Office of Chief Counsel
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Memorandum

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date: March 04, 2013

to: Associate Area Counsel,
(Large Business & International)

from: Senior Counsel, Branch 2
(Passthroughs & Special Industries)

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subject: Request for Chief Counsel Advice

This Chief Counsel Advice responds to your request for assistance on the application of federal income tax law to the form of the following transactions. We note that we are not expressing any opinion as to whether other judicial doctrines may apply to disregard or alter the form of these transactions. This advice may not be used or cited as precedent.

LEGEND

A =
B =
C =
X =
Y =
S Corp =

LLC =

Sub 1 =

Sub 2 =

Sub 3 =

Sub 4 =

Sub 5 =

Sub 6 =

Sub 7 =

Sub 8 =

Sub 9 =

Sub 10 =

Sub 11 =

LP 1 =

LP 3 =

LP 4 =

LP 5 =

LP 6 =

LP 9 =

LP 10 =

Buyer 1 =

Buyer 2 =

Date 1 =
Assets =
Amount 1 =
Amount 2 =
Amount 3 =
w =
x =
y =
z =

ISSUES

I. What is the effect of C providing LLC a promissory note in exchange for a one-third interest in LLC?

II. What is the effect of LLC selling the stock of Subs 1-5 to Buyer 1 and the stock of Subs 6-10 to Buyer 2 in exchange for promissory notes?

CONCLUSIONS

I. C providing LLC a promissory note in exchange for a one-third interest in LLC results in the following deemed transactions:
A. Conversion of LLC from a DE to a partnership
B. Taxable formation of new C corporations under § 1001 before termination of QSub status of Subs 1-10.
C. Conversion of LPs from DEs to partnerships

II. LLC selling the stock of Subs 1-5 to Buyer 1 and the stock of Subs 6-10 to Buyer 2 in exchange for promissory notes results in gain to LLC upon the sale of Subs 1-6 and Subs 8-10 with a basis of zero. The sale of Sub 7 results in a gain or loss to LLC depending on its basis in Sub 7 stock and the portion of Amount 3 allocable to Sub 7 stock.

FACTS

A and B each owned an x% interest in S Corp, a limited liability company (LLC) under state law and an S corporation for federal tax purposes. S Corp owned Subs 1-11, corporations under state law and qualified subchapter S subsidiaries (QSubs) for federal tax purposes.

Subs 1, 3, 4, 5, 6, 9, and 10 each owned a y% general partnership interest in LPs 1, 3, 4, 5, 6, 9, and 10 respectively. Sub 11 owned a z% limited partner interest in each of the LPs. Each LP was classified as a limited partnership under state law and as a disregarded entity (DE) for federal tax purposes. Each LP owned Assets. Subs that did not own an interest in an LP owned Assets directly. Thus, for federal income tax purposes, each Sub was considered to own Assets directly. All Assets were subject to liabilities.

With the exception of the Assets held by Sub 7, the liabilities to which the Assets were subject exceeded the fair market value of the Assets. In addition, except for Sub 6 and Sub 7, the amount of liabilities exceeded the basis each Sub held in its respective Asset. Sub 7 had Asset value and Asset basis in excess of liabilities.

On Date 1, S Corp formed LLC, an LLC for state law purposes and a DE for federal tax purposes and contributed to it the stock in Subs 1-10 in exchange for a

100% member interest in LLC. C then contributed his own promissory note for Amount 1 to LLC in exchange for a w% interest in LLC.

Also on Date 1, LLC and X formed Buyer 1, an LLC for state law purposes and a partnership for federal tax purposes. LLC and Y formed Buyer 2, an LLC for state law purposes and a partnership for federal tax purposes. LLC then sold the stock of Subs 1-5 to Buyer 1 for promissory notes of Amount 2 and the stock of Subs 6-10 to Buyer 2 in exchange for promissory notes of Amount 3. S Corp retained ownership of Sub 11.

LAW AND ANALYSIS

I. C provided LLC a promissory note in exchange for a one-third interest in LLC

A. Conversion of LLC from DE to partnership

Section 301.7701-3(f)(2) of the Procedure and Administration Regulations provides that a single member entity disregarded as an entity separate from its owner is classified as a partnership when the entity has more than one member.

Rev. Rul. 99-5, 1999-1 C.B. 434, describes the federal income tax consequences when a single member LLC under state law and a DE for federal tax purposes becomes an entity with more than one owner that is classified as a partnership for federal tax purposes. In Situation 2, B (who is not related to A) contributes $10,000 to the LLC in exchange for a 50% ownership interest in the LLC. The LLC is converted from a DE to a partnership when B contributes cash to the LLC. B's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest.

A partner receives no basis for a note contributed to the partnership. Gemini Twin Fund III, 62 TCM 104 (1991), aff'd unpub opinion (9th Cir. 1993) (partner's notes contributed to partnership did not increase outside basis because notes had zero basis to partners). Rev. Rul. 80-235, 1980-2 C.B. 229 (contribution of partner's personal note to partnership does not increase the basis of partner's interest under § 722 because the partner has a zero basis in the note).

LLC converted from a DE to a partnership as described in Rev. Rul. 99-5, Situation 2. When C exchanged a promissory note for a w% interest in LLC, C is deemed to have contributed his promissory note for a partnership interest and S Corp to have contributed all of its LLC assets for a partnership interest. C receives no basis in C's partnership interest in LLC for C's promissory note given to LLC.

B. Formation of new C corporations before Termination of QSub Status

1. In General

Section 1361(b)(3)(B) of the Internal Revenue Code provides that a QSub is a domestic corporation which is not ineligible under § 1361(b)(2), if (i)100% of the stock of such corporation is held by the S corporation, and (ii) the S corporation elects to treat such corporation as a QSub.

Section 1361(b)(3)(C)(i) provides, for purposes of Title 26, that if any corporation which is a QSub ceases to meet the requirements of § 1361(b)(3)(B), such corporation shall be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before such cessation from the S corporation in exchange for its stock.

Section 1.1361-5(a)(1)(iii) provides that the termination of a QSub election is effective at the close of the day on which an event (other than an event described in § 1.1361-5(a)(ii)(2)) occurs that renders the subsidiary ineligible for QSub status under § 1361(b)(3)(B).

Section 1.1361-5(b)(1)(i) provides that if a QSub election terminates under § 1.1361-5(a), the former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for the stock of the new corporation. The tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

Section 351(a) provides that no gain or loss shall be 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 (as defined in section § 368(c)) of the corporation.

Section 368(c) states that the term “control” means the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

Section 1001(a) provides that the difference between the adjusted basis and amount realized will be either a gain or a loss—a gain to the extent the amount realized exceeds the adjusted basis, or a loss to the extent the adjusted basis exceeds the amount realized.

When LLC converted from a DE to a partnership, the QSub status of Subs 1-10 terminated because LLC partnership then owned Subs 1-10, not S Corp (through its DE LLC). Immediately before the termination of QSub status, Subs 1-10 are treated as new corporations acquiring all of their assets (and assuming all of their liabilities) from S Corp in exchange for stock. § 1361(b)(3)(C)(i). Since the formation of the new C corporations occurred before the conversion of LLC from a DE to a partnership, S Corp contributed stock of the new C corporations to the LLC partnership in the deemed § 721 contribution under Rev. Rul. 99-5, Situation 2.

2. Section 351 does not apply to the formation of the new C corporations.

Section 351 does not apply to the formation of the new corporations because the transferor, S Corp, is not in control of the C corporations immediately after the transfer. The "control" requirement of § 351(a) is not met when the transferor disposes of the stock received in the transaction pursuant to a prearranged plan or binding commitment. See Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1976); S. Klein on the Square, Inc. v. Commissioner, 188 F.2d 127 (2d Cir.), cert. denied, 342 U.S. 824 (1951). In this case, S Corp disposed of 100% of the C Corporation stock received in the deemed incorporation transactions of Sub 1-10 pursuant to a prearranged plan of first contributing the stock to LLC and then having LLC sell the stock to Buyer 1 and Buyer 2. At the conclusion of the plan, Buyer 1 and Buyer 2 held all of the stock in Sub 1-10. Consequently, S Corp was not in control of Sub 1-10, and, therefore, § 351 did not apply to the formation of the C corporations.

In addition, assuming for this purpose only that the control requirement was met, the incorporation transactions do not qualify for § 351 non-recognition treatment under Prop. Treas. Reg. § 1.351-1. Prop. Treas. Reg. § 1.351-1 provides that stock will not be treated as exchanged for property, and therefore the contribution of property will not qualify for nonrecognition under § 351, if either party to the transaction does not receive net value. Here, the Assets transferred to new Subs 1-6 and new Subs 8-10 were encumbered by liabilities in excess of the value of such Assets. Thus, even if the control requirement had been met, § 351 would not apply to the transfers to Subs 1-6 and Subs 8-10.

3. Taxable Formation of C Corporations under § 1001

S Corp's adjusted basis for the purpose of calculating its gain or loss is the basis it had in each of the QSubs' assets. If the stock in the new C corporations received by S Corp is worthless, the amount realized would be equal to the liabilities assumed by the new corporations. See Crane v. Commissioner, 331 U.S. 1, 12-14 (1947) (holding that a seller's amount realized includes debt assumed by the purchaser). Whether there is a gain or a loss, S Corp's basis in the stock of new Subs 1-10, except Sub 7, going forward is zero, since it contributed no value to each of those entities.

a. Insolvency: Gain on QSub Assets Recognized

S Corp realized gain from the deemed exchange of QSub assets and liabilities for new C corporation stock to the extent that the liabilities assumed by each new Sub 1-10, except for Sub 6 and Sub 7, exceeded the basis of the Assets transferred to each new Sub. The gain realized upon the deemed exchange should be ordinary because the QSub assets were held by S Corp primarily for development and eventual sale to customers in S Corp's ordinary course of business. Section 1221(a)(1). S Corp's shareholders would report their pro rata share of S Corp's ordinary income on their tax returns. Section 1366. S Corp would then have a zero basis in the stock of new Subs 1-5 and Subs 8-10.

b. Insolvency: Loss on QSub Assets Recognized

Sub 6 was also insolvent because its liabilities exceeded its Asset value. S Corp realized a loss because the basis in the Assets transferred exceeded the liabilities assumed by new Sub 6. However, S Corp's shareholders may not get the immediate benefit of this loss (see discussion below regarding § 267). S Corp would then have a zero basis in the stock of new Sub 6.

c. Solvency: Loss on QSub Assets Recognized

Sub 7 was solvent because its Asset value exceeded its liabilities. S Corp realized a loss because the basis in the Assets transferred to new Sub 7 exceeded the sum of the liabilities assumed by new Sub 7 and the value of the new Sub 7 stock which S Corp received. However, S Corp's shareholders also would not get the immediate benefit of this loss (see discussion below regarding § 267). S Corp would then have a basis in the stock of Sub 7 equal to the net value (Asset value minus liabilities) of the Assets transferred.

d. Application of § 267 to Defer/Disallow Losses

Section 267 provides that persons are related for purposes of § 267 if they fall within any of the relationships specified in § 267(b).

Section 267(b)(3) provides that two corporations are related persons if they are members of the same controlled group (as defined in § 267(f)).

Section 267(f)(1) provides that for purposes of § 267, the term "controlled group" has the meaning given to such term by § 1563(a), except that (1) "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in § 1563(a), and (2) the determination shall be made without regard to subsections (a)(4) (certain insurance companies) and (e)(3)(C) (stock owned by certain employees' trusts described in section 401) of § 1563.

Section 1563(a)(1) provides that the term "controlled group of corporations" means any group of one or more chains of corporations connected through stock ownership with a common parent corporation if: (1) stock possessing at least 80 percent of the total combined voting power or at least 80 percent of the total value of stock of each of the corporations, except the common parent corporation, is owned by the other corporations; and (B) the common parent corporation owns at least 80 percent of the total combined voting power or at least 80 percent of the total value of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.

Section 267(f)(2) provides that a loss from the sale or exchange of property between members of the same controlled group is deferred until the property is transferred outside the controlled group and there would be recognition of loss under consolidated return principles or as otherwise prescribed by regulations.

Section 1.267(f)-1(a)(2) provides that S Corp's loss or deduction from an intercompany sale is taken into account under the timing principles of section 1.1502-13, treating the intercompany sale as an intercompany transaction between members of a consolidated group.

S Corp is a member of a controlled group with both new Sub 6 and new Sub 7. The contributions of assets by S Corp to new Sub 6 and new Sub 7 in exchange for the assumption of liabilities and stock are intercompany sales. Therefore, § 267(f) will apply to defer any loss realized upon these contributions until the Assets are transferred outside the controlled group. Here, S Corp immediately contributes the stock of new Sub 6 and new Sub 7 to LLC, which then sells the stock to Buyer 1 and Buyer 2. Assuming that Buyer 1 and Buyer 2 are not related to S Corp under § 267(b), S Corp will be entitled to the intercompany losses upon sale to Buyer 1 and Buyer 2.

4. Basis of Partnership Interests

As discussed, S Corp's basis in the stock of new Subs 1-6 and Subs 8-10 is zero. S Corp's basis in Sub 7 will be equal to the net value of the Assets which were transferred to Sub 7 in the deemed formation. S Corp contributed each of the new Subs to LLC partnership. Rev. Rul. 99-5 determines the partners' basis in the LLC partnership under § 722 and the partnership's basis in the stock of the new Subs under § 723.

C. Conversion of LPs from DEs to partnerships

The LPs convert from DEs to partnerships under § 301.7701-3(f)(2) upon the conversion of the QSubs to new C corporations. The LPs now have two owners: S Corp and each of new Subs 1, 3, 4, 5, 6, 9, and 10.

II. LLC sale of Subs 1-10 stock to Buyer 1 and Buyer 2

LLC sold the stock of Subs 1-5 to Buyer 1 for promissory notes of Amount 2 and the stock of Subs 6-10 to Buyer 2 in exchange for promissory notes of Amount 3. As LLC held the stock of Subs 1-6 and Subs 8-10 with a basis of zero, it will recognize gain upon the sale of these entities. LLC will recognize gain or loss upon the sale of Sub 7, depending on its basis in the stock of Sub 7 and the portion of Amount 3 which is allocable to the stock of Sub 7.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call or if you have any further questions.