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subject:

This Chief Counsel Advice supplements and incorporates a Chief Counsel Advice dated November 12, 2013, POSTS-125127-13 ("Prior CCA"). After our office issued the Prior CCA, Purchaser submitted additional arguments, to which we respond in this CCA. This advice may not be used or cited as precedent.

LEGEND

Purchaser =

Target =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year 1 =

Year 2 =

x% =

y% =

FACTS

Pursuant to a Stock Purchase Agreement (“SPA”) executed on Date 1, Purchaser, the common parent of an affiliated group filing a consolidated return, agreed to acquire 100 percent of the single class of outstanding stock of Target from its shareholders (“Sellers”) over the course of several purchases. As part of the SPA, Purchaser and the Sellers entered into an Escrow Agreement (“Agreement”).

Pursuant to the Agreement, all of the Target shares, except for those shares the Purchaser purchases in Year 1 (the year subsequent to Date 1), are to be surrendered by the Sellers to a third-party escrow agent. The Agreement further provides that the escrow agent shall release to Purchaser any additional shares of Target stock (hereinafter, the “additional shares”) at the time Purchaser purchases those shares. Finally, the Agreement provides that, until those additional shares have been released to Purchaser by the escrow agent, the Sellers shall remain the owners of those shares for all purposes, including, without limitation, tax purposes, and the Sellers shall have the right to vote such shares and to receive all dividends and distributions therefrom.

In the Initial Share Purchase in Year 1, Purchaser acquired x% of the Target stock, which was less than 80 percent of the Target stock. Under the Second Share Purchase provision of the SPA, in the first quarter of Year 2 (a year subsequent to Year 1), Purchaser was obligated to purchase, and the Sellers were obligated to sell, additional shares of Target stock, which would give Purchaser a total of y% ownership of Target, which was more than 80 percent of the Target stock. Under the SPA, the Second Share Purchase was to occur not later than Date 4 (the last day of the first quarter of Year 2), and the purchase price was a fixed price, which was to be determined as of Date 2 (the day before the beginning of Year 2). Such purchase occurred on Date 4.

ISSUE

Whether Purchaser must include Target in its consolidated group as of Date 3 (the first day of Year 2) or whether Target must file a short period return from Date 3 until Date 4 (i.e., the day Purchaser actually acquired the additional shares that increased its ownership of Target stock to more than 80 percent).

CONCLUSION

Because Purchaser did not own stock possessing at least 80 percent of the voting power and value of Target stock until Purchaser acquired the additional shares on Date 4, Purchaser did not satisfy the requirements of section 1504(a) until Date 4. Thus, Target must file a short period return from Date 3 until Date 4.

SUPPLEMENTAL ARGUMENTS BY PURCHASER

In response to the Prior CCA, Purchaser submits the following additional arguments:

1) The Sellers did not effectively retain the right to vote or the right to receive dividends or liquidating distributions with respect to their Target stock held in escrow. Once the Purchaser acquired over 50 percent of the voting power of the Target stock, Purchaser completely controlled Target, including whether Target would declare dividends or liquidate. Thus, the Sellers, through their remaining interest in Target, had no power to act or block any decisions made by Purchaser, the majority shareholder.

2) The Prior CCA did not consider the cases and rulings which provide that affiliation under section 1504(a)(2) is based on the benefits and burdens of ownership. As in the Prior CCA, Purchaser argues that, as of the beginning of Year 2, Purchaser had the benefits and burdens (i.e., all financial risk) of ownership for y% of the Target stock and, thus, Purchaser properly included Target for the entire year in its Year 2 consolidated return.

ANALYSIS

Law

Section 1504(a)(1) provides that the term “affiliated group” means:

(A) one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if—

(B) (i) the common parent owns directly stock meeting the requirements of section 1504(a)(2) in at least one of the other includible corporations, and

(ii) stock meeting the requirements of section 1504(a)(2) in each of the includible corporations (except the common parent) is owned directly by one or more of the other includible corporations.

Section 1504(a)(2) provides that the ownership of stock of any corporation meets the affiliation requirements of this section 1504(a)(2) if it:

> (A) possesses at least 80 percent of the total voting power of the stock of such corporation, and
>
> (B) has a value equal to at least 80 percent of the total value of the stock of such corporation.

Issue 1

Section 1504(a) provides several requirements that must be met for a corporation to be included in an affiliated group. In particular, pursuant to section 1504(a)(2)(A), in order for Target to be a member of Purchaser's affiliated group as of Date 3, Purchaser must own, as of Date 3, stock of Target possessing at least 80 percent of the total voting power of the stock of Target.

As of Date 3, Purchaser had purchased stock of Target possessing only x% of the total voting power of Target, which was less than 80 percent. Therefore, by definition Purchaser did not meet the requirements of section 1504(a)(2)(A). However, Purchaser argues that notwithstanding the fact that it did not have the right to vote the additional shares while the stock was in escrow, because Purchaser already held over 50 percent of the shares of Target stock, and because of the non-cumulative voting in Target stock, Purchaser had the ability to elect 100 percent of the board of directors of Target.

Participation in the management of a subsidiary through the election of the board of directors is the criterion used by the courts and the Service in determining voting power under section 1504(a) and its predecessors. See Erie Lighting Co. v. Commissioner, 93 F.2d 883 (1st Cir. 1937), rev'g 35 B.T.A. 906 (1937); Rev. Rul. 69-126, 1969-1 C.B. 218.

However, the inability of the Sellers to affect the outcome of a shareholder vote for Target does not mean that they did not possess any of the voting power (or less voting power than their proportionate share of the outstanding Target stock would entitle them to) or that Purchaser possessed such voting power. Sellers owned shares entitled to vote. The fact that Target's stock is voted on a non-cumulative basis, and that Purchaser owns over 50 percent of the Target stock, does not shift the voting power of the remaining shares from Sellers to Purchaser. It has long been established that practical control of a corporation does not provide affiliation. See Handy & Harman v. Burnet, 284 U.S. 136 (1931); Ice Service Co. v. Commissioner, 9 B.T.A. 386 (1927); affd., 30 F.2d 230 (2nd Cir. 1929). If a corporation has only one class of voting stock outstanding, it is axiomatic that for its shareholder to have at least 80 percent of the total voting power of the stock of that corporation, it must own at least 80 percent of the total number of outstanding voting shares of that corporation. Purchaser did not meet that requirement until Date 4. Therefore, its x% ownership of Target stock on Date 3 did not satisfy the requirements of section 1504(a)(2)(A).

The failure by Purchaser to satisfy section 1504(a)(2)(A) is sufficient to determine that Target was not a member of Purchaser's affiliated group beginning on Date 3. However, Purchaser also fails to satisfy section 1504(a)(2)(B). Specifically, pursuant to that provision, Purchaser's Target stock, as of Date 3, must have a value equal to at least 80 percent of the total value of the stock of Target.

Typically, the ownership of the value of a corporation's stock is demonstrated by the shareholder's right to receive dividends and liquidating distributions. In this case, Purchaser argues that, because it had effective control of Target, that right of the Sellers is not meaningful. In other words, because Purchaser totally controlled whether Target would declare a dividend or liquidate, the Target stock owned by the Sellers on Date 3 had no ability to receive dividends and liquidating distributions. However, as in the case of determining the voting power of the stock of a corporation, in which the right of each share to vote is what is important, the right of each share of stock to receive dividends and liquidating distributions if there is such a distribution or liquidation is what is important, and not whether that right has practical significance.

Moreover, as in the case of the right to vote, if a corporation has only one class of stock outstanding, it is again axiomatic that for its shareholder to have at least 80 percent of the total value of the stock of that corporation, it must own at least 80 percent of the total number of outstanding shares of that corporation. See §1.1504-4(b)(2)(iv), which provides that, for purposes of section 1504(a)(2)(B) and § 1.1504-4, all shares of stock within a single class are considered to have the same value. Purchaser did not meet that requirement as of Date 3. Therefore, its x% ownership of Target stock on Date 3 did not satisfy the requirements of section 1504(a)(2)(B).

Issue 2

As discussed in the Prior CCA, Purchaser argues that, as of Date 3, it had the benefits and burdens of ownership of at least 80 percent of the total number shares of outstanding stock of Target. Purchaser makes two additional arguments in support of its position.

First, Purchaser correctly notes that, for purposes of determining ownership under section 1504(a), the courts and the IRS have looked to beneficial ownership of the stock and bare legal title to stock is not determinative. In support of its position, Purchaser cites Miami National Bank v. Commissioner, 67 T.C. 793 (1977); Rev. Rul. 84-79, 1984-1 C.B. 190; and Rev. Rul. 55-458, 1955-2 C.B. 579. Purchaser argues that, under this standard, it had the beneficial ownership of at least 80 percent of the Target stock as of Date 3.

However, Purchaser misconstrues the reasoning of these authorities. These authorities address the requirement of section 1504(a)(1)(B)(i) that the shareholder, in this case, Purchaser, own "directly" the stock of the relevant corporation, in this case, Target. In

Miami National Bank, one party, a broker, possessed the relevant stock and had legal title; the issue was whether another party, i.e., a member of a consolidated group, had the benefits and burdens of ownership (e.g., the right to vote the stock and to receive any dividends) of that stock and thus directly owned it for purposes of section 1504(a)(1)(B)(i). In the instant matter, on Date 3, the Sellers not only had legal title to their Target stock, but, as explained in the Prior CCA, the benefits and burdens of ownership of such stock. Although the price for which the additional shares of Target stock would be sold on Date 4 was set on Date 2, thus providing any increase or decrease in the value of those shares between such dates to Purchaser, this did not transfer beneficial ownership of those shares to Purchaser prior to Date 4. Thus, Purchaser did not directly own these shares until Date 4.

Second, Purchaser cites the following paragraph from a Chief Counsel Attorney Memorandum, published as IRS AM 2012-7 (June 27, 2012) to support its benefits and burdens argument:

> In the context of a transfer of stock, courts have found the following factors particularly relevant in determining tax ownership: (1) which party has the opportunity to share in gain from an appreciation in value of the stock and bears the risk of loss from a decline in value of the same; (2) which party has legal title to, and the ability to dispose of, the stock; (3) which party has the right to vote the stock; and (4) which party has possession of the stock…. Courts have also focused upon the right to receive dividends.

These factors do not support Purchaser's benefits and burdens argument. Even conceding that factor (1) supports Purchaser as being the owner of the additional shares, the other factors do not. Until Date 4, Purchaser did not obtain legal title to nor did it have the ability to dispose of the additional shares. Purchaser did not have the right to vote the shares. Purchaser did not have possession of the shares. Purchaser did not have the right to receive dividends. Therefore, Purchaser is not the owner of the Sellers' Target stock as of Date 3.

CONCLUSION

As of Date 3, Purchaser did not meet the requirements of section 1504(a)(2). It did not own stock possessing at least 80 percent of the voting power nor 80 percent of the value of the Target stock. Moreover, also as of Date 3, Purchaser did not have the benefits and burdens of ownership of the Target stock held by the Sellers. Purchaser did not meet the requirements of section 1504(a)(2) until Date 4 when it acquired additional Target stock from the Sellers that gave it at least 80 percent of the total outstanding shares of Target. Therefore, Target must file a short period return from Date 3 until Date 4. Thereafter, Target must be included in the Purchaser consolidated return.

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Please call (202) 317-5024 if you have any further questions.