Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: December 24, 2008

to:
Senior Attorney
(Large & Mid-Size Business)

from:
Branch Chief
(Corporate)

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subject:

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

<u>LEGEND</u>

Acquiring =

Target =

Principal Creditor =

Target LLC =

Firm 1 =

Taxpayer's Representative =

Service Representative	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Dates 13	=
Date 14	=
Shareholder 1	=
Shareholder 2	=
Shareholder 3	=
AA	=
A	=
$B	=
C	=

D	=
E	=
F	=
G	=
H	=
J	=
K	=
L	=
M	=
N	=
O	=
P	=
Q	=
R	=
S	=
T	=
U	=
State V	=
State VV	=
W	=
X	=
Y	=
Z	=

WW	=
XX	=
Z Transactions	=
ZZ Facility	=
Year 0	=
Year 1	=
Year 2	=

ISSUES

Whether Acquiring's acquisition of Target on Date 7, the date Target emerged from bankruptcy, qualifies for treatment under section 382(l)(5) of the Code.

CONCLUSIONS

Acquiring's acquisition of Target on Date 7 does not qualify for treatment under section 382(l)(5).

FACTS

On Date 1, Acquiring entered into formal discussions regarding possible acquisition of Target. On Date 2, Acquiring and Target entered into a confidentiality agreement. On Date 3, Acquiring purchased AA shares of Target's stock, representing A% (less than 5%) of Target's stock then outstanding for $B per share. On Date 4, Acquiring, Target, and Target's principal creditor ("Principal Creditor") entered into a stock purchase agreement, under which Acquiring was to purchase newly issued Target shares and Target would solicit acceptances from its shareholders for a prepackaged plan of bankruptcy reorganization. On Date 5, Target filed a disclosure and proxy statement with the bankruptcy court (the "Court"), soliciting approval from its shareholders for a prepackaged bankruptcy plan. The stock purchase agreement, as submitted to the Court, was amended and restated on Date 6 (the "Agreement"). Shortly thereafter, on Date 7, the Court approved Target's bankruptcy plan, of which the Agreement was a part (the "Plan").

Throughout the period of the discussed in this document, Target had only one class of stock outstanding. Immediately prior to Date 3, Target had approximately G shares of its stock outstanding, and Target's stock was owned by three 5-percent shareholders and a public group in the following percentages: Shareholder 1 – C%, Shareholder 2 – D%, Shareholder 3 – E%, and Public – F%. Acquiring's Date 3 purchase of A% was made from Public. Pursuant to the Plan's becoming effective on Date 7, the following transactions occurred on Date 7—(1) all of the shares of Target stock held by Shareholder 3 and the Public (except for a deminimis number of shares held by public shareholders), H shares altogether, were redeemed for $J per share, and (2) Acquiring purchased K shares of newly issued Target stock from Target, representing L% of Target's stock then outstanding (after taking into account the approximately H shares redeemed from Shareholder 3 and the Public) for $M (which would be about $N per share). On Date 7, immediately after the redemptions and the issuance of new shares, the stock of Target was held by the following shareholders in the following percentages: Shareholder 1 – Q%, Shareholder 2 – R%, Acquiring – S% (T% as a result of the AA shares acquired on Date 3 and L% as a result of the K shares acquired on Date 7).

Also pursuant to the Plan, Acquiring paid $O to Principal Creditor s on Date 8 for which consideration Principal Creditor agreed to reduce Target's debt outstanding to Principle Creditor by $O[1]. The following month, on Date 9, Target paid off the remaining principal and interest ($P) on its debt owed to Principle Creditor. Under the Plan, all of Target's creditors, except Principle Creditor, were paid in full. Further, the $O paid to Principle Creditor s pursuant to the Plan represented more than 75% of the debt owed by Target to Principle Creditor, and the remaining portion of the debt owing was paid off by Target the following month, all of which occurred within 4 months of Target's emerging from bankruptcy.

On Date 10 and 11, respectively, Target redeemed all of Shareholder 2's Target stock and all of Shareholder 1's Target stock for $U per share. Shareholder 1's redemption (as well as that of the deminimis number of shares held by public shareholders not redeemed on Date 7) was effectuated by means of a "short-form cash-out merger", which Acquiring, as the majority shareholder of Target, could implement without the approval of other Target shareholders under the terms of its Restated Articles of Incorporation as permitted under State V law. Dates 10 and 11 fell within 3 weeks after Date 7. On Date 12, Target was converted into Target LLC, which was a single member limited liability company, and a disregarded entity for Federal income tax purposes.

Dates 2, 3, 4, 5, 6, 7, 10, 11, and 12 all fall within calendar Year 1. As of the end of calendar Year 0 (the preceding year) Target had net operating loss carryovers of approximately $W. As of the end of calendar Year 1 Target had net operating loss carryovers of approximately $X. The Acquiring group used all of these net operating loss carryovers to offset taxable income in its first two taxable years ending after its

[1] Between Dates 4 and 5, Principle Creditor had, itself, filed a chapter 11 bankruptcy petition in State VV. Taxpayer has stated that, in form, the payment to Principle Creditor was treated as a loan of $O by Acquiring to Target, documented through intercompany note receivable and payable entries on the companies' books, followed by Target's payment of $O to Principle Creditor s . Taxpayer further indicates that this loan was retired by means of a capital contribution from Acquiring to Target in Year 2.

acquisition of Target (except for a relatively small portion of the carryovers, approximately $Y, that expired unused after the first of those two taxable years).

LAW AND ANALYSIS

Section 382 provides that, after an ownership change, the amount of a loss corporation's taxable income for any post-change year that may be offset by pre-change losses (which include net operating loss carryovers) shall not exceed the section 382 limitation for that year. An ownership change occurs with respect to a corporation if it is a loss corporation on a testing date and, immediately after the close of the testing date, the percentage of stock of the corporation owned by one or more 5-percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of such corporation owned by such shareholders at any time during the testing period. See section 1.382-2T(a)(1) of the Income Tax Regulations. The testing period is generally a 3-year period ending on a testing date. Section 1.382-2T(d)(1).

Section 382(l)(5)(A) provides an exception under which a loss corporation's pre-change losses shall not be limited after an ownership change if the loss corporation is (immediately before such ownership change) under the jurisdiction of the court in a title 11 or similar case, and the shareholders and creditors of the loss corporation (determined immediately before such ownership change) own (after such ownership change and as a result of being shareholders or creditors immediately before such change) stock of the loss corporation which meets the requirements of section 1504(a)(2) (determined by substituting "50 percent" for "80 percent" each place it appears). For purposes of section 382(l)(5)(A), section 382(l)(5)(E) provides that stock transferred to a creditor shall be taken into account only to the extent such stock is transferred in satisfaction of indebtedness and only if such indebtedness was held by the creditor at least 18 months before the date of the filing of the title 11 or similar case, or arose in the ordinary course of the trade or business of the loss corporation and is held by the person who at all times held the beneficial interest in such indebtedness.

Thus, section 382(l)(5) provides an exception to the general rule of section 382(a) in recognition of the fact that, by the time a corporation is in bankruptcy (i.e., under the jurisdiction of the court in a title 11 or similar case), it is often the corporation's creditors, and not its shareholders, who are effectively its economic owners. It is not uncommon in such cases for the court to approve a plan under which—(i) shares of stock held by the historic shareholders are cancelled without consideration, and (ii) and the company's creditors are issued new shares of stock (thus becoming the company's new shareholders). Were it not for the section 382(l)(5) exception, such a corporation's pre-change losses would be limited under section 382(a) by virtue of the fact that creditors, who formerly owned none of the loss corporation's stock before the effective date of the plan, now own more than the 50 percent. Section 382(l)(5) provides that pre-change losses will not be limited if pre-change, qualified creditors, as a result of their creditor's interest, and historic shareholders hold 50 percent or more of the stock of the loss corporation on its emergence from bankruptcy.

Prior to Date 3 (in Year 1), Acquiring had no interest, either as a stockholder or a creditor, in Target. By the end of that year, Acquiring owned all of the stock of Target. In filing its tax returns for its taxable years ending after Date 3, Acquiring took the position that Target's pre-change losses could be used without limitation against Acquiring's post-change income, notwithstanding the ownership change that occurred on Target's emergence from bankruptcy on Date 7, on grounds that the acquisition of Target qualified for application of section 382(l)(5). We believe the ownership change of Target occurring on Date 7 does not qualify under section 382(l)(5).

Acquiring structured its acquisition of Target in a way that, superficially, might appear to meet the requirements of section 382(l)(5). That is, on Date 7, the day that Target emerged from bankruptcy, Shareholder 1 and Shareholder 2 held Q% and R% of the stock of Target, respectively. Furthermore, Acquiring, as a result of its acquisition of AA shares of Target on Date 3, held T% of Target's stock on Date 7. Q% + R% + T% = Z% (just over 50 percent). We believe, however, that the transaction, as structured, does not reflect economic reality, especially as regards—(i) the number of shares of Target stock received by Acquiring on Date 7 in exchange for Acquiring's contribution to Target's capital on that date, and (ii) the amount of consideration paid to Shareholders 1 and 2 in redemption of their Target stock on Dates 10 and 11. There are several approaches or analyses that arguably reveal the economic unreality of the transaction:

<u>Analysis 1</u>. Consider the prices paid for the issuance/redemptions of shares occurring on Dates 7, 10, and 11. On Date 7, the shares held by Shareholder 3 and Public were redeemed for $J per share. On Dates 10 and 11 the shares held by Shareholder 2 and Shareholder 1 were redeemed for $U per share. The difference between $J and $U is a less than 1 percentage point difference. The redemption amounts paid for these shares are in line with the amount paid ($B) by Acquiring in purchasing AA shares from Public on Date 3. Yet, on Date 7, when Acquiring contributed $M to Target in exchange for K newly issued shares, the amount contributed per share received ($N) was about 8 times the amount paid in redemption of the shares redeemed on the same day. Considering the amount paid in by Acquiring, Acquiring arguably should have received 8 times as many Target shares as were actually issued. Had those shares been issued, the number of Target shares outstanding would have been approximately WW, and the percentage of Target stock held by the 'historic shareholders' on Date 7 would have been just over 10 percent. Clearly the requirements of section 382(l)(5) would not have been met.

Taxpayer argues that both the amounts paid out by Target on Date 7 (in redemption of shareholder 3 and Public) and the amount paid in by Acquiring for the newly issued shares reflect the reality of the transaction. First, Target got a fairness opinion from Firm 1 to the effect that the consideration received by the shareholders redeemed on Date 7 was fair from a financial point of view. Second, Taxpayer stated arguably good business reasons for wanting to acquire Target (and, by extension, for paying the amount of consideration that it did). We need not contest these points, but we do assert that, had Acquiring received an economically reasonable percentage of Target's stock in exchange for the amount of consideration paid, it would have received a much larger percentage than L%. This aspect of the transaction does not reflect economic reality. It appears that Acquiring's failure to take a greater number of shares was not of any economic detriment to Acquiring[2], but merely served as a device for claiming the tax benefits of section 382(l)(5).

Third, Taxpayer argues that the bankruptcy court's approval of the Plan supports the values attributed under the Plan to the Target shares issued/redeemed on Date 7. We disagree—we do not think the Court would be concerned with what number or percentage of Target shares was issued to Acquiring in exchange for its capital infusion into Target. The Court's primary focus, we believe, would be on the fairness of the Plan to the various creditors whose interests might be cut back in the bankruptcy action. If all parties to a pre-packaged plan of bankruptcy are happy with the proposed resolution, the court is likely to approve it. Thus, we believe, Acquiring could have taken a greater or lesser number of Target shares in the proposed resolution without the Court's taking notice.

<u>Analysis 2</u>. Arguably, Shareholders 1 and 2 should not be considered to be continuing shareholders after Date 7, but rather should be considered to have been redeemed, in substance, as part of a predetermined plan. It should be noted that, when redeemed, Shareholders 1 and 2 received only the same amount of consideration, per share, as was received by the shareholders who were redeemed as part of the Plan (actually a deminimis lesser amount per share, said to be fair because of the lack of marketability of the shares). This does not appear to square with the fact that Acquiring made a large contribution to Target's capital on Date 7, taking back only a relatively few Target shares in exchange therefor. As a result, one might have expected the value, per share of Target stock, would have substantially increased on Date 7. Stated another way, the fair value per share of the Target shares redeemed on Date 7 was determined by Firm 1, *taking into account all of Target's debt outstanding before any discharge or repayment under the Plan*[3]. With the reduction in the amount of Target's debt outstanding on Date 7, one could reasonably expect Target's value per share to have increased. Yet, Shareholders 1 and 2 received no more per share than those who were redeemed under the Plan on Date 7. This arguably suggests that the amount paid for their shares was fixed by side agreement as of the time the Plan became effective. Arguably, the only reason Shareholders 1 and 2 were not, in form, redeemed out with the other outside shareholders on Date 7 was Acquiring's desire to construct a

[2] That is, Shareholders 1 and 2 were redeemed out of Target a few weeks after Date 7 for essentially the same amount, per share, as was paid to redeem out other shareholders on Date 7, leaving Acquiring as Target's sole shareholder. Seen in this light, it would not have made any economic difference to Acquiring whether it was issued a greater or lesser number shares of Target stock on Date 7, given that Acquiring was destined to become Target's 100-percent owner. See "Analysis 2" under which we suggest that the redemption of Shareholders 1 and 2 on Dates 10 and 11 was already planned as of Date 7.

[3] See the answer to question 4.(b) provided by Taxpayer's Representative in its letter to Service Representative dated Date 14.

transaction that, in form, would appear to meet the requirements of section 382(l)(5). Given the inferred side agreement fixing the amount to be received by Shareholders 1 and 2, it would not have mattered to Shareholders 1 and 2 whether a greater or lesser number of Target shares had been issued to Acquiring on Date 7[4].

Analysis 3. Under Analysis 3, we step back to take a look at the bigger picture. As we said earlier, it is often the case that a company in bankruptcy is effectively owned, in an economic sense, by its creditors, notwithstanding the fact that the company's stock remains outstanding (often trading for negligible amounts in light of the reality that it may soon be cancelled). If such a company is to be acquired by an outsider, it is primarily the company's creditors, not its shareholders, who must be satisfied by the fairness of the deal. Acquiring wanted to acquire Target in a pre-packaged bankruptcy. The bankruptcy proceeding was critical to Acquiring's execution of the Agreement. Acquiring was willing to pursue a stock acquisition of Target only if Target's bankruptcy would relieve Target of all of its unknown liabilities. Thus, for Acquiring to accomplish its objectives, it would have to satisfy Target's creditors.

It may further be noted that the amount of cash infused by Acquiring into Target as part of the Plan was significantly greater than the $M contributed to Target on Date 7. In addition to the $M, Acquiring loaned Target, as part of the Plan, $O (which amount was more than three times greater than $M). While such amounts were not fully sufficient to satisfy all the claims of Target's creditors, all creditors, other than Principle Creditor, were "made whole" under the Plan, and about 75 percent of the amount owing to Principle Creditor was essentially paid off under the Plan. Creditors agreed to the plan, which was then approved by the Court.

The market arguably would have valued all the stock of Target at about $XX prior to the adoption of the Plan (i.e., as determined by multiplying the number of shares outstanding by about $J per share)[5]. The amount contributed to Target ($M) was nearly 4 times this amount. The amounts contributed and loaned to Target ($M + $O) were more than 16 times this amount[6]. Acquiring had to put these amounts into Target if it were to get creditor approval for the plan. When all was said and done, Acquiring had gone from a 0-percent interest in Target at the beginning of Year 1 (having neither a shareholder's nor a creditor's interest in Target) to having a 100-percent interest as a

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[4] Taxpayer's Representative, in answer to question 5.(c) in its letter to Service Representative on Date 14, stated that the price at which Shareholder 2 was redeemed out of Target "was negotiated between Target and Shareholder 2 in an arm's length transaction". This may be true. What is not stated is the *date* on which these negotiations took place. The redemption price received by Shareholders 1 and 2 would seem to be perfectly reasonable if we view the negotiations with Shareholders 1 and 2 as having taken place in conjunction with the formulation of the Date 7 plan.

[5] This valuation, $XX, arguably is on the high side. That is, were it not for Acquiring's interest in acquiring Target and in securing Target shareholder cooperation in approving the plan, the value of Target's stock might have been considerably less.

[6] The amount owing Acquiring under the loan was retired by means of a capital contribution from Acquiring to Target in Year 2.

shareholder in the financially restructured company by the end of the year. This looks very much like a 100-percent shift that does not qualify under section 382(l)(5), since Acquiring was neither a historic shareholder nor a historic creditor of Target.

Caselaw authorities:

Courts have developed a number of judicial doctrines that can negate the intended effect of transactions structured solely or primarily to avoid taxation. These doctrines are often overlapping and have been used interchangeably by courts to address abusive transactions.

Economic substance doctrine: The courts generally will deny claimed tax benefits where the transaction giving rise to those benefits lacks economic substance independent of tax considerations - notwithstanding that the purported activity did actually occur. The Tax Court recently described the doctrine as follows—

> The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.
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> ACM Partnership v. Commissioner, T.C. Memo. 1997-115, 73 T.C.M. (CCH) 2189 at 2245, aff'd in part and rev'd in part by 157 F.3d 231 (3d Cir. 1998).

The seminal authority most often credited for laying the foundation of the economic substance doctrine is the Supreme Court and Second Circuit decisions in Gregory v. Helvering, 293 U.S. 465 (1935), aff'g 69 F.2d 809 (2nd Cir. 1934). In Gregory, a transitory subsidiary was established to effectuate, utilizing the corporate reorganization provisions of the Code, a tax advantaged distribution from a corporation to its shareholder of appreciated corporate securities that the corporation (and its shareholder) intended to sell. Although the court found that the transaction satisfied the literal definition of a tax-free reorganization, the Second Circuit held (and the Supreme Court affirmed) that satisfying the literal definition was not enough—

> [T]he underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholder's taxes is not one of the transactions contemplated as corporate "reorganizations."
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> Gregory v. Helvering, 69 F.2d at 811.

In the present case, two aspects of the structuring of the transaction would seem to lack economic substance, apart from tax considerations—(1) Acquiring's receipt of only K shares of Target stock (rather than a much larger number) for its Date 7 contribution of $M to Target's capital, and (2) Target's redemption of Shareholders 1 and 2, in form, on Dates 10 and 11, rather than on Date 7[7].

Business Purpose Doctrine: Another doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine. Although numerous authorities apply this doctrine in the context of individuals or partnerships, the doctrine equally applies in the corporate context. Additionally, the doctrine is not limited to cases where the relevant statutory provisions by their terms require a business purpose or profit potential. Supra, ACM Partnership at 253. The business purpose test is a subjective inquiry into the motives of the taxpayer - that is, whether the taxpayer intended the transaction to serve some useful nontax purpose. Rice's Toyota World v. Commissioner, 752 F.2d 89 (4th Cir. 1985) at 92.

In its common application, the courts use business purpose (in combination with economic substance, as discussed above) as part of a two-prong test for determining whether a transaction should be disregarded for tax purposes: (i) the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and (ii) the transaction lacks economic substance. Id. at 91. In essence, a transaction will only be respected for tax purposes if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

Finally, where appropriate, the court may bifurcate a transaction in which independent activities with non-tax objectives have been combined with an unrelated transaction having only tax-avoidance objectives in order to establish a business purpose for the overall transaction. Supra, ACM Partnership at 256 n.48. Thus, a taxpayer cannot utilize an unrelated business objective to hide the lack of business purpose with respect

[7] Target's redemption of Shareholders 1 and 2 for $U per share on Dates 11 and 10, respectively, seems not to comport with economic reality for reasons explained under the discussion of Analysis 2, above. $U per share was, practically speaking, the same amount received by the other departing shareholders, all of whom were redeemed out on Date 7. Given the relatively large amount of money contributed to Target on Date 7 and the discharge of Target indebtedness (at least as to its unknown liabilities) on that same date, one would expect the value of Target shares to have been greater when redeemed a couple of weeks later (in the absence of evidence of a dramatic change in Target's fortunes between the Date 7 discharge and the redemptions of Dates 10 and 11). Acquiring arguably wanted to structure the redemptions of Shareholders 1 and 2 as occurring after Date 7 in order to qualify for tax relief under section 382(l)(5), but, at the same time, did not want to pay out more to Shareholders 1 and 2 than was paid out to the other redeemed shareholders. Thus, we might infer that the redemption of Shareholders 1 and 2 for $U per share was pre-arranged as of Date 7. If it were not for the fact that the evidence for an unreported side-agreement between Shareholders 1 and 2 and Acquiring is circumstantial in nature, the Service could, in our view, reasonably consider asserting the fraud penalty.

to the particular tax-motivated activities. While Acquiring has enumerated a number of business reasons for its acquiring of Target[8], these should not serve to protect superfluous aspects of the transaction, unrelated to any business purpose, engaged in for purposes of tax avoidance.

Substance-Over-Form Doctrine: The concept of the substance-over-form doctrine is that the tax results of an arrangement are better determined based on the underlying substance rather than an evaluation of the mere formal steps by which the arrangement was undertaken. The substance-over-form doctrine originated in Gregory v. Helvering, supra. It is the most general of the judicial doctrines discussed in this document and the source from which the other doctrines are considered to have emanated.

Step-Transaction Doctrine: "[A] given result at the end of a straight path is not made a different result because reached by following a devious path." Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938). A business transaction often does not have a sharply defined beginning or ending. One step in a transactional sequence often bears a strong relationship to that which came before it and that which follows it. For analytical purposes, however, it is often necessary to examine a transaction as an organic whole. To that end, the IRS and courts often fuse formally separate transactional steps to determine the tax consequences of the overall transaction. This approach may be viewed as a strand of the substance over form doctrine, in that it ignores the multiple steps (i.e., the form) of a transaction and instead focuses on the whole (i.e., the substance). This step transaction doctrine is pervasive in corporate tax law and has been articulated using three alternative threshold tests (i.e., the “binding commitment” test, the “end result” test, and the “mutual interdependence” test)[9]. More than one threshold test may be appropriately applied to a single set of circumstances; however, the satisfaction of only one of the tests is sufficient for a court to disregard transitory or unnecessary steps.

In the present case, the step-transaction doctrine may serve as a formal means to collapse the Date 7 and the Dates 10 and 11 steps into a single step for tax purposes. I.e., the Dates 10 and 11 redemptions would be combined with the Date 7 restructuring, treating the whole as occurring as part of a single transaction.

Assertion of penalties: We note that the agent in this case proposed asserting the penalty for substantial understatement under section 6662(d) with respect to Acquiring’s use of Target’s net operating loss carryovers to reduce its taxable income for its taxable

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[8] Among them, Acquiring listed—(i) increasing its volume of Z Transactions, (ii) obtaining the services of talented, experienced Target employees, (iii) expanding markets, and (iv) cutting costs by integrating redundant functions, and by effectively utilizing Acquiring’s state-of-the-art ZZ Facility to increase Z Transactions and to further client development, etc.

[9] For the various iterations of the test, see Penrod v. Commissioner, 88 T.C. 1415 (1987); King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); Commissioner v. Gordon, 391 U.S. 83 (1968); and McDonalds Restaurants of Ill. v. Commissioner, 688 F.2d 520 (7th Cir. 1982).

years ending on Dates 13.[10] We strongly support the proposed assertion of this penalty.

SUMMARY

We believe that Acquiring's acquisition of Target on Date 7 does not qualify for treatment under section 382(l)(5). We believe that aspects of the transaction that, in form, might serve to support application of section 382(l)(5), do not reflect economic reality. We have set forth three analyses (ways of viewing the structuring of the transaction) in support of the lack of economic reality attending aspects of the transaction that would be critical for qualifying under section 382(l)(5). Further, we have discussed four case law doctrines (economic substance, business purpose, substance-over-form, and step-transaction), one or more of which could be used in support of viewing relevant aspects of the transaction in accord with their economic reality.

Although we inferred the existence of a side-agreement in Analysis 2, we want to emphasize that Analysis 1 stands on its own, irrespective of the existence of any side-agreement. Simply stated, Acquiring took far fewer shares in Target under the Plan on Date 7 than would appear to be economically justified. Conveniently, the number of shares taken just happened to be the maximum amount (within a tenth of a percentage point or so) that could have been taken, while still constructing a transaction that, in form, could qualify under section 382(l)(5).

Under the facts and law discussed above, Taxpayer is not permitted the benefit of section 382(l)(5). We believe the case for denying application of section 382(l)(5) is a strong one. That is, we believe that Target's pre-change losses should be subject to the section 382 limitation. Given that section 382(l)(5) does not apply, the Service (if it has not already done so) should look into the possible application of section 382(l)(6) for purposes of determining the Taxpayer's section 382 limitation for the years at issue.[11]

Please call 202-622-7750 if you have further questions.

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[10] See Form 886-A, Issue No. 8.

[11] Section 382(l)(6) provides: "If paragraph (5) does not apply to any reorganization described in subparagraph (G) of section 368(a)(1) or any exchange of debt for stock in a title 11 or similar case (as defined in section 368(a)(3)(A)), the value under subsection (e) shall reflect the increase (if any) in value of the old loss corporation resulting from any surrender or cancellation of creditors' claims in the transaction." See also §§1.382-9(j) – (l) of the Income Tax Regulations.