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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: W. EDWARD WILLIAMS
SENIOR TECHNICAL REVIEWER, CC:INTL:1

SUBJECT:

This Field Service Advice responds to your memorandum dated July 2, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Taxpayer =
Date A =
USCo =
FCo =

Trust =
Date B =
Date C =
Amount D =
X percent =
Y percent =

ISSUE(S):

I. Whether Taxpayer’s transfer of USCo stock to FCo should be treated as a taxable sale because it was not undertaken for a valid business purpose.

II. Whether Taxpayer lacked the required control of FCo immediately following the transfer of the stock of USCo to FCo, thereby causing the transfer to fail to qualify for nonrecognition treatment under section 351.

CONCLUSION(S):

I. Based on the limited available facts, the transfer of USCo stock to FCo does not appear to have been undertaken for a valid business purpose. If not undertaken for a valid business purpose, the transfer will either be disregarded or treated as a taxable sale or exchange.

II. Assuming that the transfer of the stock of USCo to FCo was partially motivated by a valid non-tax business purpose, it is likely that Taxpayer will be viewed, under the facts presented, as controlling FCo immediately after the transfer for purposes of section 351.

FACTS:

Taxpayer voluntarily relinquished his U.S. citizenship (“expatriated”) on Date A. On that date, Taxpayer owned 50 percent of USCo, a domestic corporation. The stock of USCo was held by a domestic grantor trust of which Taxpayer was an owner. Shortly after Taxpayer expatriated, he directed the trust to transfer his entire interest in USCo to FCo, a newly-formed foreign corporation. It is believed that FCo does not engage in any business and holds no other assets.

Taxpayer claims that he transferred his shares of USCo in exchange for one share of FCo stock in a transfer described under section 351 and subsequently irrevocably transferred this FCo share to Trust, a foreign trust. However, FCo's stock transfer records do not reflect this purported issuance of the FCo share to Taxpayer, but rather, show that FCo issued one share of its stock to Trust approximately two weeks after the date of Taxpayer’s purported transfer of the USCo stock to FCo. Taxpayer claims that he received no consideration in exchange for the contribution of the FCo stock to Trust.

Taxpayer claims that the lack of an entry in FCo’s records documenting the transfer of the FCo stock to Taxpayer is an oversight. There is no evidence that Taxpayer received any other consideration in exchange for the transfer of the USCo stock to

FCo. Taxpayer claims that he does not have the power to amend the terms of Trust or to otherwise control, either directly or indirectly, the operations of Trust. Taxpayer also maintains that he is not a beneficiary of Trust and does not know the identity of the beneficiaries or potential beneficiaries of Trust.

USCo contemplated executing an initial public offering during the year that the transactions described above occurred, but that public offering did not actually take place until two years later on Date B. A prospectus issued by USCo on Date C in connection with the contemplated public offering states that Taxpayer transferred the USCo stock to FCo in exchange for 100 percent of the FCo stock in connection with an estate planning transaction.

When the public offering actually took place two years later, a percentage of the USCo stock held by FCo was sold to the public at a gain of approximately Amount D. After this sale, FCo held, and apparently continues to hold, shares of USCo representing approximately X percent of all the shares entitled to vote and Y percent of the value of all classes of stock.

LAW AND ANALYSIS:

Section 351(a) provides that gain or loss shall not be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock of such corporation and, immediately after such exchange, such person or persons are in control of the corporation. For purposes of section 351(a), the term “control” means the ownership of at least 80 percent of (i) the total combined voting power of all classes of voting stock, and (ii) the total number of shares of all other classes of stock of such corporation. See section 368(c) and Treas. Reg. § 1.351-1(a)(1).

I. Business Purpose Requirement

Courts have recognized that a taxpayer may benefit from nonrecognition treatment under section 351 so long as some valid, non-tax business purpose partially motivated the transaction. See e.g., Caruth v. United States, 688 F. Supp. 1129, (N.D. Tex. 1989), aff’d 865 F2d 644 (5th Cir. 1989); Stewart v. Commissioner, 714 F.2d 977, 987 (9th Cir. 1983), aff’g T.C. Memo 1982-209; and Estate of Kluener v. Commissioner, 154 F.3d 630 (6th Cir. 1998), (aff’g in relevant part and rev’g in part (on another issue)) T.C. Memo 1996-519. In determining whether a valid, non-tax business purpose partially motivated the transaction, courts examine all the facts and circumstances, with particular emphasis on the following factors: whether the transfer fulfilled its stated purpose; the extent to which the transferor, rather than the transferee, benefitted from the transfer; the extent to which the transferee needed the property; the length of time between the transfer and subsequent events; the number of such transfers; the taxpayers' expertise in tax matters; and the transactions' form. Courts also examine any indicators of a taxpayer's intent, such as documents or negotiations that confirm or belie the existence of a pre-arranged plan. Estate of Kluener at 635.

Other cases involving business purpose in the section 351 context also focus on whether the corporation to which property was transferred in a purported section 351 transaction was used solely as a mere conduit to accomplish tax benefits that could not have been accomplished directly. For example, in West Coast Marketing v. Commissioner, 46 T.C. 32 (1966), the taxpayer and its sole shareholder contracted to exchange appreciated land they collectively owned for stock of a publicly traded corporation. This exchange, if consummated directly by the taxpayer and its shareholder, would have been taxable. At a time when the exchange was imminent, the taxpayer's sole shareholder organized a new corporation and taxpayer and the shareholder transferred the land to the new corporation. The new corporation then transferred the land to the publicly traded corporation in exchange for stock of that corporation. The new corporation was liquidated shortly thereafter. The taxpayer argued that the transactions described above were tax-free under sections 351 and 368(a)(1)(B) of the Code, respectively. The Tax Court rejected the taxpayer's arguments, holding that the exchange of land for stock is taxable to the taxpayer because the new corporation served no purpose other than as a conduit to hold title to the land pending the contemplated transfer of the land to the publicly traded corporation. Id. at 40. Under circumstances where a transfer of property to a corporation is undertaken to advance a tax avoidance plan and serves no other independent business purpose, courts generally disregard the transfer. See e.g., Estate of Kluener, supra; Gregory v. Helvering, 293 U.S. 465 (1935), aff'g 69 F.2d 809 (2d Cir. 1934). See also Rev. Rul. 70-140, 1970-1 C.B. 73 (a transfer to a controlled corporation in a purported section 351 exchange is disregarded under circumstances demonstrating that the transfer was motivated by tax avoidance considerations) and Hallowell v. Commissioner, 56 T.C. 600 (1971) (transfer of appreciated securities by shareholder to corporation followed by the corporation's sale of the securities treated as a sale by shareholder of the securities).

Based on the limited facts presented, we do not believe that Taxpayer's transfer of the USCo stock to FCo was undertaken for a valid business purpose. The available facts strongly suggest that Taxpayer expatriated with a principal purpose to avoid U.S. taxes[1] and that he executed the transaction at issue to further his tax

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[1] If Taxpayer had remained a U.S. citizen, the transfer of the USCo stock to FCo would be taxable under section 367(a)(1). Under the expatriation tax provisions of sections 877(e), 2107(e), and 2501(a)(4) as in effect at the time of Taxpayer's

avoidance plan. Given that documents related to the contemplated initial public offering of USCo were filed on Date C with the Securities and Exchange Commission (a few months after Taxpayer's expatriation), we believe that Taxpayer contemplated selling his shares of USCo at the time of his expatriation. In addition, since FCo's records do not reflect any issuance of stock to Taxpayer, but rather, show that an original issue share of FCo stock was issued directly to Trust, we believe this fact indicates that Taxpayer planned on transferring his interest of USCo to Trust (albeit cast in form as a transfer of the FCo stock) at the time of the purported section 351 transfer.

A direct sale of USCo by Taxpayer or a direct gift of USCo by Taxpayer to Trust, however, would have been subject to U.S. income and gift taxes, respectively, under the expatriation tax provisions if it is determined that Taxpayer expatriated with a principal purpose to avoid U.S. taxes. See sections 877 and 2501(a)(3). It was necessary for Taxpayer to transfer the USCo stock to a foreign corporation in exchange for an interest in that corporation, and then transfer the foreign corporation stock to Trust to provide Taxpayer with a basis for arguing that (i) the foreign corporation, and not Taxpayer, would derive the gain from the contemplated sale of USCo, and (ii) the transfer to Trust should be viewed as a gift of the foreign corporation stock, not USCo stock. In other words, these facts indicate that Taxpayer's objective was to move the USCo stock into an offshore trust (without incurring any U.S. tax liability on the transfer to the trust) in order to avoid U.S. taxes. The prospectus issued in connection with the contemplated public offering of USCo, which states that Taxpayer transferred the USCo stock to FCo for estate planning purposes, provides further evidence that the transfer was not motivated by a valid business purpose.

Based on the limited available facts, it appears that the transfer of the USCo stock to FCo lacked a valid business purpose for the following reasons: (1) evidence that the transactions were all integrated parts of a prearranged plan to avoid U.S. taxes, (2) the use of FCo in an attempt to indirectly accomplish tax advantages that could not have been accomplished directly, and (3) the use of a newly formed holding company that apparently holds no other assets and engages in no business for the purpose of holding legal title to USCo in order to effectuate the tax avoidance plan.

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expatriation (sections 877(e) and 2107(e) were redesignated as sections 877(f) and 2107(d), respectively, by the Health Insurance Portability and Accountability Act of 1996), the burden shifts to Taxpayer to show that he did not expatriate with the proscribed tax avoidance purpose since the Service can demonstrate that Taxpayer's expatriation resulted in a substantial reduction of taxes that Taxpayer would otherwise owe by reason of section 367(a)(1). An analysis of the section 367 issue is set forth in a prior Field Service Advice.

If a valid business purpose is lacking, the Service can argue that the transaction fails to qualify for nonrecognition treatment under section 351, and should therefore be treated as a taxable sale or exchange. On the other hand, the facts that are indicative of no business purpose may lead one to conclude that the transfer should be disregarded completely, rather than regarded as a taxable sale or exchange.

II. Control Requirement under Section 351

Although the facts suggest that Taxpayer's transfer of the USCo stock to FCo may not have been motivated by a valid business purpose, we will assume the existence of a valid non-tax business purpose in connection with providing advice on the question presented. Even assuming the existence of a valid non-tax business purpose, Taxpayer's transfer of the USCo stock to FCo will nevertheless be treated as a taxable exchange if Taxpayer does not control FCo immediately after the transfer. Since Taxpayer claims that he exercises no control over Trust, the "control" requirement under section 351 will not be satisfied if Trust is treated as controlling FCo immediately after the transfer. Since FCo's records show that the FCo stock was issued directly to Trust and not to Taxpayer, you have asked for advice on whether Taxpayer failed to satisfy the "control" requirement under section 351 for this reason. Even if the Service were to accept as true Taxpayer's assertion that the FCo stock was issued directly to Taxpayer and that Taxpayer transferred the stock to Trust shortly thereafter, you have also asked for advice on whether these two steps may be integrated so that Trust would be treated as controlling FCo immediately after the transfer for purposes of section 351.

The concept of ownership for purposes of the control requirement under section 351 has been developed through caselaw. Most of the cases in this area determine such ownership by examining the obligations and freedom of action of the taxpayer with respect to the stock acquired in the exchange. Courts generally find that the control requirement under section 351 is satisfied unless the existence of an agreement supported by consideration at the time of the exchange obligates the taxpayer to transfer the stock of the corporation acquired in the exchange to another person (hereinafter referred to as the "binding commitment" test). See Fahs v. Florida Mach. & Foundry Co., 168 F.2d 957 (5th Cir. 1948), aff'g 73 F. Supp. 379 (S.D. Fla. 1947); Mojonnier & Sons, Inc. v. Commissioner, 12 T.C. 837 (1949) (nonacq.) (control requirement is not satisfied where the stock is directly issued to the taxpayer's children pursuant to a preexisting agreement supported by consideration). If a taxpayer has irrevocably foregone or relinquished the legal right to determine whether to keep the shares of the corporation acquired in the exchange prior to his acquisition of the shares, the taxpayer is not considered to own such shares for purposes of the "control" requirement under section 351. If, however, there are no restrictions upon the taxpayer's freedom of action at the time he acquired the shares, it is immaterial how long thereafter he disposes of the stock or whether the disposition is pursuant to a plan not amounting to a binding legal obligation. See e.g., Wilgard Realty Co. v. Commissioner, 127 F.2d 514 (2nd Cir. 1942), cert. denied, 317 U.S. 655 (1942) (control requirement is satisfied even though the taxpayer immediately after the exchange gave the stock to his children pursuant to a nonbinding prearranged plan); Intermountain Lumber Company and Subsidiaries v. Commissioner, 65 T.C. 1025 (1976) (control requirement is not satisfied where taxpayer was, on the date of the exchange, under a legal obligation to transfer the stock seven years later).

Similar principles have also been applied to cases where the stock of the corporation to which property is transferred is issued directly to a family member as a gift, on the basis that the decisive factor in determining control rests on whether the transferor of the property had the "absolute right...to designate who would receive all of the stock". D'Angelo Assocs., Inc. v. Commissioner, 70 T.C. 121, 132 (1978) (acq. in result). See also Stanton v. United States, 512 F.2d 13 (3d Cir. 1975), rev'g 371 F. Supp. 103 (E.D. Pa. 1974). The D'Angelo and Stanton courts distinguished their facts from Mojonnier & Sons and Fahs on the ground that the taxpayers in the latter cases never obtained control because they were under contractual obligations at the time of the transaction (albeit to a family member) to dispose of the stock.

However, several cases reject the restrictive binding commitment test articulated by other courts. [2] In Culligan Water Conditioning of Tri-Cities, Inc. v. United States, 567 F.2d 867, 869 (9th Cir. 1978), the court concluded that the "control immediately after the exchange" requirement would be subject to manipulation if it required a binding obligation to dispose of control. Similarly, in Maine Steel Inc. v. United States, 174 F. Supp. 702, 712-713 (D. Me. 1959), the court reasoned (in dicta) that, even assuming the lack of a legally binding obligation, a series of steps must be viewed as a whole to determine whether they should be treated as parts of a single integrated transaction.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

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[2] For a detailed analysis of the binding commitment test as it has been applied in section 351 cases, see Jensen, "Of Form and Substance: Tax-Free Incorporations and Other Transactions Under Section 351" 11 Va. Tax Rev. 341 (1991).

The business purpose doctrine is extremely fact-sensitive and it is not possible to predict the circumstances under which a court will find the lack of a business purpose. We note that a court may apply a low threshold in determining whether a valid business purpose motivated a particular transaction. [redacted].

As an alternative to arguing that the transfer of the USCo stock to FCo should be treated as a taxable sale or exchange, we believe that the facts may support an argument that the purported gift of the FCo stock to Trust was in substance a gift of the USCo stock to Trust. Characterizing the transaction in this manner would allow the imposition of the gift tax under section 2501(a)(3) if Taxpayer is determined to have expatriated with a principal purpose to avoid U.S. taxes. [redacted], we believe that general substance over form principles and regulations under section 2511, which look to the substance of a transaction to determine gift tax consequences, support this position.

If the Service advances this argument, we predict that Taxpayer may attempt to recant his current position that he does not control Trust and argue that a gift was not made to Trust because Taxpayer never surrendered dominion and control over the USCo stock. [redacted]

This Field Service Advice has been coordinated with the Office of Assistant Chief Counsel (Corporate) and the Office of Assistant Chief Counsel (Field Service), Corporate branch and Passthroughs & Special Industries branch.

If you have any further questions, please call (202) 622-3850.

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