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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
ASSISTANT DISTRICT COUNSEL

FROM: Deborah Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Substance Over Form

This Field Service Advice is a reconsideration of a previous Field Service Advice issued on October 29,1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A	=
B	=
C	=
CC	=
L	=
o	=
date a	=
date b	=

date c	=	
date d	=	
date e	=	
y	=	
p	=	

ISSUE: Whether litigating hazards exist in arguing that A's sale of the assets to B is in substance a distribution of those assets from B to A, followed by a capital contribution from CC to B, in light of the Tax Court's opinion in *Turner Broadcasting System, Inc. v. Commissioner,* 111 T.C. 315 (1998).

CONCLUSION: [redacted]

FACTS:

Background

This case involves a transaction in which A may attempt to effectively claim the losses on the sales of the Distributed Assets twice: once in selling the B stock (since A's stock basis in B would not be reduced by losses on the sale of the Distributed Assets) and a second time in later selling the Distributed Assets (since section 267 provided that A increased its basis in the Distributed Assets by the amount of the losses that B recognized on B's sale of the Distributed Assets to A).

Facts -- in general

A, the parent corporation of a consolidated group, wholly owned a subsidiary, B. C, a corporation unrelated to A, wanted to acquire B, but objected to purchasing certain unwanted assets held by B and its subsidiaries. B was engaged in the p business, and state regulatory rules required B to maintain certain surplus balances. These state regulatory rules, which restricted B's ability to make distributions, precluded B from making an outright distribution of the Distributed Assets to A.

A, C and CC (a subsidiary of C) reached an agreement on date d for A to sell its stock in B to CC -- without the Distributed Assets -- with economic effect as of date c. This stock purchase agreement between A, C and CC contemplated that B and its subsidiaries (hereinafter referred to as just “B”) were to “sell” the Distributed Assets to A before date a, and A was to sell its stock in B on date b. While the agreement actually provided that A was either to sell the Distributed Assets or transfer the Distributed Assets, not only did state regulatory rules restrict B’s ability to distribute the Distributed Assets (as previously indicated), but the sales agreement to sell the B stock also provided that B could not distribute amounts that B received in selling the Distributed Assets to A. The sales agreement also required B to have the permission of C to pay a distribution, and indicated that B could not make a distribution to the extent it could lower B’s o ratings.

A, C, and CC structured the deal by agreeing to a “Base Purchase Price” for the B stock. This Base Purchase Price reflected the value of the B stock without the Distributed Assets. A, C and CC then agreed to further increase this Base Purchase Price by amounts arising from B’s “sale” (rather than distribution) of the Distributed Assets (“Excess Purchase Price” or “Excess Purchase Price Amount”). In form, B was to “sell” these Distributed Assets to A, and consequently, B was to hold the “cash proceeds” from these “sales” of the Distributed Assets which were then to factor into the amount of the Excess Purchase Price that CC would pay to B. Or, in other words, CC would “pay” an Excess Purchase Price to essentially “purchase” the “cash proceeds” that B received from A in “selling” the Distributed Assets to A. CC also agreed to pay A interest on these cash proceeds held by B.

Although B was to sell the Distributed Assets to A, A did not have sufficient cash to purchase the Distributed Assets. Consequently, A negotiated short-term loans on date e to make the purchases. According to the credit agreements for these loans, A received the loans on the condition that A use the loan proceeds solely to acquire the Distributed Assets (or to refinance certain Distributed Assets purchased) and to repay these loans on the date on which B was sold to CC. The credit agreement also required B to retain liquid assets equal to the outstanding debt balance.

Between date d and date b, B “sold” Distributed Assets having a value of y to A. The “sales” of the Distributed Assets would not have occurred but for the agreement for the sale of A’s stock in B to CC. A also requested permission from the state to resell the Distributed Assets to B in the event the sale to CC was not consummated.

LAW AND ANALYSIS :

Where the substance of a transaction does not coincide with the form chosen by the parties, the transaction should be taxed in accordance with its substance. *Gregory v. Helvering,* 293 U.S. 465 (1935). The substance over form inquiry involves determining whether the labels of the transaction match the economic substance of the transaction as a whole. *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995). The meaning of a transaction may be more than its separate parts and the transaction must be viewed in light of the particular circumstances. *Gregory v. Commissioner*, 69 F.2d 809 (2d Cir. 1934); aff'd 293 U.S. 465 (1935). A transaction can be recharacterized where the form of the transaction does not match its substance and does not reflect the real rights and obligations of the parties. See *Estate of Schneider v. Commissioner,* 88 T.C. 906 (1988).

In order to recharacterize the transaction, there must be a logically plausible alternative explanation that accounts for all the results of the transaction. The explanation may combine steps, but if it invents new ones, courts have refused to apply the step transaction doctrine. *Esmark, Inc. & Affiliated Cos. v. Commissioner*, 90 T.C. 171 (1988). Even if alternative explanations are available to account for the results of a transaction, a court will not disregard the form of a transaction if it accounts for the transaction at least as well as alternative explanations. *Esmark*, *supra*.

In *Turner Broadcasting System, Inc. v. Commissioner*, 111 T.C. 315 (1998), Turner Broadcasting System, Inc. ("Turner Broadcasting") acquired MGM/UA Entertainment Co. ("MGM") stock at the same time MGM sold all of its stock in its wholly owned subsidiary, United Artists Corp. ("UA") to Tracinda Corporation ("Tracinda") at a loss. Before this transaction, Tracinda owned a controlling interest in the MGM stock. Tracinda paid for the UA stock with the cash it received from Turner Broadcasting in the MGM stock purchase. MGM used some of the money received from Tracinda to pay off bank debt. When Turner Broadcasting acquired the MGM stock, MGM loaned Turner Broadcasting approximately 107 million dollars.

The government argued that the transaction's substance was a distribution of UA stock in redemption of MGM stock, followed by a capital contribution from Turner Broadcasting to MGM equivalent to the value of UA. (The portion of MGM stock equal in value to the UA stock was redeemed by MGM in exchange for the UA stock.) The Tax Court held in favor of the petitioners and ruled that the form they adopted should determine their tax consequences. The Tax Court held that the loss was recognized by MGM and was available to the Turner Broadcasting Group.

The Service will continue to analyze when a transaction will be taxed in accordance with its substance and not its form.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

If you continue to pursue the substance over form issue, further case development is needed in determining: [redacted] However, we caution that, even if this case is further developed along these lines, our offices may determine the substance over form argument should not be pursued.

We anticipate that the taxpayer will oppose a substance over form argument by arguing that state regulatory rules restricted the amount of dividends B was allowed to distribute. The taxpayer will also argue that state regulatory rules required B to maintain certain surplus requirements, and that the transactions were structured accordingly. We could counter this argument by contending, assuming proper factual development, that it is not unusual for [redacted] companies to be in a temporary default with respect to these surplus requirements, assuming the surplus requirements are paid back within a short period of time. The taxpayer may then argue that temporary default status requires permission from a state agency, and that approval from the state agency would have complicated, and possibly delayed, the transactions. [redacted]

Moreover, the taxpayer will argue that even if alternative explanations are available to account for the results of a transaction, a court will not disregard the form of the transaction if the taxpayer's explanation accounts for the transaction at least as well as alternative explanations. The taxpayer may argue that its explanation for structuring the asset transfer as a sale is as good as any explanation that the government could bring forward.

[redacted]. Although A may have planned the transaction in an attempt to obtain the two tax losses, A also had a valid business purpose for "purchasing" the unwanted Distributed Assets from B.

[redacted]

In *Turner Broadcasting,* the Tax Court rejected the government's argument that Turner Broadcasting should be treated as making a capital contribution to MGM equal in value to the UA stock. In order to recharacterize the transaction, the government must have a logically plausible alternative explanation that accounts for all the results of the transaction. The explanation may combine steps, but if it invents new ones, courts have refused to apply the step transaction doctrine. *Esmark, Inc. & Affiliated Cos. v. Commissioner*. 90 T.C. 171 (1988). In the instant case, treating CC's excess purchase price as a capital contribution to B arguably adds a step.

In the instant case, however, the transaction created two losses for A. A effectively claimed the equivalent of a double deduction, which A arguably should not be allowed. *See Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934). (Where the court held appropriate adjustments need to be made to stock basis to prevent double deductions.) Also, the loans A took out to purchase the Distributed Assets were outstanding for less than three weeks in duration, and were arguably transitory and illusory. A was arguably never at risk for the loans. The loan amounts were used only to purchase distributable assets; B was required to have liquid assets equal to the value of the loan; the loan would be paid from the proceeds of the sale of the B stock to CC, and CC reimbursed A for the interest amounts A paid in holding the loan proceeds. The procurement of the loans and the sale of the stock all took place within three weeks of one another. As discussed above, however, the taxpayer will argue that state regulatory rules required it to structure the transaction in this form, and that the government is adding a meaningless step to the transaction. (The capital contribution from CC to B.)

[redacted]

EARNINGS AND PROFITS

We recommend that you consider an alternative argument involving a reduction in earnings and profits. B's loss on the sale of its assets to A is denied or "precluded" to B under I.R.C. § 267(f). Under Treas. Reg. §§ 1.267(f)-1T(c)(6) & (7) the loss, even though unrecognized, reduces B's earnings and profits, thereby causing A to reduce its basis in the stock of B by the amount of the loss pursuant to Treas. Reg. § 1.1502-32(b)(2)(i). A similar theory has been advanced in the examination of at least one other case; the case was ultimately settled without litigation.

Earnings and profits are computed on a member by member basis. Arguably, B's precluded loss on the sale of its assets to A should individually affect B's computation of its earnings and profits.

I.R.C. § 267(f) and the temporary regulations thereunder provide the income tax treatment for this transaction. The temporary regulations incorporate certain rules applicable to controlled groups not filing a consolidated return. These rules provide that a deferred loss <u>will never be restored</u>, if, at the time the selling member ceases to be a member of both the affiliated group and the controlled group, the property is still owned by another member. Temp. Reg. § 1.267(f)-1T(c)(6). If a deferred loss is precluded under Temp. Reg. § 1.267(f)-1T(c)(6), the temporary regulations under I.R.C. § 267(f) provide that the basis of such property in the owning member should be increased by the amount of the selling member's unrestored deferred loss at the time the selling member leaves the controlled group. Temp. Reg. § 1.267(f)-1T(c)(7)[1] .

Applying the law to the facts of this case, when B sells the unwanted assets to A at a loss, the loss is deferred under I.R.C. § 267 and Treas. Reg. § 1.1502-13(c). When the stock of B is sold outside the consolidated group, B is not allowed its loss on the sale of the unwanted assets to A; instead B's loss on the sale of its unwanted assets to A is permanently denied to B under Temp. Reg. §§ 1.267(f)-2T(d)(1) and 1.267(f)-1T(c)(6). A's basis in the unwanted assets received from B is, however, increased by the amount of the permanently denied loss on the sale of the B assets to A. Temp. Reg. §§ 1.267(f)-2T(d)(2) and 1.267(f)-1T(c)(7).

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[1] B joined A in filing a consolidated return for the year in which the Distributed Assets were sold. Thus, the provisions of Temp. Reg. § 1.267(f)-1T do not seem applicable to the transaction. Temp. Reg. § 1.267(f)-1T(a)(3). The 1T regulations are, however, made applicable to the transaction by Temp. Reg. § 1.267(f)-2T(d).

The taxpayer may counter that Treas. Reg. § 1.1502-33 does not require B to adjust its earnings and profits to account for the loss on the sale of its assets to A because that loss was not restored under Treas. Reg. § 1.1502-13. Therefore, no reduction to A's basis in its B stock to reflect the loss in B's earnings and profits is required by Treas. Reg. § 1.1502-32(b)(2)(i).

This interpretation of Treas. Reg. § 1.1502-33 should be rejected because if B is not required to reduce its earnings and profits by the amount of the disallowed loss, there is a duplication of a loss for earnings and profits purposes. In effect, A is able to deduct the same economic loss twice for earnings and profits purposes, once on the sale of the B stock (by virtue of the fact that the amount received for the stock reflects the economic loss from the sale of the underlying asset) and again when it sells the assets purchased from B (as a result of the step up in basis for the amount of the disallowed loss to B under Temp. Reg. §§ 1.267(f)-2T(d)(2) and 1.267(f)-1(T)(c)(7)).

Moreover, such an argument misconstrues Treas. Reg. §§ 1.1502-33(a) and 1.1502-13 and the proper function of earnings and profits. Treas. Reg. §§ 1.1502-33(a) and 1.1502-13 assume that there will be an eventual restoration event when the loss will be restored and the earnings and profits will be adjusted. Since no restoration event would ever take place in this case, there is no reason to delay the adjustment in earnings and profits. Thus, arguably, Treas. Reg. § 1.1502-33(a) does not address the situation where the gain or loss is permanently precluded as in the case of a transaction to which Temp. Reg. §§ 1.267(f)-1T(c)(6) & (7) apply. It is therefore appropriate to look to the general rules of E&P, I.R.C. § 312 and the regulations thereunder to determine how B should adjust its earnings and profits to reflect the loss disallowed to B. Under Treas. Reg. § 1.1502-80, the Code or other law shall be applicable to a consolidated group to the extent the regulations do not exclude its application.

Generally, gain or loss realized increases or decreases earnings and profits to the extent such gain or loss was recognized in computing taxable income. Treas. Reg. § 1.312-7(b)(1) and *Bangor & Aroostook R. R*. Co. *v. Commissioner*, 193 F.2d 827 (1st Cir. 1951). Furthermore, an economic loss that is never allowed for income tax purposes may nevertheless reduce earnings and profits. *See* Treas. Reg. § 1.312-7(b)(1)

Treas. Reg. § 1.312-7(b)(1) provides that a recognized loss, even though not allowed as a deduction (for example, by reason, of the operation of sections 267 and 1211 and corresponding provisions of prior revenue laws), may result in a decrease in earnings and profits by the amount of the disallowed loss. Under Treas. Reg. § 1.312-7(b)(1), B must reduce its earnings and profits at the time of sale by the amount of its loss on the sale of its unwanted assets to A because, for earnings and profits purposes, that loss becomes an economic loss that will never be allowed for income tax purposes as to B at the time of the sale by virtue of Temp. Reg. §§ 1.267(f)-2T(d)(1) and 1.267(f)-1T(c)(6). Accordingly, A must reduce its basis in the stock of B by the amount of the precluded loss to B under Treas. Reg. § 1.1502-32(b)(2)(i). Although this loss is deferred within the group (in the basis of the unwanted assets in the hands of A), B must compute its earnings and profits on a separate member basis, taking into account the loss B is not allowed.

The taxpayer may argue that Treas. Reg. § 1.1502-33(a) provides that there are no adjustments to earnings and profits until there is a restoration event under Treas. Reg. § 1.1502-13. Although B's leaving the consolidated group would normally constitute a restoration event under Treas. Reg. § 1.1502-13(f)(1)(iii), Treas. Reg. § 1.267(f)-2T(d)(1) provides that such event does not result in the restoration of the deferred loss. Thus, since no restoration event has occurred, no adjustment is to be made to the earnings and profits of B under Treas. Reg. § 1.1502-33(a). Even though this result arguably conflicts with the section 312 regulations, when there is a conflict between a consolidated return regulation and another regulation, the consolidated return regulation must prevail. Treas. Reg § 1.1502-80.

Additionally, the taxpayer may argue that, under Treas. Reg. § 1.267(f)-1T(c)(3) (which applies to controlled groups that do not file a consolidated return) or Treas. Reg. § 1.1502-33(a) (which applies to consolidated groups), B is not required to reduce its earnings and profits to account for the loss on the sale of the assets to A. Under Treas. Reg. § 1.267(f)-1T(c)(3) or Treas. Reg. § 1.1502-33(a), the proper time to reflect a deferred loss in earnings and profits is the time the deferred loss is restored. (Note that we believe Treas. Reg. § 1.267(f)-1T(c)(3) does not apply to the transaction in the instant case; Treas Reg. 1.1502-33(a) applies because the transaction involves a consolidated group.) The taxpayer may argue that when B ceases to be a member of the group, Treas. Reg. §§ 1.267(f)-1T(c)(6)&(7) provide that the deferred loss is never restored to B, and, because the loss is never restored to B, the loss is never reflected in B's earnings and profits. Although we believe this is a possible reading of the regulations, we believe the better reading of the regulations is, as discussed below, that B must reduce its earnings and profits by the amount of loss permanently denied to B. Not only is this the better reading of the regulations, but it is also the interpretation of the regulations that comports with the underlying economic realities of the transaction. See *IU International Corp*. v. *United States*, 97-2 USTC ¶ 50,534 (Fed. Cir. 1997) (in which the court construed regulations to comport with underlying economic realities of the transaction.)

In adopting this reading of the regulations, there is no conflict between the section 312 and consolidated return regulations. Under Treas. Reg. § 1.1502-33(a), gain or loss on an intercompany transaction shall be reflected in the earnings and profits of a member for its taxable year in which such gain or loss is taken into account under Treas. Reg. § 1.1502-13. Treas. Reg. § 1.267(f)-1T(c)(6) provides, however, that if a selling member of property for which loss has been deferred ceases to be a member while the property is still owned by another member, then for purposes of this section, Treas. Reg. § 1.1502-13(f)(1)(iii) shall not apply to restore that deferred loss and that loss shall <u>never</u> be restored to the selling member. As a result, the rules under Treas. Reg. §§ 1.1502-13 and 1.1502-33 that apply to a deferred loss that will be taken into account or restored do not apply to this situation. Or, another way to view the operation of these rules is that the mandate under Treas. Reg. § 1.267-1T(c)(6) that B's loss is no longer allowed or restored to B means that at the time B ceased being a member of the group (because A sold B's stock), there was no longer a deferred intercompany transaction or a deferred loss between B and A for B or A to take into account. Therefore, Treas. Reg. §§ 1.1502-33(a) and 1.1502-13 do not apply in this case. Accordingly, no conflict exists between Treas. Reg. § 1.1502-33(a) and Treas. Reg. § 1.312-7(b)(1).

The taxpayer may also challenge the argument that B should be required to reduce its earnings and profits on the sale of its assets to A because A will also be required to reduce its earnings and profits when it sells the assets received from B at a loss. The taxpayer may argue that it is not appropriate for both A and B to reduce their earnings and profits because there has only been one economic loss.

We would argue that at the time A increased its basis in the assets received from B, (by the amount of A's unrestored loss) A should increase its earnings and profits by the amount of B's unrestored loss. This increase creates a parity between the tax basis and earnings and profits basis of A's assets, as well as the more general rule of parity between the recognition of income for tax and E&P purposes. This result can be derived, in part, from *Bangor & Aroostook R. R*. Co. *v. Commissioner*, 193 F.2d 827 (1st Cir. 1951)[2] which holds that a corporation does not increase its earnings and profits on the receipt of certain income where there is a corresponding downward adjustment to the basis of that corporation's remaining

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[2] We believe that where a corporation increases its basis in an asset (or decreases its basis in an asset) for income tax purposes it must increase its E&P (or decrease its E&P) by that amount. Our rationale behind this rule involves a theory of how E&P generally works. However, this theory is beyond the scope of this FSA request. We request that you seek further guidance from us concerning our position that a tax basis increase increases E&P, if you pursue the argument set forth above.

assets.[3] The deduction and basis increase in this case are not occurring to the same corporation, accordingly neither corporation has a corresponding adjustment at the time of the sale of B. Therefore, at the time of the sale, B will have a reduction of E&P as a result of the deduction and A will have an increase in E&P as a result of the basis increase.

The increase in earnings and profits to A as a result of the basis increase will negate A's decrease in earnings and profits when A sells the assets received from B at a loss. In other words, there will only be one tax loss (the tax loss to A on the sale of the assets as a result of the increased basis) to match the one economic loss to B as a result of B's reduction of E&P when it is disallowed the loss.

In summary, we believe an argument should be made that B's loss on the sale of its assets to A that was precluded under I.R.C. § 267(f) & Treas. Reg. §§ 1.267(f)-1T(c)(6) & (7), reduces B's earnings and profits, thereby causing A to reduce its basis in the stock of B by the amount of the precluded loss pursuant to Treas. Reg. § 1.1502-32(b)(2)(i).

As already discussed, please forward the Form 872 consent form for the tax year at issue in this case to our office.

If you have any further questions, please call 202-622-7930.

cc: Regional Counsel CC:NER
Assistant Regional Counsel (LC) CC:NER

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[3]While the facts of this case are the converse of the facts in *Bangor and Aroostook R. R.*, a permitted deduction with a corresponding basis increase, the rationale is still applicable.