo would not otherwise enjoy. Under Treas. Reg. § 1.269-7, section 269 may disallow a deduction even though section 382 also limits or reduces the deduction, but the fact that section 382 applies may be relevant to whether the principal purpose of the acquisition is tax avoidance.

<u>Issue 4</u>:

Finally, we are asked whether, in the alternative, section 482 may be applied under the facts of this case.

Section 482 provides the Service broad authority to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among controlled parties to ensure that taxpayers clearly reflect income and to prevent the evasion of taxes. You have asked whether, under the facts presented, the Service has authority under section 482 to disregard Country A Co's check-the-box election and then reallocate to Country A Co, as a separate entity, the loss recognized by USCo on the sale of the Country A Sub stock to Foreign Co. Please note that this discussion does not affect our conclusions above that the recognition of any loss (by any party) on the sale of the Country A Sub stock to Foreign Co may properly be limited by section 382 and/or section 269(b)(1).

Independently of the loss limitations mandated by sections 382 and 269(b)(1), section 482 may permit the Service to reallocate losses from USCo to Country A Co, if such an allocation is necessary to clearly reflect income or to prevent the evasion of taxes. See, e.g., General Electric Co. v. United States, 3 Cl. Ct. 289 (1983). Such an allocation would not, however, have any U.S. tax effect provided that Country A Co's check-the-box election remained in effect and Country A Co were disregarded as an entity separate from USCo. In the present factual context, we do not believe it is appropriate to apply section 482 to disregard Country A Co's check-the-box election, given that entity classification for Federal income tax purposes does not directly implicate the allocation of items of income between controlled taxpayers. It is not clear, therefore, that section 482 should have application to these facts. Given the extensive limitations on recognition of built-in losses contained in section 382, we believe that the relevant losses in the present case are more appropriately addressed under this targeted statutory framework, rather than the general authority of section 482.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Because section 382 applies to the loss sale without regard to the underlying purpose of the deemed liquidation, it may be harder to prove that the liquidation was motivated by tax avoidance under section 269.

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.

Please call (202) 874-1490 if you have any further questions.

By: ______________________________

JOHN M. BREEN
Senior Technical Reviewer
CC:INTL:6