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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

FROM: Deborah Butler
Associate Chief Counsel (Procedure & Administration)
CC:PA

SUBJECT: Business Purpose Economic Substance

This Field Service Advice responds to your memorandum dated April 19, 2000 requesting a reconsideration of a previous Field Service Advice issued March 1, 2000. This response has been coordinated with the office of the Associate Chief Counsel (Corporate). 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.

<u>LEGEND</u>

A =

B =

C =

<u>c</u> =

CorpD =

E =

Date 1 =

Date 2 =

Date 3 =

Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Month 1	=
a	=
b	=
#a	=
#b	=
#c	=
#d	=
#e	=
#f	=
#g	=
#h	=
#i	=
#j	=
#k	=
#l	=
#n	=
#o	=

ISSUES

1. Whether CorpD's Dutch auction preferred stock is debt or equity for federal income tax purposes.

2. Whether the transfer of worthless properties by A to CorpD for on Date2, qualified as a non-taxable transaction under I.R.C. § 351.

CONCLUSIONS

1. The Dutch auction preferred stock is equity for federal income tax purposes.

2. The transfer of worthless properties by A to CorpD on Date2 is not described in I.R.C. § 351.

FACTS

On Date 1 companies A, B, and C, all members of E's consolidated group, contributed selected a and b properties to a newly formed non-consolidated subsidiary CorpD in a section 351 transaction. A contributed properties with high bases (#a) and little or no fair market value (#b), while B and C contributed properties with low bases (#c) and high fair market value (#d).

In the transaction, A received auction rate voting preferred stock in CorpD having a liquidation preference of b, while B and C received common stock in CorpD. At the time, CorpD raised #e in cash through the issuance of preferred stock to third parties.

Company A had previously arranged, on Date 2, to sell in Month 1 all of the auction preferred stock it would receive on Date 1. On Date 3, A sold #f of its auction preferred stock in CorpD to third parties for #g in cash. As a result A reported a large capital loss (over #h) which A utilized in full through capital loss carrybacks to Year 1-Year 2 and a carryforward to Year 4. A claims its basis in its retained auction preferred stock is approximately #i.

According to a report prepared by an independent appraiser before (and in connection with) the transfer of the properties, of the #k properties (or property accounts) contributed by A, #l properties, those located in c, had no value. A paid term rental fees on some of the c properties transferred to CorpD, however, as recently as several months before their transfer. CorpD did not pay any rental fees with respect to these properties thereafter.

During the years Year 4-Year 5, CorpD abandoned worthless former A properties located in c having a total basis of about #j.

Currently, CorpD owns none of the former A properties located in c, which were transferred to it in Year 3.

A principal business purpose for the formation of CorpD set forth by E was to raise cash in CorpD to develop the properties transferred by the E group. The A properties located in c were not being developed at the time of the transfer. Nor were there any plans, specific or otherwise, to do so. CorpD was also limited in its ability to develop the A properties located in c by the terms of the auction preferred stock. E alleges that another purpose for the formation of CorpD was to “monetize” the non producing A properties.

LAW AND ANALYSIS

LAW

Section 351

Section 351 of the Internal Revenue Code generally provides for the non-recognition of gain or loss upon the transfer of property to a corporation in exchange for stock in circumstances where, immediately after the exchange, the transferors are in control of the corporation to which the property was transferred.

In a qualifying section 351 transaction, the assets retain a carryover basis in the hands of the transferee. Section 362(a). The transferor’s basis in the stock received in the transaction is equal to the basis of the transferred assets. Section 358(a). Under section 351, control is defined as 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. Section 368(c).

The purpose of section 351 is to “facilitate movement into the corporate form by preventing immediate recognition of gain or loss when there has been a mere change in the form of ownership”. Hempt Bros, Inc. v. United States, 354 F. Supp. 1172 (M.D. Pa 1973).

In Meyer v. United States 129 Ct. Cl. 214 (1942), the Court explained in dicta that the transfer of worthless property in exchange for stock did not meet the exchange requirement of section 351, and therefore the transaction did not meet the requirements of a nontaxable section 351 exchange.

In Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1976), the Court held that if there was a binding commitment to sell stock received by a transferor in a 351 transaction to a third party, then the 351 transaction and stock sale can be stepped to produce sale treatment with respect to the 351 transaction.

Doctrine of Substance over Form

In determining the tax consequences of a transaction, including whether transactions qualify for favorable non-recognition treatment, the courts will look at the substance of the transaction or relationship, not merely its form. Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945).

The inquiry into whether transactions have sufficient substance to be respected for tax purposes turns on both the objective economic substance of the transactions and the subjective business motivation behind them. Kirchman v. Commissioner, 862 F.2d 1486 (11th Cir. 1989). The objective and subjective prongs of the inquiry are related factors, both of which form the analysis of whether the transaction had sufficient substance apart from its tax consequences. ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998).

Doctrine of Economic Substance

While a taxpayer may structure a transaction to minimize tax liability, that transaction must have economic substance apart from tax consequences, if it is to be respected for tax purposes. See Kirchman v. Commissioner, 862 F.2d 1486 (11th Cir. 1989). Where an entity is created that has no real economic effect and which affects no cognizable economic relationship, the substance of a transaction involving the entity will control over its form. Zmuda v. Commissioner, 79 T.C. 714, 720 (1982). Transactions which serve no economic purpose other than the generation of tax losses are accorded no tax effect. Knetsch v. United States, 364 U.S. 361 (1960).

Compaq Computer Corp. v. Commissioner, 113 T.C. No.17 (1999) involved a prearranged transaction designed to eliminate typical market risks. P purchased and immediately resold American Depository Receipts (ADR's) of a foreign corporation on the floor of the NYSE. The court held the transaction lacked economic substance and business purpose. The Court found that every aspect of the transaction was deliberately predetermined and designed to yield a specific result and to eliminate all economic risks and influences from outside market forces.

In Frank Lyon Co. v. United States, 435 U.S. 561 (1978), the Supreme Court stated that a genuine multi-party transaction with economic substance compelled or encouraged by business or regulatory realities imbued with tax independent considerations, and not shaped by solely tax avoidance features, should be respected for tax purposes. In Frank Lyon Co., the Supreme Court held that the arrangement of a contemplated business transaction in a tax advantaged manner should be respected, whereas a prearranged loss transaction designed solely for the reduction of tax should not be respected.

Business Purpose Doctrine

Under the general “business purpose doctrine,” long recognized by the Supreme Court, transactions that have no legitimate business purpose and that are undertaken purely for tax avoidance reasons are not recognized for tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935). Nonetheless, it is also well recognized that a taxpayer may prearrange, change and divide business activities among business entities. Normally, a choice to transact business in corporate form will be recognized for tax purposes as long is there is a business purpose or the corporation engages in business activity. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

Courts have suggested that there is business purpose requirement in section 351. Opinions discussing other section 351 issues often indicate that the taxpayer has a valid business purpose for the transaction in question. Hempt Bros., Inc. v. United States, 490 F.2d 1172 (3d Cir. 1974). Perhaps the most thorough judicial exploration of the business purpose doctrine in section 351 is in Caruth v. United States, 688 F. Supp. 1129, 1138-1141 (N.D. Tex. 1987). In Caruth, the court explains that section 351 is tied very closely to the reorganization provisions, and reasons that the doctrines applicable there are equally valid for capital contributions. Under Caruth, the business purpose requirement for section 351 transactions appears to be the same as the business purpose requirement for acquisitive reorganizations.

While each case turns on its specific facts, courts consistently look to several factors to evaluate the existence of a valid, non-tax business purpose in cases involving section 351 and closely-held corporations. These factors include the following: 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 taxpayer's expertise in tax matters; and the transaction’s form. Courts also examine any explicit indicators of a taxpayer's intent, such as documents or negotiations that confirm or belie the existence of a pre-arranged plan. Kluener v. Commissioner 154 F.3d 630 (1998).

In at least two cases, these factors led courts to find no valid, non-tax business purpose. Stewart v. Commissioner, 714 F.2d 977 (9th Circuit 1983), Hallowell v.Commissioner, 56 T.C. 600 (1971). In Stewart, the taxpayer transferred securities to his corporation, ostensibly because it needed to reduce its debt.
The corporation sold the securities and sheltered the gain. Despite supposedly needing capital, the corporation distributed most of the proceeds to the taxpayer. It kept a mere thirteen percent for itself. The trial court found no non-tax business purpose and refused to recognize the transfer.

Hallowell reached a similar result. In Hallowell, the taxpayers transferred greatly appreciated stock to their corporation over three years. Soon after each transfer, the corporation sold the stock and distributed most of the proceeds to the taxpayers. The Tax Court disregarded the formalities and held that the taxpayers sold the stock. The court stressed that the corporation retained very little money even though it needed capital, and that it repaid the taxpayers roughly the amount earned from each sale. While there was no evidence of a formal prearranged plan, the court found this irrelevant; because an open market existed for the stock, the taxpayers could execute a plan without a formal arrangement.

Dutch Auction Preferred stock

In Rev. Rul. 90-27 1990-1 C.B. 50, the Service stated that Dutch auction preferred stock represents an equity interest in the issuing corporation.

In Rev. Rul 94-28 1994-1 C.B. 86, the Service differentiated Dutch auction preferred stock and debt.

ANALYSIS

Auction Preferred Stock - Debt or Equity — Issue 1

You have asked whether the Dutch auction preferred stock is equity or debt for federal income tax purposes. This classification depends upon the circumstances of each case. From the perspective of the holders, Dutch auction preferred stock is an investment alternative to commercial paper or other short term debt. In certain critical respects, however, the legal rights embodied in the Dutch auction preferred stock are similar to those found in traditional preferred stock and are unlike those usually associated with debt. In the instant case, as a holder of preferred Dutch auction stock, A did not receive a sum certain either on demand or on a specified date, and, at liquidation or bankruptcy, A's rights are subordinate to the claims of CorpD's creditors. In addition, the Dutch auction preferred stock is voting stock and A cannot compel redemption of the Dutch auction preferred stock. Therefore, based on the circumstances of this case, the Dutch auction preferred stock received by A from CorpD should be classified as equity. Rev. Rul. 94-28 1994-1 C.B. 86 and Rev. Rul. 90-27 1990-1 C.B. 50.

Transfer of the worthless properties --- Issue 2

Section 351, by its terms, applies to transfers of property in exchange for stock. If the facts establish that A's c properties were clearly worthless at the time of transfer, then no stock was received for those properties. Rather, all #b of the CorpD preferred stock received by A was obtained with respect to non-c properties**.**

Moreover, it is the Service's position that section 351 only applies to transactions in furtherance of a business purpose. As discussed above, this position is supported by the weight of existing authority. The transfer of A's c properties does not appear to further any business purpose asserted by the E group. The c properties added nothing to A's ability to raise cash. A should, and presumably would, have received #b worth of CorpD stock for its non-c properties regardless of whether it also transferred the properties in c. The c properties also added nothing to CorpD's ability to raise cash. Since the c properties clearly produced no cash flows and were widely viewed as having no value, their presence in CorpD could not have been viewed in the marketplace as support for a larger issuance of stock than would otherwise have occurred. Although the financing by CorpD could have enhanced the E group's ability to develop the c properties, that does not appear to have been intended, based on the facts known to us. The c properties appear to have been slated for abandonment, and were in fact abandoned by CorpD. Based on the results, the transaction appears to have been intended to duplicate the tax loss available upon the abandonment of the c properties, or, stated differently, to provide CorpD with a tax shelter without depriving the E group of the benefit of its built-in loss.

Accordingly, if the facts establish that A's c properties were clearly worthless at the time of transfer, A's transfer of the c properties was not in exchange for CorpD stock and was lacking a business purpose and economic substance. Stated differently, in applying "substance over form" or "step transaction" principles, the transfer of worthless properties from A to CorpD appears to be an unnecessary step towards the abandonment of those properties. In that case, section 351 would not apply to the transfer of the c properties and A's basis in the CorpD preferred stock, as determined under section 358 would not reflect its basis in the c properties.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Before discussing the various hazards associated with the Service's potential arguments in this case, we think it would be useful to summarize the results of these arguments (on a "best case" basis, in a sense). Because we do not see a viable challenge to the transfer of the non-c properties, A obtains a basis in its CorpD stock equal to its basis in those properties. Moreover, the inevitable result of our arguments about the worthlessness of the c properties is to give A an abandonment loss with respect to those properties. Accordingly, we do not foresee any adjustment against the E group with respect to this transaction. (Since A only sold 60% of its CorpD stock, our theory would in fact accelerate its losses over those claimed on the return.)

If our arguments prevail, we will be able to deny CorpD the losses it claimed with respect to the properties in c, #j.

[redacted]

There is substantial evidence that the transaction was largely tax-motivated and that the c properties were known to be worthless and slated for abandonment. Nevertheless, the record is not unambiguous. For example, the fact that A paid delay rentals on the properties is not helpful. The fact that A (and, apparently, for some time, even CorpD) continued to employ personnel with respect to the c properties also is problematic. The fact that some of the properties in c were sold by CorpD for cash rather than abandoned is also troublesome (and, at a minimum, will shield the transfer of those assets to CorpD from successful challenge by the Service). To the extent the abandonment of the c properties appears to be an open question, rather than inevitable, as of Date 1, we foresee difficulties in convincing the Court that the transaction lacks a business purpose and that the exchange requirement is not satisfied. The law does not permit the Service to substitute its business judgment for the taxpayer's, and so the Service will, in effect, have to convince the Court that the taxpayer had decided by Date 1 not to develop these properties but instead to write them off.

Moreover, we expect the taxpayer will argue that the transaction should be viewed as a whole, and the Service should not be free to isolate one part of a transaction that, overall, makes business sense. We believe that the Service has viable arguments, given that the transfer of the c properties accomplished nothing from a non-tax standpoint. Little changed in the way these properties were managed and, to the extent anything changed, nothing changed that could not have been directed by E before or absent the transaction. A, B, C, and CorpD were all run by E with E group personnel. Nothing in the structure of CorpD as a financing vehicle facilitated the development of the c properties and, indeed, some of the restrictions on CorpD may have hindered such development. [redacted]

A's transfer of its non-c properties to CorpD in exchange for #b of preferred stock appears to have furthered A's ability to raise cash by giving it preferred stock to sell, and may have enhanced CorpD's ability to raise cash as well. Thus, we believe the Service should respect A's transfer of the non-c properties to CorpD as a non taxable exchange under I.R.C. § 351. Although A planned to sell the CorpD preferred stock from the start, we do not think this would defeat characterization of the transaction under section 351 given that A had no binding commitment to sell the CorpD stock. Cf. Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1976).

[redacted] As noted above, our challenge would be directed at CorpD's basis in c properties received from A. In this challenge, the application of section 351 is not directly relevant, because, under section 362, the same basis rule applies to shareholder contributions to capital. There is a significant amount of law distinguishing shareholder from non-shareholder contributions, and it is fairly clear that this transaction does not qualify for the non-shareholder rule (which automatically would deprive CorpD of basis in the properties). [redacted]

A further hazard, along these lines, is the fact that, but for the transfer of the c properties to CorpD, it is not clear that A met the normal standards for a realizing an allowable loss as of that time. Our finding of an abandonment is predicated in large part on the argument that the properties were so worthless that A received nothing in exchange for them.

[redacted] but for the transfer of the c properties to CorpD, it is unclear whether A met the normal standards for the realization of an allowable loss as of the date of transfer. Our finding of an abandonment is predicated in large part on the argument that the properties were so worthless that A received nothing in exchange for them.

[redacted]

Please call if you have any further questions.

By: ______________________________
George Bowden
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CC:MSR:PODCHI:LC