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

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR ASSOCIATE AREA COUNSEL (LMSB),

ATTN: Donald E. Osteen
CC:LM:CTM:

FROM: Debra L. Carlisle, Chief
CC:CORP:B05

SUBJECT:

This memorandum is in response to your request for advice. In accordance with section 6110(k)(3) of the Internal Revenue Code, this document should not be cited as precedent. We are continuing to examine the issues raised herein. Accordingly, we may issue supplemental advice regarding this case at a future date.

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.

LEGEND

X =

A =

B =

C =

State A	=	
Product XYZ	=	
Product X	=	
Product Y	=	
Product Z	=	
Bank	=	
a	=	
b	=	
c	=	
d	=	
e	=	
f	=	
g	=	
h	=	
i	=	
j	=	
k	=	
l	=	
m	=	
n	=	
p	=	
q	=	

Date 1	=	
Date 2	=	
Date 3	=	
Date 4	=	
Date 5	=	
Date 6	=	
Date 7	=	

ISSUE

What legal theories should be used by the Field to disallow a loss claimed by taxpayer in the transaction described below.

FACTS

The taxpayer, X, a U.S. corporation, is one of State A's leading importers, processors, packers and distributors of Product XYZ, principally Product X, Product Y and Product Z. Prior to the transaction discussed herein, the stock of X was owned a-percent by A, b-percent by B and b-percent by C. A, B and C are related corporations. B and C were regular and ongoing suppliers of product for resale by X and X purchased the majority of its inventory from B and C.

X, A, B and C entered into a "Common Stock Subscription Agreement" (the "Agreement") dated Date 1[1] whereby A, B and C agreed to acquire additional shares of X in exchange for property in a transaction intended to qualify under § 351. Under the Agreement, B and C each agreed to contribute inventory, including Product Y and Product Z, with a fair market value of no less than $c and A agreed to contribute cash of $d.[2] These transfers will be referred to hereinafter as the "Inventory Transfers."

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[1] The date that the Agreement was actually signed is in controversy and there is evidence indicating that it was likely signed in Date 2 and made to be retroactive to Date 1.

[2] Apparently, A never made a direct infusion of cash. Instead, the $d was recorded as a receivable on the books of X by an adjusting journal entry at year's end.

On Date 3 B and C refinanced their existing loans with Bank in the amounts of e (approximately $f) and g (approximately $h), respectively. The loans were scheduled to be funded on Date 4. B and C pledged all of their assets (including, but not limited to, inventory) to secure the loans and entered into certain covenants on sale or transfer of the assets. The refinancing agreement allowed B and/or C to nominate a member of the group to be jointly and severally liable for the repayment of the loans. On Date 4 B and C nominated X to be jointly and severally liable on their loans with Bank. However, a separate agreement limited Xs' liability on the Bank loans to the value of the secured inventory it received in the Inventory Transfers.

No special shipment or special order of inventory was made by X from either B or C to satisfy the Agreement. X continued to place orders from B and C in the same manner as in other time periods. Instead, X identified purchases already made from B and C that totaled $i and $j, respectively, made during the period Date 5 through Date 4.[3]

Although the Agreement states that A, B and C would each receive k additional common shares of X in the Inventory Transfers, as of Date 6, no additional shares were issued and no entry had been made to the stock record book. In addition, no mention of the Inventory Transfers were made in the corporate minutes of X and no contemporaneous entry was made to record the Inventory Transfers on the books of X. At year end an adjusting journal entry was made to record the stock issued and additional paid-in capital.

On Date 7, X filed its Federal Income Tax return, Form 1120, and claimed a loss of $*l* from the Inventory Transfers. X took the position that in both Inventory Transfers the transferred inventory was subject to liabilities in excess of its basis. According to X, the inventory it received from B had a cost basis of $i and was subject to liabilities of approximately $m. Further according to X, the inventory X received from C had a cost basis of $j and was also subject to liabilities of approximately $m. X took the position that § 357(c) applied to the transfers since the inventory was transferred in § 351 transactions and the "subject to" liabilities exceed the transferred inventory's basis. Applying this rationale, B recognized gain of $n on the transfer to X. Similarly, C recognized gain of $p on the transfer to X. However, since B and C had no U.S. trades or businesses or permanent establishments in the U.S., X maintained that this $q gain recognized was not subject to U.S. taxation.

Even though the § 357(c) gains recognized by B and C were not subject to U.S.

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[3] Presumably the transfers were done in this manner due to concerns of completing the transaction prior to the effective date of §§ 357(d) and 362(d), October 18, 1998.

taxation, X took the position that, pursuant to § 362(a), its basis in the transferred inventory was increased by the § 357(c) gains recognized by B and C. On the subsequent sale of the transferred inventory, X claimed an adjusted basis of $h[4] and a loss on the sale of $*l* (calculated $i + $j Amount Realized less $h Adjusted Basis). The Service is seeking to disallow this loss.

GROUNDS FOR DISALLOWING TAXPAYER'S LOSS

1. *The Transferred Purchased Inventory Was Not "Subject To" the Entire Amount of the Liability It Partially Secured.* The taxpayer, X failed to determine what amount of liability the transferred inventory was "subject to" and, therefore, the amount of gain computed and basis increase generated was incorrectly inflated. Under § 357(c), the amount of liability the transferred property is subject to is not the whole amount of the liability that the transferred property secures, when based on the facts the transferred property will not satisfy the whole liability. Both the courts and the IRS have determined in individual cases, depending on the facts, that an amount of liability less than the whole liability to which transferred collateral was subject, was the appropriate amount that could be treated as the "subject to" amount of liability.

For example, the case of Owen v. Commissioner, T.C. Memo. 1987-375, aff'd, 881 F.2d 832 (9th Cir. 1989), cert. denied, 493 U.S. 1070 (1990), supports allocating less than the entire liability when other property also secures the liability and is available to satisfy the liability. In Owen the taxpayer's partnership borrowed money on a recourse basis and pledged equipment as collateral. The taxpayer guaranteed the partnership's liability with a pledge to the lender of its own certificate of deposit. The partnership then transferred the equipment subject to its recourse liability to a controlled corporation. The Service took the position that the taxpayer recognized § 357(c) gain on the entire amount of the liability. The Tax Court determined that the amount of "subject to" debt did not include the amount of the certificate of deposit that the taxpayer pledged as a guarantee. The Tax Court held, and the appeals court affirmed, that only the remainder of the liability amount should be included in determining the amount of § 357(c) gain. Thus, in effect, the court reduced the amount of the debt that the property was "subject to" by the retained collateral.[5]

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[4] We note that there is a slight difference in the basis shown on taxpayer's financial statements and that calculated using the carryover basis and § 357(c) gain equal to $4,596.

[5] Other cases that contain similar holdings to Owen, for example Smith v. Commissioner, 84 T.C. 889, contain facts that distinguish it from our situation. In Smith the court held that a transfer of property subject to a liability resulted in section 357(c) gain that took into account the entire liability. In its analysis, the court stated that when

In addition, there are significantly different facts in Owen than in the case at hand. In Owen the equipment at issue was purchased for $1,288,000 between 6 and 18 months before the transfer to the corporation, and it had begun declining in value. Thus, although the court did not recite the value of the equipment at the time of transfer, it was highly likely that the value of the equipment still exceeded the amount of the liability ($988,000) it secured. Therefore, the Owen court did not have to address whether the amount the property is "subject to" should be capped by its fair market value, since in all likelihood the property's value exceeded the amount of the liability.

In Notice 2002-21, 2002-14 I.R.B. 730, the Service interpreted the section 1001 regulations[6] as permitting a reasonable allocation of assumption of recourse liability, stating "under the facts and circumstances of the transaction described in this Notice, as a matter of economic reality, the parties will bear responsibility for repayment of the Loan in accordance with their relative ownership of the Assets immediately after the transfer from Transferor to Taxpayer." In the Notice the Service stated as support for its position the fact that courts have limited the portion of an assumed indebtedness that may be taken into account for tax purposes, citing Maher v. United States, No. 16253-1 (W.D. Mo. 1969) (property was not in substance "subject to" liability where lender was not actually relying on property as collateral); and Maher v. Commissioner, 469 F.2d 225 (8th Cir. 1972) (corporation's assumption of primary liability on shareholder's indebtedness becomes taxable dividend only as corporation makes payments as promised). Accordingly, the Service and the Treasury determined that the taxpayer's basis in the Conveyed Assets in the Notice was equal to the fair market value of such assets upon their acquisition by Taxpayer, which was under those facts a pro rata portion of the debt. This approach, which ties the amount treated as assumed

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property is subject to a liability, the debt is to be satisfied out of the property, even when the transferor retains personal liability on the debt. The property in Smith was valued at more than the debt. In the case at hand, however, the transferred Purchased Inventory has a significantly lower value than the debt to which it is subject. Thus there can be no expectation that relinquishing the property can satisfy the entire debt.

[6] In general, § 1001 governs the tax treatment of sales or other dispositions of property. Section 351 is an exception to the general rule of § 1001, for situations in which stock is the consideration for the transfer of property. Section 357(c) operates as almost a parallel to §1001. The regulation under section 1.1001-2(a)(4)(ii) provides that "the sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability)." The effect of a recourse liability being considered discharged is that the amount of the liability discharged is included in the amount realized. Under §357(c), the amount of the liability property is transferred subject to is included in the amount realized.

to the pro rata values of all the secured properties, is another reasonable means of determining the amount of liability a transferred property is"subject to" in § 357(c) cases.

Moreover, limiting the "subject to" amount to the fair market value of the transferred property or the pro rata amount of debt associated with the transferred property, is consistent with a prior position taken by the Service in a case that had favorable consequences to a domestic taxpayer who had to actually pay tax on its §357(c) gain. See TAM 9640001.

2. *Alternative Position -- The Amount Realized on Sale of Transferred Inventory Includes "Subject To" Liabilities.* Even if the taxpayer should prevail with the argument that the entire "subject to" liability is included in the basis of the transferred inventory, then under § 1001 principles there is no loss on the transferee's subsequent sale of the inventory at fair market value because the amount of the "subject to" liability that was included in the transferee's basis must be treated as an amount realized by the transferee. Thus, the transferee will have an amount of §1001 gain on the sale approximately equal to its basis in the inventory, resulting in a zero loss. See Crane v. Commissioner, 331 U.S. 1 (1947) and Tufts v. Commissioner, 461 U.S. 300 (1983). In Crane, the Supreme Court held that a taxpayer, who sold property encumbered by a nonrecourse mortgage (the amount of the mortgage being less than the property's value), must include the unpaid balance of the mortgage in the computation of the amount the taxpayer realized on the sale. The taxpayer in Crane did not incur the mortgage liability, but inherited the property with the amount of mortgage having determined the basis of the property in Crane's hands. In Tufts the taxpayer transferred property subject to a nonrecourse mortgage whose value was less than the debt which it secured. The Supreme Court in Tufts held, as in Crane, that the selling taxpayer must include the amount of the mortgage in the amount realized. The Tufts Court stated:

> Nothing in . . . [section 1001] . . . requires the Commissioner to permit a taxpayer to treat a sale of encumbered property asymmetrically by including the proceeds of the nonrecourse obligation in basis but not accounting for the proceeds upon transfer of the encumbered property.

461 U.S. at 313. In our case the debt the inventory is subject to is partially recourse and partially nonrecourse in the hands of the transferee. The liability is recourse to the extent that X assumed the liabilities of B and C (an amount equal to the value of the inventory received). The excess of the liability over the amount assumed that is "secured" by the inventory is nonrecourse to X. Thus, consistent with Crane and Tufts principles, if the excess liability the inventory secured gives rise to additional basis in the hands of the transferee of the property, then when the transferee sells the inventory it should be treated as having received an amount realized equal to the amount of the

liability that resulted in the transferee having basis in the transferred inventory. Therefore, X should include the total amount of the liabilities assumed or taken subject to in its amount realized upon the subsequent sale of the transferred inventory.