Office of Chief Counsel
Internal Revenue Service

memorandum

CC:CORP:2:POSTS-109367-03
Number: **200408030**
Release Date: 2/20/04
UILC: 482.06-00

date: October 29, 2003

to:

Appeals Officer

from: Gerald B. Fleming
Senior Technician Reviewer CC:CORP:02

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subject: Section 482 Adjustment

This Chief Counsel Advice responds to your request that we consider whether the information and legal analysis submitted by the taxpayers' representative affects our conclusion in an earlier Field Service Advice, FSA 200108003 (the "FSA"). In accordance with I.R.C. § 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent.

Legend

CorpA =

CorpB =

CorpC =

CorpD =

CorpE =

CorpF =

LLC =

NameG =

CountryZ =

Year1 =

Date1 =

Date2 =

Date3 =

Date4 =

Date5 =

Date6 =

Date7 =

Date8 =

$k =

$m =

$n =

p% =

q% =

r% =

s% =

u =

v =

BusinessX =

BusinessY =

Ecite1 =

Ecite2 =

Pg1 =

Pg2 =

Pg3 =

I. Background

During a v-month period in Year1, certain commonly owned domestic and foreign corporations entered into the two transactions that are at issue in this matter.[1] First, on Date2, an inversion occurred through a reverse subsidiary merger that left CorpC and CorpD as the controlling shareholders of CorpA.[2] In that transaction (the "Exchange"), CorpC and CorpD each contributed cash and assets to CorpA in exchange for CorpA stock. CorpC's contribution included preferred stock of CorpE and its p% membership interest in LLC. At the time of the Exchange, the CorpE stock yielded an annual dividend of q% (or $m) and was subject to immediate redemption at a price of $n at the option of the issuer. Beginning Date7, the dividend on the preferred stock increased to r% per annum and would increase by u basis points per year to a maximum rate of s%.[3]

CorpA had a $k net operating loss ("NOL") carryover that was scheduled to expire on Date4. After the Exchange described above, but before the NOL expiration date, CorpA transferred the CorpE stock to its wholly owned CountryZ subsidiary, CorpF. The stock transfer triggered recognition of built-in gain under section 367(a). The gain was offset by CorpA's soon-to-expire NOL carryover. Less than one year later, in Date 5, CorpE exercised its option and redeemed the CorpE stock then held by CorpF.

In the FSA we concluded that the Service might allocate to CorpC, pursuant to section 482, CorpA's reported gain on the CorpE stock. In response, CorpA and CorpC (collectively, "Taxpayers") filed a protest claiming that section 482 is inapplicable on several independent grounds.

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1 The "FACTS" section of the FSA describes, in detail, the ownership by the same interests of the corporations involved in the relevant transactions. The FSA also alludes to the overlapping boards of directors of the corporations.

2 Immediately before the merger, CorpA was the newly formed subsidiary of CorpB. Immediately after the merger, CorpA owned 100% of its former parent. For simplicity, this memorandum refers to both corporations collectively as "CorpA."

3 Form 10-K405, CorpE, Pg1 (filed Date3), available at http://www.sec.gov/Archives/edgar/data/Ecite1.

Taxpayers argue that the motivation for the transactions described above was the funding of CorpF, which was trying to establish a business in CountryZ.[4] Taxpayers assert that the CorpE stock, with its $m annual dividend and potential $n redemption, was the only asset held by the commonly owned corporations capable of funding CorpF's new business. Moreover, Taxpayers suggest that (1) the shifting of built-in gain (in the CorpE stock) from CorpC to CorpA, (2) the triggering of gain recognition through the outbound transfer of the CorpE stock, and (3) the shifting of the benefit of the CorpE dividends and redemption to a tax indifferent entity do not indicate a tax avoidance purpose but, rather, are simply the collateral effects of necessary business transactions.

In light of Taxpayers' protest, you have asked whether our position on the section 482 issue remains the same.

II. Comments

We analyzed the facts and arguments[5] that Taxpayers asserted in their protest. After careful consideration of Taxpayers' submission, we continue to believe that section 482 applies to this case, as discussed more fully below. In the remainder of this memorandum, we summarize and respond to Taxpayers' protest regarding the applicability of section 482.

A. No Common Control

Argument: Taxpayers argue that there was no common control (within the meaning of section 482) with respect to the Exchange and, therefore, section 482 does not apply. Taxpayers reason that, because state law required the boards of directors of CorpC, CorpD, and CorpA to represent the interests of minority shareholders,[6] no common control was present. In short, they contend that rights of minority shareholders preclude the possibility of section 482 common control.

Response: Taxpayers' narrow interpretation of the section 482 control requirement does not reflect the plain language of the statute. Section 482 applies to two or more entities "owned or controlled directly or indirectly by the same interests. . . ." This requirement is disjunctive. Section 482 requires the presence of either ownership or control by the same interests. See, e.g., Collins Elec. Co. v. Commissioner, 67 T.C. 911, 918 (1977); Bransford v. Commissioner,

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[4] CorpA was in the process of transforming from BusinessX to BusinessY.

[5] We note, with respect to Taxpayers' arguments discussed below, that we were unaware of Taxpayers' "no common control/complete power" and "minority shareholder/fiduciary duty" theories until we reviewed Taxpayers' protest.

[6] In this case, the terms "minority shareholder" and "uncontrolled shareholder" are synonymous.

T.C. Memo. 1977-314 (1977). Therefore, section 482 applies where two or more entities are "owned" by the same interests. It is undisputed that the same interests own CorpC, CorpD, CorpA, and CorpF directly or indirectly. (A subsequent consolidation of CorpD, CorpA and CorpC into a single public company became effective Date6. CorpD (renamed NameG) was the survivor of the transaction.)[7]

Even if the question turned on whether the entities were controlled (rather than owned) by the same interests, we believe that such common control was present in this case. Treas. Reg. § 1.482-1(i)(4) defines "controlled" broadly:

> Controlled includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

Moreover, Taxpayers analyze the common control element only with respect to the valuation of consideration in the Exchange. Taxpayers disregard the relevance of control in the planning and structuring of the Exchange and the outbound transactions in coordination with the expiring NOL carryover. As discussed in the FSA, it is particularly relevant to the control of such planning and structuring that the person who was the chairman of the boards of directors of CorpA, CorpC, and CorpD was (1) the controlling shareholder of CorpD, (2) a principal shareholder of CorpC, and (3) a director on the CorpE board.

In their protest, Taxpayers cite several cases in support of their "no common control" argument, relying principally on Commissioner v. First Security Bank of Utah, 405 U.S. 394 (1972), and asserting that section 482 allocations are authorized "only where the controlling interests have 'complete power' to shift income between controlled entities." (Protest at 8.) In First Security, the Service had made section 482 allocations of insurance premiums from a parent corporation to subsidiary banks that were prohibited under Federal law from receiving such payments. The Supreme Court held that section 482 allocations of income are inappropriate where the recipient of the allocation is prohibited from receiving such income. 405 U.S. at 405.

The key element of the First Security fact pattern -- a prohibition against receiving the income in question – is not present in this case. Id. at 403. On the contrary, Taxpayers assert in their protest that CorpC was required by state law to receive fair consideration in exchange for the CorpE stock. Therefore, First Security is inapposite to the present case. The fiduciary duty described by Taxpayers is not equivalent to a clear bar to the receipt of all income as was at issue in First Security. Moreover, we discern no connection between section 482 and state

[7] Form 10-K, NameG, Pg3 (filed Date8), available at http://www.sec.gov/Archives/edgar/data/Ecite2.

fairness standards. Furthermore, the regulatory concept of "complete power," on which the First Security opinion is premised, was removed from the section 482 regulations in 1994 and, therefore, does not apply to this case.[8]

Taxpayers also cited R.T. French Co. v. Commissioner, 60 T.C. 836 (1973), in support of their control argument. In R.T. French, the sole shareholder of corporation X owned 51 percent of the stock of corporation Y. Taxpayers claim in their protest that the Tax Court held in R.T. French that X and Y were not commonly controlled for purposes of section 482. Presumably, Taxpayers believe that this alleged holding demonstrates that common ownership does not guarantee common control. Taxpayers misread the R.T. French opinion. In the opinion, the Tax Court observed that the two corporations were, in fact, controlled by the same interests. 60 T.C. at 853. The actual holding in R.T. French is that the common control of the two corporations is irrelevant because the parties dealt with each other at arm's length. Id. at 848, 851. Therefore, Taxpayers' reliance on R.T. French in support of their control argument, as with First Security, is misplaced.

Even if the minority shareholders were deemed to possess some control for the purpose of valuation, the arrangement of the transactions was solely in the hands of the commonly owned and controlled entities. In short, we are not persuaded by Taxpayers' claim that their asserted technical compliance with state laws designed to protect the financial interests of minority shareholders negates the section 482 ownership and control that the participants in the Exchange shared in common.

B. Taxpayers Satisfied the Arm's Length Standard

Argument: Taxpayers assert that, even if common control is present, section 482 does not apply to the Exchange because Taxpayers satisfied the arm's length standard. Specifically, Taxpayers claim that their compliance with state law standards of fairness for the minority shareholders in valuing the Exchange is tantamount to dealing at arm's length.

Response: We have no basis, other than Taxpayers' unsupported claims, to believe that CorpC valued the CorpE stock in a manner that satisfies the arm's length standard. Moreover, we have no reason to believe that compliance with state laws satisfies the arm's length standard. As stated above, we do not see the relevance of state law fiduciary duties to the application of section 482 and the regulations thereunder, which constitute a separate and distinct system for measuring and determining arm's length prices.

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[8] Taxpayers' protest also cites Bransford v. Commissioner, T.C. Memo. 1977-314 (1977). Like First Security, the Bransford opinion is premised on the now obsolete concept of complete power. T.C. Memo. 1977-314. In addition, Bransford involved a corporation and a partnership that were not owned by the same interests within the meaning of section 482. The lack of common ownership in Bransford distinguishes that case from the present case, in which common ownership is present.

C. Treas. Reg. § 1.482-1(f)(1)(iii) Does Not Apply

Argument: Taxpayers assert that Treas. Reg. § 1.482-1(f)(1)(iii), which permits the application of section 482 to transactions covered by non-recognition provisions, does not apply to the Exchange for several reasons. First, Taxpayers claim that they satisfied the arm's length standard, thereby rendering Treas. Reg. § 1.482-1(f)(1)(iii) irrelevant. Second, the Exchange did not entail an impermissible tax avoidance purpose or a mismatching of income and deductions. Third, the Exchange was not followed by an ultimate disposition to an unrelated third party that triggered recognition of income or loss. The latter two reasons are allegedly based on the case law involving the application of section 482 in the non-recognition provision context.

Response: Taxpayers' first rationale for the non-applicability of Treas. Reg. § 1.482-1(f)(1)(iii) – that they satisfied the arm's length standard – is already addressed in this memorandum. Taxpayers' second and third rationales are arguments that, we believe, were appropriately considered, addressed, and rejected in the FSA. Nonetheless, we take this opportunity to underscore the notion that it is the shifting of income and distortion of true taxable income, not the nature of the triggering event, that represent the relevant consideration.

Citing the Tax Court's discussion in Eli Lily & Co. v. Commissioner, 84 T.C. 996, aff'd in part and rev'd in part, 856 F.2d 855 (7th Cir. 1988), Taxpayers assert that section 482 applies only where the sole purpose of the transfer is tax avoidance motive or where there is an artificial separation of income from the expenses of earning the income. However, in G.D. Searle & Co. v. Commissioner, 88 T.C. 252, 371-376 (1987), the Tax Court expressly rejected this position, and applied section 482 to correct a distortion of income resulting from a nonrecognition transaction.

The present case is similar to the situation in National Securities. Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943). In National Securities, a parent corporation transferred to its subsidiary stock with a built-in loss for which the subsidiary subsequently claimed a deduction when it sold the stock. 137 F.2d at 601. In the present case, CorpC transferred to CorpA stock with a built-in gain that CorpA subsequently reported as income when it contributed the stock to CorpF. In National Securities, the transferor and transferee improved their aggregate tax position by advantageously shifting a potential loss. In the present case, the transferor and transferee improved their aggregate tax position by advantageously shifting a potential gain. The relevant issue is the shifting of income and resulting distortion of true taxable income, not the nature of the event that triggers recognition of the shifted item. As the National Securities court observed, "[t]he shifting of the loss to the subsidiary gives an artificial picture of its true income and one which it was unnecessary for the Commissioner to accept." Id. at 603. The same principle applies in this case.

D. Previously Cited Cases Do Not Support Service's Position

Argument: Taxpayers assert that every case previously cited in support of the Service's position either are distinguishable from this case or may be viewed as adverse to the Service's position.

Response: Because of (1) tensions between non-recognition provisions and section 482, (2) variations in fact patterns, and (3) the overlap of the tax evasion and clear reflection of income prongs of section 482, the case law in this area is susceptible to more than one interpretation. The FSA acknowledges this fact and identifies cases that, arguably, may be interpreted as harmful to the Service's position in this case. However, the FSA concludes that no single case prevents the Service position. The FSA reflects the Service view that the policy underlying section 482 and pervading the case law supports the application of section 482 in this case. Moreover, the plain language of section 482 and Treas. Reg. § 1.482-1 permits allocations of income and deductions to prevent tax evasion or clearly to reflect income. In this case, CorpC economically accrued the gain on the CorpE stock and, therefore, the gain is properly attributable to CorpC. <u>See</u> <u>National Securities</u>, 137 F.2d at 602-603. Taxpayers' alleged business purpose notwithstanding, the FSA observes that the instant case involves substantial tax avoidance motives for transactions that prevented clear reflection of income.

E. Conflict between FSA Positions on Section 351 and 482

Argument: Taxpayers observe that the FSA accepts the applicability of section 351, which entails a business purpose. Accordingly, Taxpayers assert that the Service's finding of tax avoidance motives for purposes of section 482 contradicts the Service's approval of section 351 treatment. More specifically, Taxpayers argue that the presence of a business purpose precludes the presence of a tax avoidance motive and, therefore, prevents application of section 482 in the non-recognition provision context.

Response: As discussed above and in the FSA, section 482 may apply even in the absence of a tax avoidance purpose. Accordingly, the existence of a business purpose for the Exchange would not determine whether section 482 should apply. Moreover, the Exchange involved the transfer of more than just the CorpE stock. Thus, the FSA's conclusion that the Exchange qualified as a transaction under section 351 is not inconsistent with the application of section 482 with respect to CorpC's transfer of the CorpE stock, which was only one of the transfers that occurred as part of the Exchange

Prior to the Exchange, CorpC was an owner of LLC, which directly owned CorpF. Thus, CorpC could have provided funding to CorpF, without funneling the CorpE stock through CorpA, by contributing the CorpE stock to LLC, which could then have transferred the CorpE stock to CorpF. Under such a contribution, CorpC (rather than CorpA) would have had to recognize the gain on the CorpE stock, assuming LLC was treated as a partnership for federal income tax.[9] The possibility of a direct contribution by CorpC, along with the additional elements of timing, control, and abundant tax motivation, shed doubt on CorpC's claimed business purpose as far as section 482 is concerned.

Furthermore, Taxpayers' argument implicitly assumes that a business purpose that is sufficient for a transaction to qualify under section 351 would necessarily be sufficient to preclude the application of section 482. We are not aware of any authority to support such a proposition. Indeed, the existence of a business purpose substantial enough to satisfy the requirement for section 351 does not preclude the application of section 482. The FSA addresses the question of whether the presence of a business purpose prevents section 482 allocations in the non-recognition context. The FSA analyzes the case law on this issue and concludes that the presence of a business purpose does not preclude the presence of a tax avoidance motive and does not prevent the application of section 482 in this case. The FSA also points out that section 482 may be applied absent a tax avoidance purpose under the clear reflection of income prong as applied in National Securities.

F. Stock Redemption Not Part of a Tax Avoidance Plan

Argument: Taxpayers disagree with the conclusion in the FSA that Taxpayers had tax avoidance motives for the Exchange and subsequent transfer of the CorpE stock. In particular, Taxpayers emphasize the need to provide capital to CorpF and the fact that the possible immediate redemption was not definite at the time of the Exchange.

Response: The FSA explains that elements such as common control, the timing of the transactions, and the expiration date of the CorpA NOL carryover strongly suggest tax avoidance motives. We emphasize "motives" in the plural. CorpC avoided taxation on the appreciated value of the CorpE stock, and CorpA benefited by using an NOL carryover that otherwise would have expired unused. By focusing on the fact that an immediate redemption was uncertain, Taxpayers attempt to draw attention away from the built-in gain and NOL carryover elements of the tax avoidance. Moreover, given the overlapping membership of the boards of directors of CorpA, CorpC, CorpD, and CorpE, we are not convinced that the possibility or likelihood of the CorpE stock redemption was entirely unknown at the time of the Exchange. According to the annual report that CorpE filed with the SEC for the period ending Date1, the chairman of CorpC's board of directors was a member of the CorpE board of directors during Year1 and would have had knowledge of CorpE's planning concerning the redemption and its ability to obtain the needed funds.[10]

[9] A transfer by LLC of the CorpE stock to CorpF would require that gain be recognized pursuant to section 367(a). Under section 704(c), CorpC would be treated as recognizing LLC's gain. The fact that CorpC contributed both the CorpE stock and its p% membership interest in LLC to CorpA as part of the Exchange suggests a tax avoidance motive to shift the recognition of gain on the CorpE stock from CorpC to CorpA.

[10] Form 10-K405, CorpE, Pg2 (filed Date3), available at http://www.sec.gov/Archives/edgar/data/Ecite2.

To summarize, Taxpayers' protest does not substantially alter our view of the case as expressed in the FSA. The issues that Taxpayers raised in the protest were either considered in the FSA or reflect a misinterpretation of section 482 and the relevant case law.

Case Development, Hazards and Other Considerations

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[redacted]