Office of Chief Counsel
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Memorandum

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date: June 12, 2008

to: Associate Area Counsel
(Small Business/Self-Employed)
Attn:

from: Branch Chief (Passthroughs & Special Industries) CC:PSI:B02

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subject:

This Chief Counsel Advice responds to your request for assistance dated March 14, 2008. This advice may not be used or cited as precedent.

LEGEND

X =

Y =

Z =

A =

a =

b =

c =

d =

e =

Date1 =

Date2 =

Date3 =

Date4 =

Date5 =

Date6 =

Date7 =

Date8 =

Year1 =

Year2 =

Year3 =

Year4 =

Year5 =

Year6 =

Airplane =

Bank =

Business =

State =

ISSUES

1. Whether Y's election to be treated as an association taxable as a corporation caused X to recognize $2 million of gain under § 357(c).

2. Whether income or gain from the Airplane leasing activity of X would be properly characterized as passive investment income for purposes of §1362(d)(3).

CONCLUSIONS

1. Based on the facts presented, through the application of the Step Transaction Doctrine, the Economic Substance Doctrine, and § 269, it appears that Y's election to be treated as an association taxable as a corporation should not be respected and did not cause X to recognize $2 million of gain under § 357(c).

2. Based on the facts as presented, it appears that substantial costs may have been incurred by X in the Airplane leasing activity and therefore the income received by X from the Airplane leasing activity may be properly treated as income that is not passive investment income for purposes of § 1362(d)(3).

FACTS

As we understand them, the facts are as follows. X was formed on Date1 as a C corporation and elected to be treated as an S corporation effective Date2 and conducted Business. A is the sole shareholder of X. X currently has accumulated earnings and profits, and A possesses substantial carryover net operating losses generated by the business activities of X.

In Year1, X purchased and placed in service the Airplane. The purchase price of the Airplane was $b. The Airplane was operated exclusively for A's business and personal needs. The Airplane was fully depreciated by the close of X's taxable year in Year2. In Year2, X formed Y, a limited liability company under the laws of State, and X chose to treat Y as a disregarded entity for federal tax purposes. After the formation of Y, X contributed the Airplane to Y. It is not known what the value of the Airplane was for any of the years at issue.

In Year3, X's Business was sold to an unrelated company, Z. The submission indicates that A does not hold any ownership percentage or management responsibility in Z. After this sale, A retained his ownership of X and Y (along with Y's sole asset, the Airplane). After the sale of the Business, X's business activity of record became "management and investing". In addition, with the sale of the Business, X ceased to have any employees. However, A had an agreement with Z whereby one former employee of X would continue to perform certain personal assistant duties for A in addition to her duties at Z.

After the sale of the Business to Z, X entered into an agreement with Z whereby Z would handle the scheduling and day-to-day operations of leasing the Airplane owned by X through Y. Z would schedule all aircraft maintenance and incur any other expenses necessary for the operation of the Airplane. The expenses incurred by Z in the Airplane leasing activity were paid by Z and then billed to X each month in an itemized expense report. The payment by X to Z for these expenses would be

overseen by A's personal assistant employed by Z. Z would issue invoices to rental customers under the name of X for the Airplane usage fees. Rental customers would remit payment for the Airplane usage fees directly to X, and the receipt of these payments would be overseen by A's personal assistant employed by Z. Z would also provide pilots and other services to rental customers and then issue invoices for pilot services and fuel surcharges directly to these customers for payment. The rental customers would remit payments for these invoices to Z. The Airplane leasing operations continued to be handled by Z on behalf of X in this manner through Year6.

In addition to operating the Airplane leasing activity on a day-to-day basis with respect to rental customers, Z would also use the Airplane for its own business purposes. No invoices were issued for this usage. However, X would be credited by Z for the rental value of these flights.

As part of the agreement between X and Z, X was also permitted to schedule and operate the Airplane for A's business and personal needs. No invoices were issued by Z to X for this usage. The expenses incurred for these operations were paid by Z and then billed to X as part of the monthly expense report.

On Date3, A executed a promissory note on behalf of Y in exchange for a loan in the amount of $c from Bank. Also on Date3, A executed an unconditional guaranty to Bank as President of X to guarantee the repayment of the $c loan borrowed by Y. The loan proceeds of $c were wire transferred by Bank to a newly opened bank account of Y on Date3. On Date3, a check drawn on this bank account was made payable to X for $c, and this check was deposited by X into X's money market bank account several days later. X has stated that the funds were borrowed for general corporate purposes and in anticipation of investment opportunities. It does not appear from the facts as presented that any portion of the loan proceeds were devoted by X for use in the Airplane leasing activity. Based on the facts as submitted, it is not known whether the fair market value of the Airplane on Date3 would have been sufficient to provide for full repayment of this loan.

On Date7, A, on behalf of Y, executed a Form 8832, Entity Classification Election, to change the entity classification of Y from a disregarded entity to an entity electing to be classified as an association taxable as a corporation. The effective date of this election was Date4.

On Date8, A, on behalf of X, executed a Form 8869, Qualified Subchapter S Subsidiary Election, to treat Y as a qualified subchapter S subsidiary of X. The effective date of this election was Date6.

Y filed a Form 1120 for the period starting Date4 and ending Date5 (a two-week period in Year6). (For the two week period covered by the Form 1120, Y may be referred to as the "C corporation.") This tax return included a statement under § 1.351-3(b) that listed the property transferred as an Airplane with an adjusted basis of $d and

cash in the amount of $e (the combined values being significantly less than the $c borrowed by Y from Bank). There was no mention of any assumption of liabilities by Y.

X's tax return for the taxable year ending in Year6 reported gain of $a, taxed as ordinary income, based on Y's election to be taxed as a C corporation for a two-week period in Year6. X argues that this gain was derived from the fact that X was deemed to have transferred both liabilities and assets to Y and that the liabilities exceeded the adjusted tax basis of the assets deemed transferred to Y. X also argues that this gain permitted Y to increase the adjusted basis of the Airplane by approximately that amount. X further argues that the taxable gain recognized by X was derived in connection with its Airplane leasing activity, that this gain was not passive investment income to X, and that the recognition of this gain prevented the termination of X's Subchapter S election after Year6 under § 1362(d)(3) for excess passive investment income. X otherwise admits that it had passive investment income, within the meaning of § 1362(d)(3)(C), that exceeded 25 percent of its gross receipts in Year4 and Year5, and also admits that its Subchapter S election would have terminated after the end of Year6 under § 1362(d)(3)(A) but for the gain purportedly recognized by X in Year6 as a result of the election by Y to be taxed as a C corporation.

LAW AND ANALYSIS

Issue 1.

Under Reg. § 301.7701-3(g)(1)(iv), X's Form 8832 election is treated as if X transferred all of the assets and liabilities of disregarded entity Y to a new corporation Y in exchange for its stock. The taxpayer claims that this transaction is tax free under § 351 of the Internal Revenue Code. X's subsequent Form 8869 election is treated as if Y liquidated into X under Reg. § 1.1361-4(a)(2)(i).

Section 301.7701-3(g)(2) provides that the tax treatment of a change in the classification of an entity for tax purposes by election is determined under all relevant provisions of the Code and general principles of tax law, including the step transaction doctrine.

Section 351

Under § 351(a), no gain or loss is 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 of the corporation. The basic purpose of § 351 is to permit deferment of gains or losses where there has been a mere readjustment of the form of ownership rather than a termination of the taxpayer's interest in the transferred property. See Helvering v. Cement Investors, Inc., 316 U.S. 527, 533-34 (1942) (discussing the purpose of § 112(b), the predecessor to § 351). As stated by the court in Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st. Cir. 1940):

> It is the purpose of Section 112(b)(5) 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 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.

Under § 358(a), a transferor's basis in the transferee corporation's stock received in the § 351 exchange is equal to the transferor's basis in the contributed assets, decreased by the amount of any boot or money received, and increased by any gain recognized by the transferor on the exchange.

The amount of the assumption of any liability is treated as money received by the transferor for purposes of determining its basis in the transferee's stock. Accordingly, basis is decreased by the amount of the assumed liability under §§ 358(a)(1)(A)(ii) and 358(d)(1). Treating the assumption of a liability as money received resulting in a reduction in basis produces problems in transactions in which the sum of the transferor's liabilities assumed by the transferee exceeds the adjusted basis of the assets transferred. Thus, § 357(c)(1) was enacted to provide that the excess of the amount of liabilities assumed over the total of the adjusted basis of the property transferred is considered gain from a sale or exchange of an asset. See Focht v. Commissioner, 68 T.C. 223, 235 (1977); Rosen v. Commissioner, 62 T.C. 11, 19 (1974)[1].

The intent of § 357(c) is to tax gain in a circumstance where the transferee corporation has relieved the transferor of an obligation. The transferor has essentially "cashed out" to the extent that the liability assumed by the corporation exceeds the adjusted basis of the assets transferred. In the instant case, however, the deemed assumption of the liability under the election did not result in a cashing out or any actual debt relief. The taxpayer was still liable as the unconditional guarantor on the note, held the cash in its money market account for purposes unrelated to the transferee corporation's Airplane leasing activity, and any relief was illusionary.

The Step Transaction Doctrine

But, alternatively, the § 351 transaction need not be respected at all. Section 1.1361-4(a) of the regulations states that general principles of law, including step transaction doctrine, apply to Form 8869 elections. The step transaction doctrine is a

[1] In the instant case X's basis in the C corporation stock is the basis of the Airplane, ($d), cash and property that was transferred, minus the amount of money received by taxpayer (assumption of liability or $c) plus amount of recognized gain on the exchange ($a). X's basis in the C corporation stock is zero. Under § 362(a), the C corporation's basis in the Airplane is the same as in the hands of X ($d) plus the amount of gain recognized by X in the exchange ($a). Section 362(d) states that the basis of any property shall not be increased by § 362(a) above the fair market value of the property.

variant of the substance over form doctrine. The doctrine holds that where a taxpayer has embarked on a series of transactions that are in substance a single, unitary, or indivisible transaction, the courts will disregard the intermediary steps and give credence only to the completed transaction. Redwing Carriers, Inc. v. Tomlinson, 399 F. 2d 652, 654 (5th Cir. 1968).

The case of Penrod v. Commissioner, 88 T.C. 1415 (1987), established what is commonly referred to as the "step transaction doctrine" and three formulations for how to test the applicability of the doctrine:

1) *the binding commitment test* - under the binding commitment test, one or more steps of an overall transaction are disregarded if, at the time the first step is entered into, there is a binding commitment to undertake the later step.
2) *the interdependence test* - the interdependence test asks whether the steps that make up the transaction are so interdependent the legal relations created by one transaction would be fruitless without a completion of the series.
3) *The end result test* - the end result test applies to a situation in which a series of separate steps are in substance just prearranged parts of a single transaction intended from the outset to reach the ultimate result.

It appears that the end result test applies to the facts presented. This test relies on the parties' intent at the time of the transactions, which can be derived from the actions surrounding the transactions. Penrod at 1429. The end result test applies when separate transactions were "really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result." The Falconwood Corporation v. United States, 422 F.3d 1339, 1349 (Fed. Cir. 2005), citing King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969); Associated Wholesale Grocers, Inc. v. United States, 927 F. 2d 1517, 1523 (10th Cir. 1991); Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd without published opinion, 886 F.2d 1318 (7th Cir. 1989).

Y was an entity that was disregarded for Federal income taxes purposes under § 301.7701-3 prior to Date4. After the Form 8869 election effective on Date6, Y as a Qualified Subchapter S Subsidiary was ignored for virtually all Federal income purposes under § 1.1361-4(a). The existence of the C corporation for a mere two weeks can be collapsed and ignored for Federal income tax purposes under the end result test.

Economic Substance

The economic substance doctrine is a judicial doctrine developed through 70 years of case law and applies to align the tax consequences of a transaction with its substance rather than its form. The doctrine has been applied in a variety of forms and is closely related to the step transaction, substance over form, and business purpose doctrines. Its test has been articulated in a variety of ways. The doctrine's genesis is generally credited to the Supreme Court in Gregory v. Helvering, 293 U.S. 538 (1934),

although earlier cases stated similar ideas. See, e.g., United States v. Phellis, 257 U.S. 156, 168 (1921). While a taxpayer can legitimately structure a transaction to minimize tax liability under the Code, the transaction must nevertheless have factual and economic substance in order to be "the thing which the statute intended." Gregory, 293 U.S. at 469. As the Seventh Circuit observed in Saviano v. Commissioner, 765 F.2d 643, 654 (7th Cir. 1985):

> … The freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along. The Commissioner and the courts are empowered, and in fact duty-bound, to look beyond the contrived forms of transactions to their economic substance and to apply the tax laws accordingly. …

In Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985), the appellate court agreed with the tax court's determination that the Supreme Court in Frank Lyon Co. v. United States, 435 U.S. 561 (1978), mandated a two-pronged inquiry to determine whether a transaction is, for tax purposes, a sham:

> … To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists. …

See also Hilton v. Commissioner, 74 T.C. 305, 349-50 (1980), aff'd per curiam, 671 F.2d 316 (9th Cir.1982).

In the instant case, the formation of the C corporation and its quick liquidation had no economic purpose at all. In fact, X tried to form the C corporation solely for a tax-motivated, not an economic, purpose. X tried to generate a taxable *gain* solely for the purpose of maintaining its Subchapter S status. Based on these facts, an application of the economic substance doctrine would yield the conclusion that X's formation of the C corporation for two weeks has no economic substance, was undertaken purely for tax-motivated purposes, and can be disregarded.

Section 269

Section 269(a)(1) provides that if any person or persons acquire, or acquired, directly or indirectly, control of a 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. The statute sets forth three major elements that must be satisfied in order for § 269(a)(1) to apply to a tax benefit:

1. A person or persons;

2. Must directly or indirectly acquire 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 a corporation; and

3. 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.

In the instant case, it is clear that the first two elements are satisfied. Section 1.269-1(d) defines a "person" for purposes of § 269 and the regulations to include a corporation such as X , and X organized and wholly owned Y, the C corporation. The creation of the C corporation was an "acquisition of control" for purposes of the statute. See, e.g., Your Host, Inc. v. Commissioner, 489 F.2d 957 (2d Cir. 1973), cert. denied 419 U.S. 829 (1974).

Satisfaction of the third element, however, requires closer examination. Section 1.269-3 elaborates upon when § 269(a) can apply. In relevant part, §1.269-3(a) provides as follows:

> … In either instance [(i.e., under section 269(a)(1) or (2),] the principal purpose for which the acquisition was made must have been the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person, or persons, or corporation, would not otherwise enjoy. If this requirement is satisfied, it is immaterial by what method or by what conjunction of events the benefit was sought.

The third element requires that the acquisition must have had as its principal purpose the evasion or avoidance of Federal income tax. This is a question of fact, to be determined by considering all the facts and circumstances of the entire transaction, with the burden of proof on the taxpayer. J.T. Slocomb Co. v. Commissioner, 334 F.2d 269, 273 (2d Cir. 1964); see also, Treas Reg. § 1.269-3(a). In the instant case, the short time that the C corporation existed is evidence that the sole purpose of the election was to maintain X's Subchapter S status and to enjoy the tax benefits that status permits.

Issue 2.

Except as provided in § 1362(g), § 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) shall be terminated whenever the corporation (1) has accumulated earnings and profits at the

close of each of three consecutive taxable years, and 2) has gross receipts for each of such taxable years more than 25 percent of which are passive investment income.

Except as otherwise provided in § 1362(d)(3)(C), § 1362(d)(3)(C)(i) provides that the term “passive investment income” means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1.1362-2(c)(5)(ii)(B)(1) of the Income Tax Regulations provides that “rents” means amounts received for the use of, or the right to use, property (whether real or personal) of the corporation.

Section 1.1362-2(c)(5)(ii)(B)(2) provides that “rents” does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in the active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Based on the facts as presented, it appears that significant services may have been performed and substantial costs may have been incurred by X in the Airplane leasing activity. Even though most of the services provided in connection with the Airplane leasing were provided by or through Z, X was billed separately by Z for the expenses related to these services. The fees for the use of the Airplane were paid directly to X by customers. Accordingly, based on the facts as presented, it appears that the possibility existed that X’s expenses related to the Airplane leasing activity could exceed the rental income from the Airplane leasing activity under certain conditions. Therefore, it appears that the arrangement between X and Z would not have been equivalent to a net lease, and X likely should be considered as having incurred the expenses in connection with the Airplane leasing activities. If, upon examination of all of the facts and circumstances surrounding the relationship between X and Z, it is determined that significant services were performed and substantial costs were incurred by X in the Airplane leasing activity, the rental income X received from the Airplane leasing activity for the years at issue is properly treated as income that is not passive investment income under § 1362(d)(3)(C)(i).

Therefore, to the extent that X is properly treated as deriving gain from its Airplane leasing activity, this gain is likely properly treated as income that is not passive investment income.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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[redacted]

[redacted]

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Please call (202) 622-3060 if you have any further questions.

By: _____
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