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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR THOMAS W. WILSON, DIRECTOR - COMMUNICATIONS, TECHNOLOGY, AND MEDIA INDUSTRIES
Large and Mid-Size Business Division, Northern California District

FROM: Filiz Serbes, Branch Chief, CC:CORP:B03

SUBJECT: , WTA-N-122362-00

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LEGEND

Parent =

Sub =

X =

$A =

Date =

Representative =

ISSUES

1. Whether certain transfers of stock in a parent corporation, by a subsidiary, to the parent's employees are distributions under §§301, et seq., of the Internal Revenue Code.

2. Whether these transfers are capital contributions under §1.83-6(d) of the Income Tax Regulations.

3. Whether these transfers lack sufficient economic substance to support the claimed tax benefits.

CONCLUSIONS

1. The transfers are distributions under §301.

2. The transfers are not capital contributions under §1.83-6(d).

3. The transfers lack sufficient economic substance to support the claimed tax benefits.

FACTS

Parent (also referred to herein as Taxpayer) is a domestic corporation that is the common parent of a consolidated group. Sub is a domestic subsidiary of Parent, and X is a third party that is related to Parent but is not an includible corporation within the meaning of §1504(b) of the Internal Revenue Code. Parent and X transferred a total of $A to Sub in exchange for Sub stock. After this exchange, Parent owned stock representing less than 80 percent of the voting power of Sub stock, thus preventing Sub from being a member of Parent's consolidated group. X owned preferred stock of Sub. Parent's basis and X's basis in their Sub stock reflected the $A contributed to Sub. Sub used the $A to purchase stock of Parent from Parent's shareholders.[1] Sub then held the Parent stock, and, from time to time, at the direction of Parent, Sub transferred Parent shares to Parent employees in satisfaction of Parent's stock-based employee compensation obligations (e.g., upon the exercise by an employee of a non-statutory option to purchase Parent stock). On Date, more than three years after the initial transfer of cash, Sub sold any remaining Parent stock, and Sub liquidated. All of these steps were taken pursuant to written agreements entered into by Parent, Sub, and X.

Notwithstanding that Parent was the majority shareholder of Sub, Parent and Sub treated, under §1.83-6(d) of the Income Tax Regulations, Sub's transfers of Parent stock to Parent's employees as deemed capital contributions by Sub to Parent followed by transfers by Parent to the Parent employees. Parent did not reduce its basis in its Sub stock as a result of Sub's deemed transfers to Parent. Sub increased its basis in its remaining Parent stock by the amount of the basis of the Parent shares Sub transferred in the deemed capital contributions to Parent. Under §1032, Parent reported no gain or loss from the deemed transfers of Parent stock to its employees. Parent took deductions under §83(h) in the amount that the Parent employees included in income under §83(a) from their receipt of the Parent stock.

When Sub liquidated, Parent reported a very large capital loss under §331 because Sub already had transferred most of its Parent stock to the Parent employees, which substantially reduced the value of Sub, without a corresponding downward adjustment in Parent's basis in its Sub stock. Because Sub claims to have shifted all of its basis in the Parent stock to Sub's shares of Parent stock remaining after the transfers to the Parent employees, Sub also reported a capital loss on the sale of its remaining Parent stock immediately before Sub's liquidation.

There are two significant, and apparently undisputed, factual observations to be derived from the foregoing. First, Parent essentially claimed the same deduction twice: Parent deducted the amount that the employees included in income under the general provisions of §83 at the time of Sub’s transfers of Parent stock to Parent employees; then, Parent claimed a loss on its consolidated return under

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[1]Under §304(a)(2), any cash paid by Sub to Parent’s shareholders for Parent stock is treated as a distribution in redemption of Parent’s stock by Parent. Sections 302 and 318 apply to determine whether the deemed redemption should be treated as a sale or as a §301 distribution.

§331 when Sub liquidated because of the value that Sub had lost as a result of the transfers. In addition, a third tax benefit was improperly created when Sub took a loss on the sale of the remaining Parent stock to which basis was shifted. The second observation is that, to the extent that the total tax losses and deductions were in excess of Parent's portion of the original $A investment, they have no economic underpinning whatsoever, as is explained in more detail below.

LAW AND ANALYSIS

1. The transfers are distributions under §301

Section 301 provides that "a distribution of property... made by a corporation to a shareholder with respect to its stock in the corporation" will be treated according to that section. Sub is a corporation making distributions of appreciated property, stock in Parent, to its shareholder Parent, which Parent then uses to compensate its employees. When a corporation makes a payment that discharges a liability of its shareholder, the discharge of the liability is treated as a distribution to the shareholder with respect to the shareholder's stock. See, e.g., Tennessee Securities Inc. v. Commissioner, 674 F.2d 570, 573 (6th Cir. 1982), citing Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929). Thus, the transaction is governed by §§301, 311(b)(1) and 316.

As a result, Sub should recognize gain in excess of its adjusted basis in the property as if such property were sold to the Parent/distributee at its fair market value. Section 311(b)(1). In addition, Sub would not adjust its basis in its remaining Parent shares and therefore would not recognize a loss on the sale of its remaining Parent stock. Under §301(c), that portion of the distribution from Sub that is a dividend shall be included in Parent's gross income. Since we do not anticipate Sub's having any significant earnings and profits, it is likely that Parent will apply "[t]hat portion of the distribution which is not a dividend ... against and reduce the adjusted basis of the [Sub] stock." Section 301(c)(2). Thus, the effect of the distributions will be to reduce Parent's basis in its Sub stock, thus reducing or eliminating the loss realized on that stock upon liquidation. Sections 301(c), 316.

2. The transfers are not capital contributions under §1.83-6(d)

Section 1.83-6(d) states that "[i]f a shareholder of a corporation transfers property to an employee of such corporation ... in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee...."

Representative argues that, although ordinarily whether a payment is a capital contribution depends on the facts and circumstances, because Parent and Sub fulfill the literal language of §1.83-6(d), which characterizes transfers by a shareholder to the corporation's employees as capital contributions, there can be no other considerations in characterizing Sub's transfers of Parent stock to Parent employees as contributions to the capital of Parent.

However, Taxpayer in this case may not solely rely on §1.83-6(d) to characterize the transfers as contributions to the capital of Parent. See Notice 2000-60, 2000-49 I.R.B. 568 (December 4, 2000). These transfers are described both in §1.83-6(d) and in §301. When characterizing a transaction that fits within two Code sections, courts will consider other factors in determining the appropriate tax treatment of the transaction. Cf. Crosby Valve & Gage Co. v. Commissioner, 380 F.2d 146 (1st Cir. 1967) (when property transfers received by charitable entity from a wholly owned corporation were literally described in both §316(a) and §170(c), the transfers were held to be dividends rather than deductible charitable contributions, based on the court's analysis of the purposes sought to be achieved by Congress in taxing unrelated business income of charitable organizations); see also Textron, Inc. v. Commissioner, 115 T.C. No. 6 (2000) (loss on a note between corporations, which became members of a new consolidated group before the note was canceled, was required to be deferred despite the corporations' status as nonmembers of the new group prior to the cancellation based in part on the court's decision that the word "nonmember" must be read in context and that the application of a regulation should not lead to an unreasonable result).

Interpreting §1.83-6(d) as permitting a controlled subsidiary to avoid dividend treatment for transfers made on behalf of its parent corporation merely by purchasing shares of Parent stock would contravene the statutory framework governing dividends under §§301, 311, and 316. Cf. United States v. Hill, 506 U.S. 546, 562 (1993) (in rejecting taxpayer's argument that regulations under §612 affect adjusted basis determination under §57(a)(8), the Supreme Court stated that "when an arguable suggestion of the title of one subsection of a regulation is pitted against the entire Code framework for determining basis, the Code wins....").

Furthermore, the characterization in §1.83-6(d) of a shareholder's transfer of property to a corporation's employees as a deemed contribution to capital only applies when the transferor is acting in its capacity as a shareholder. That characterization is clearly inapposite when the transferee is a controlling shareholder of the transferor, and the transferor has no plausible investment motive for making such transfers. Notice 2000-60, supra.

In insisting that the literal language of §1.83-6(d) is determinative, Representative misstates the legislative history of §83 and the emphasis Congress placed on capital contribution treatment. In Senate Report 91-552, 91st Cong., 1st Sess. 123, 1969-3 C.B. 500, the Senate placed emphasis on the fact that "[p]resent law does not contain any specific rules governing the tax treatment of deferred compensation arrangements known as restricted stock plans[,]" resulting in more generous treatment for such plans than the treatment specifically provided in the law for other types of similarly funded deferred compensation arrangements. As a result, changes to §83 were adopted to bring the treatment of restricted stock plans in line with other deferred compensation arrangements. In discussing the new rules being provided to allow the employer a deduction for restricted property given to employees as compensation, the Senate states that:

> *In general*, where a parent company's or a shareholder's stock is used to compensate employees under a restricted stock plan, the transfer of the stock by the parent company or shareholder is to be treated as a capital contribution to the company which is to be entitled to a deduction in accordance with the restricted property rules. *The parent company or the shareholder merely is to reflect the contribution as an increase of the equity in the company which is entitled to the compensation deduction.* [emphasis added.]

1969-3 C.B. at 502. The emphasized portions indicate that tax principles generally would treat such transfers as contributions to the capital of the employer entitled to deduct the compensation (as opposed to treating them as current loss deductions). The legislative history and case law, however, do not demonstrate that the intent of §83(h) was to "force" a shareholder to treat stock transfers to the corporation's employees as capital contributions to the corporation in the absence of a determination that general tax principles would yield such a result.

Furthermore, Representative misconstrues the interaction of §1.83-6(d) and the zero basis doctrine and their applicability to this case. The zero basis result finds its origins in Rev. Rul. 74-503, 1974-2 C.B. 117. That revenue ruling considers the tax consequences of a parent corporation's transfer to its subsidiary of its own treasury stock in a transaction to which §351 applies. Rev. Rul. 74-503 holds that, since the basis of previously unissued parent stock in the hands of the parent corporation is zero, the basis of the parent corporation's treasury stock in the hands of the parent corporation too is zero. Accordingly, under the transferred basis rule of §362(a), the subsidiary corporation's basis of the treasury stock of the parent corporation is also zero. This zero basis result was intended to limit certain planning opportunities available to taxpayers to selectively recognize losses on stock (see Rev. Rul. 74-503 for full explanation and examples).

Rev. Rul. 74-503, however, also states that "[t]he transfer of [parent] stock was not for the purpose of enabling [the subsidiary corporation] to acquire property by the use of such stock." Recently issued regulations under §1032 recognize that such tax avoidance possibilities are not present in transactions in which one corporation transfers its stock to another corporation pursuant to a plan by which the second corporation immediately transfers the first corporation's stock to acquire money or other property, which includes the transfer of stock for compensation for services. See §1.1032-3 and -1(a).

Representative suggests that "serious zero basis and artificial gain problems would result if the transfers by [Sub] to [Parent] employees were treated as dividends[,]" relying on Rev. Rul. 80-76, 1980-1 C.B. 15. In that ruling, a parent corporation or a shareholder was utilizing parent corporation's stock to compensate employees of a subsidiary corporation. Problems arose because the parent corporation stock had a zero basis in the subsidiary corporation's hands and, prior to §1.1032-3, there was no explicit protection against gain or loss for the subsidiary upon its immediate transfer of parent corporation stock in exchange for money or other property, including compensation for services.

Representative relies upon this ruling to argue that the Internal Revenue Service (the Service) has "embraced the view that a transfer by a subsidiary to the parent should be treated as a capital contribution instead of a dividend, since, if the initial constructive transfer were treated as a dividend, gain would be recognized by the subsidiary on parent stock (under §1.83-6(b)[,]" and no such holding is included in the ruling. Section 1.1032-3 obsoletes Rev. Rul. 80-76, 1980-1 C.B. 15, but even prior to its obsolescence, the ruling addresses a specific fact pattern and holdings in relation thereto and does not provide the basis for a determination of whether or not there is gain or loss recognized by a subsidiary on the transfer of parent stock in all cases.

More importantly, these issues are simply not present in this case. Parent is transferring Parent stock to its employees as compensation for services, whether routed through Sub or not. Section 1032 provides no gain or loss to Parent on such transfers, so there is no zero basis concern. In addition, there are no "artificial gain problems" as a result of the application of dividend treatment as suggested by Representative; the amount of the distribution that Parent must recognize as a dividend, as an amount applied against basis, or as an amount in excess of basis is based on Sub's earnings and profits and on Parent's basis in its Sub stock, not the basis that Parent has in its own stock. Any amount that Parent must include in income or by which Parent must reduce its basis in its Sub stock is not artificial but is the result of having received a distribution of property from its subsidiary. Under §301(d), Parent would receive a fair market value basis in the property received in the distribution, which is irrelevant since it is Parent's own stock that was received in the distribution and Parent is protected under §1032 from gain or loss on the transfer of that stock even if its basis in the stock were zero. In this case, the Service merely is seeking to disallow the artificial losses generated by Parent through the use of Sub in transferring its own stock to its employees.

In light of the literal language of §1.83-6(d) not being dispositive, Representative acknowledges that the Service would argue that the transfer of Parent stock by Sub does not "look and feel" like a capital contribution; that is, that Sub is transferring the Parent stock to Parent employees not in its capacity as a Parent shareholder but rather as a controlled subsidiary of Parent. In fact, Representative concedes that, ordinarily, whether a transaction constitutes a capital contribution depends on the facts and circumstances, not just the identity of the transferor. Oakland Hills Country Club v. Commissioner, 74 T.C. 35 (1980). Representative further concedes that, in the absence of §1.83-6(d), the facts and circumstances of Sub's transfers would not lead to the conclusion that the transfers are capital contributions. Representative cites Board of Trade of the City of Chicago v. Commissioner, 106 T.C. 369, 379 (1996), in which the Tax Court addresses the nature of capital contributions. In that case, the court notes that the correct characterization of a shareholder payment to a corporation depends on the capacities in which the shareholder and the corporation deal with each other in making and receiving the payment.

In Board of Trade, the court found that the transfer fees paid by members of the Board of Trade of the City of Chicago (the CBOT), a taxable membership corporation, are nontaxable contributions to capital rather than taxable payments for services. The parties in that case agreed that the payer's motive controls whether a payment is a contribution to capital, whether the payer is a nonshareholder or a shareholder, citing United States v. Chicago, B & Q. R.R., 412 U.S. 401, 411-413 (1973); Brown Shoe Co. v. Commissioner, 339 U.S. 583, 591 (1950); Washington Athletic Club v. United States, 614 F.2d 670, 673-677 (9th Cir. 1980). Further, upon such agreement, the court then determined that, if the payer is a shareholder, "we specifically look to see whether the payer has an investment motive in making the payment." 106 T.C. at 381. If an investment motive exists, then the payments are capital contributions. Id. at 382, citing Lake Petersburg Association v. Commissioner, T.C. Memo. 1974-55 (holding that payments of assessments to a housing cooperative were capital contributions and not membership fees for services turned on the conclusion that an investment motive existed); Minnequa Univ. Club v. Commissioner, T.C. Memo. 1971-305 (an investment interest in members' payment of assessments to a social club led to the conclusion that the payments were contributions to capital).

The court recognized that, since direct proof of the motives of a payer is rarely available, objective manifestations and external factors evidencing an investment motive must be examined. The court, therefore, looked to the objective facts and circumstances surrounding the payments to determine whether the members must or should be deemed to have an investment motive in paying the transfer fees. The court based its holding in Board of Trade that the payments were capital contributions on the fact that the transferees paid the fees with an investment motive, as evidenced by (1) the earmarking of the fees for reduction of

CBOT's mortgage indebtedness, (2) the resulting increase in the members' equity in CBOT, and (3) the members' opportunity to profit from their investment in CBOT because of the lack of restrictions on the transferability of their membership interests.

In this case, there are a number of factors evidencing the lack of an investment motive: Parent, not Sub, directed Sub's transfers of Parent stock to Parent employees in satisfaction of Parent's obligation to compensate them; Sub's equity interest in Parent was diminished, not enhanced, by the transfers of Parent stock; and there was no opportunity to profit from the stock of Parent, as Sub's own by-laws prevented Sub from receiving the strike price from the Parent employees or doing anything with the stock other than transferring it to Parent employees. It should be noted that these factors are congruent with the factors that would show a lack of economic substance, further discussed below.

3. Taxpayer's form is not in accordance with true economic substance

(a) true economic substance is distribution treatment under §301

Taxpayer argues that its chosen form, the use of Sub to transfer Parent stock to Parent employees, for the transactions reflects a valid business purpose and economic substance. Taxpayer has made several general assertions that the whole transaction was structured as such to meet the requirements of its stock repurchase plan, while avoiding a possible downgrade in its credit rating. Taxpayer argues that, having made a showing of a business purpose for the transaction, certain criteria for the Service's assertion of the step transaction and economic substance doctrines have not been met.

It is a well-established principle of tax law that when transactions lack a legitimate business purpose and are undertaken solely for tax avoidance purposes, their tax consequences will be determined based on substance and not form. This "substance over form" doctrine originates from the opinion of Gregory v. Helvering, 293 U.S. 465 (1935). There, the Supreme Court held that an otherwise valid corporate formation and subsequent reorganization could be disregarded when the substance of those transactions was to avoid tax on a transfer of stock. See also Knetsch v. United States, 364 U.S. 361, 366 (1960) (Court disregarded the otherwise valid purchase of certain bonds and subsequent use of them as loan collateral as "... nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction.").

Since Gregory v. Helvering, the courts have looked beyond the form of a transaction to determine whether it has the economic substance that its form represents because, regardless of its form, a transaction that is "devoid of economic substance" must be disregarded for tax purposes. Lerman v.

Commissioner, 939 F.2d 44, 45 (3rd Cir. 1991); accord, U.S. v. Wexler, 31 F.3d 117, 122 (3rd Cir. 1994). In ACM, the Third Circuit attempted to distill the holdings of prior economic substance cases into one coherent analysis:

> The inquiry into whether the taxpayer's transaction had sufficient economic substance to be respected for tax purposes turns on both the 'objective economic substance of the transactions' and the 'subjective business motivation' behind them...[T]hese distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes [emphasis added, citations omitted].

ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3rd Cir. 1998), cert. denied 119 S.Ct. 1251 (1999).

The first of these two factors focuses on whether the transaction at issue had any practical economic consequences other than the creation of tax benefits (i.e., whether the transaction appreciably changed the taxpayer's "economic position") Id. at 248-249. The second factor focuses on whether the taxpayer had a valid business purpose or profit motive. Id. at 253-254.[2]

Recent cases imply that the mere presence of some business purpose and economic effect does not necessarily rebut the argument that a given transaction lacks economic substance. The Tenth Circuit has observed:

> We acknowledge the [petitioners'] evidence of business purpose and economic effects. However, we do not agree with their conclusion that business purposes and economic effects relating to the individual steps in each complex series of transactions preclude application of

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[2] This analysis bears a striking resemblance to the "generic tax shelter" analysis once suggested by the Tax Court in Rose v. Commissioner, 88 T.C. 386, 408-415, aff'd on other grounds, 868 F.2d 851 (9th Cir. 1989). Also, the Tax Court has recently specifically cited this bifurcated objective-subjective analysis with approval in both Winn-Dixie, supra at 279-280, and Saba Partnership, supra. Although in Compaq, supra, the Tax Court only cited ACM generally and based its decision upon objective factual findings (that the transaction was predetermined, with controlled arrangements, and a lack of market risk) and a perceived lack of business purpose to the transaction, it is clear that both subjective and objective factual criteria are pertinent to an inquiry into economic substance.

> the step transaction doctrine in this instance. The substance over form inquiry is not nearly as narrow as the [petitioners] suggest. To ratify a step transaction that exalts form over substance merely because the taxpayer can either (1) articulate some business purpose allegedly motivating the indirect nature of the transaction or (2) point to an economic effect resulting from the series of steps, would frequently defeat the purpose of the substance over form principle. Events such as the actual payment of money, legal transfer of property, adjustment of company books, and execution of a contract all produce economic effects and accompany almost any business dealing. Thus, we do not rely on the occurrence of these events alone to determine whether the step transaction doctrine applies. Likewise, a taxpayer may proffer some non-tax business purpose for engaging in a series of transactional steps to accomplish a result he could have achieved by more direct means, but that business purpose by itself does not preclude application of the step transaction doctrine.

True v. U.S., 190 F.3d 1165, 1177 (10th Cir. 1999).

In applying the standards set forth above in determining whether the form of Taxpayer’s transaction should be respected, it is clear that this transaction does not have sufficient substance apart from its tax consequences. Although in the normal course of business, the reimbursement of one's employees through the exercise of compensatory stock options is a legitimate corporate activity, imbued with certain tax consequences, the facts of this case strongly suggest something other than the normal course of business. Sub used the capital infusion of $A to purchase Parent stock from other shareholders. This step was at the direction of Parent. No evidence has been proffered that this purchase of Parent stock through Sub rather than direct purchases by Parent has any economic advantage besides the vague allegation that Parent was generally concerned about its credit rating. Without such evidence, it appears that only the tax effect claimed at the end of the sequence of events provides the basis for undertaking the transaction. It is unclear exactly what aspects of the subject transactions enhanced or protected the taxpayer's credit rating. For example, there has been no explanation of how the credit worthiness of taxpayer improved or could have improved through the use of a subsidiary corporation. Thus far, Taxpayer's arguments regarding credit rating maintenance have not been accompanied by any empirical data or explanations.

(b) alternatively, steps may be disregarded to yield redemption treatment

Taxpayer also argues that the facts of this case do not fulfill any of the three formulations of the step transaction doctrine: (1) the binding commitment test, (2) the end result test, or (3) the mutual interdependence test. See McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982). The

Supreme Court has cited Gregory to disregard a liquidating dividend and stated that the tax consequences of the transaction could not simply be determined by the means used to transfer title. U.S. v. Court Holding Co., 324 U.S. 331 (1945). Rather, “the transaction must be viewed as a whole and each step, from the commencement of the negotiations to the consummation of the sale, is relevant.” Id. at 334. This formulation gave rise to the “step transaction” doctrine, which is a subset of the economic substance doctrine. See also Commissioner v. Clark, 489 U.S. 726 (1989); Commissioner v. Hansen, 360 U.S. 446, 461 (1959) (Court used same analysis to note that “the incidence of taxation depends upon the substance, not the form of the transaction.”); Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

The binding commitment test is a series of formally separate transactions that will be stepped together or collapsed if, when the first step is taken, there is a binding commitment to take the later steps. Commissioner v. Gordon, 391 U.S. 83 (1968). The end result test is a series of formally separate transactions that will be stepped together or collapsed if they appear to be “really prearranged parts of a single transaction intended from the outset to reach the ultimate result.” Penrod v. Commissioner, 88 T.C. 1415, 1429 (1987). The mutual interdependence test is a series of formally separate transactions that will be stepped or collapsed if they “are so interdependent that the legal relations created by one transaction would be fruitless without a completion of the series.” American Bantam Car Co. v. Commissioner, 11 T.C. 297 (1948), aff’d 177 F.2d 513 (3d Cir. 1949).

The binding commitment test is the most rigorous of the formulations of the step transaction doctrine, and it is sometimes applied to transactions that span several tax years. For example, in Gordon, the Supreme Court held that shareholders of a corporation that divided into two subsidiaries who received stock of the new companies and rights to purchase more shares of the new companies in one year, and exercised those rights and received stock in a later year, do not get tax free treatment under §355. Commissioner v. Gordon, supra. The Court found that the initial distribution of stock and rights to purchase more stock could not be characterized as a first step because there was no binding commitment to take the later steps. Id. From all of the information thus far submitted by Representative, it appears that all the distributions of Parent stock by Sub and the eventual liquidation of Sub were made pursuant to a binding, written commitment entered into at the beginning of the transaction. Therefore, even under the most rigorous formulation, a court would be likely to apply the step transaction doctrine in finding the true substance of the transaction.

As an alternative to the dividend argument, the Service may disregard the described steps and treat the transaction as a redemption by Parent. The transfer of cash from Parent to Sub, the purchase by Sub of Parent stock from Parent shareholders, the transfers by Sub of Parent stock to Parent’s employees, and the ultimate liquidation of Sub, all pursuant to the same arrangement, may be disregarded for tax purposes and, instead, be treated according to its true substance -- a redemption by Parent of its stock followed by compensatory transfers of treasury stock by Parent to its employees. No deduction is permitted for amounts paid to redeem stock. See §162(k).

Taxpayer asserts that this inquiry into substance over form and the step transaction doctrine actually need not be undertaken because a showing of business purpose need not be made in this case due to the unqualified rule of §1.83-6(d). Taxpayer supports this claim with a fairly selective reading of a few step transaction doctrine cases. Taxpayer implies those cases do not require any showing of a business purpose. Close review of these opinions does not support this assertion. For example, the Tenth Circuit in Associated Wholesale Grocers v. U.S., 927 F.2d 1517 (10th Cir. 1991), noted that, even if a business purpose had been shown, the step transaction doctrine was applicable. See also Security Industries Insurance v. U.S., 702 F.2d 1234 (5th Cir. 1983) (step transaction analysis shows corporate reorganization did not fulfill necessary requirements for tax free carryover of certain assets). Therefore, although in certain applications of the step transaction analysis the business purpose question is not considered, it does not follow that the lack of a business purpose is irrelevant, particularly in application of the economic substance doctrine.

There is an agency argument to be made as well. The taxpayer places undue reliance on the holding of Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), which upheld the taxation of a controlled corporation as a separate entity from its shareholder. In Moline, a taxpayer organized a corporation and transferred the title to real property to the corporation, which assumed the mortgage to the property. The taxpayer used the stock in the corporation as security for a further loan, which was used to pay property taxes owed on the property. The corporation also refinanced the mortgages, defended condemnation proceedings, and received a small lease payment for some of the property. Id. Since the corporation had carried out some business activity with regard to the assets it held, the Court found that there was a "business necessity" to the creation of the corporation. Id. at 440. And, because of the business purpose finding, the Court rejected an argument based on the theory that the corporation was acting as an agent of its shareholder.

More recently, in Commissioner v. Bollinger, 485 U.S. 340 (1988), the Court clarified the standards for finding a corporation to be the agent of its shareholders. In Bollinger, the taxpayer organized corporations solely in order to obtain loans to develop apartments. The organization of the corporations was necessary because state law required a corporation to be the borrower on a loan with market rate interest. The corporations held the titles to the apartment buildings, but the shareholders (which were partnerships in this case) had control of the loan proceeds and construction of the buildings. The Court agreed with the Commissioner that "normal indicia of agency cannot suffice for tax purposes, when, as here, the alleged principals are the controlling shareholders of the alleged agent corporation." Id. at 345. The Court found the corporations to be agents of the shareholders, using an asset by asset test in order not to undermine Moline. The Court required that there be a written agreement at the time the asset is acquired, that the corporation function as an agent and not as a principal with respect to the asset for all purposes, and finally that the corporation is held out as the agent and not the principal in all dealings with third parties relating to the asset.

Under the present facts, with respect to the Parent stock acquired by Sub, there is a written agreement between Parent and Sub which dictated what Sub could do with the Parent stock. Sub was limited to transferring the stock to Parent's employees (and other employees of the controlled group of corporations that were participants in the stock compensation arrangement). Sub functioned as an agent and not as a principal with respect to the Parent stock for all purposes; as is discussed in greater detail below, Sub had no independent investment motive in Parent. Sub had no choice in what it could do with the stock and used it only to satisfy Parent's obligations, getting nothing in return. Although whether Sub was held out as an agent to third parties has not yet been determined, there are sufficient indicia of agency in this case to undercut taxpayer's reliance on Moline in supporting the steps taken in this transaction.

Therefore, in summary, in determining the appropriate characterization of the transactions undertaken in this case, dividend versus capital contribution treatment, the facts of this case as well as case law lead to the conclusion that dividend treatment best reflects the true economic substance of the steps taken by Parent, Sub, and X in generating the tax benefits at issue. To characterize such transfers as capital contributions made by Sub in its capacity as a shareholder of Parent would be inconsistent with the substance of these transactions. See generally Washington Athletic Club v. United States, supra. The characterization in §1.83-6(d) of a shareholder's transfer of property to a corporation's employees as a deemed capital contribution only applies when the transferor is acting in its capacity as a shareholder. That characterization is inapposite when the transferee is a controlling corporate shareholder of the transferor, and the transferor subsidiary has no plausible investment motive for making such transfers. Since Sub's transfers of Parent stock are being made at the direction of Sub's controlling shareholder, Parent, they are more properly treated as distributions with respect to the Sub stock. See Sparks Nugget, Inc. v. Commissioner, 456 F.2d 631 (9th Cir. 1972) (excessive rental payments from brother corporation to sister corporation were constructive dividends to controlling shareholder, rather than nonshareholder capital contributions). Finally, under a step transaction doctrine analysis, there is also authority to treat these transfers as redemptions by Parent. Regardless, the taxpayer's claimed benefits do not reflect the true economics of the transactions.

OTHER CONSIDERATIONS

The transfers of stock from Sub to the Parent employees do fit within the literal language of the regulations characterizing such transfers as capital contributions, thus we would be arguing that the outcome of a superficially straightforward application of our regulations is wrong. See CSI Hydrostatic Testers, Inc. v. Commissioner, 103 T.C. 398 (1994) aff'd 62 F.3d 136 (5th Cir. 1995); Wyman-Gordon Co. and Rome Industries, Inc. v. Commissioner, 89 T.C. 207 (1987); Woods Investment Co. v. Commissioner, 85 T.C. 274 (1985). In CSI, the court states that the problem with an excess loss account being satisfied by the inclusion of cancellation of indebtedness income in the earnings and profits of an insolvent taxpayer is "a problem of the respondent's [the Commissioner's] own making," because the problem of the excess loss account was the result of the application of our regulations. CSI 103 T.C. at 411. The court in CSI cites Woods to conclude that the court "will apply the consolidated return regulations and the Code as written." Id., citing Woods, 85 T.C. at 282. Representative may argue that this line of cases supports its argument that the characterization of the transfers from Sub to the Parent employees as capital contributions is a problem of our own making, being found in regulations, and must be corrected prospectively.

However, the above-cited cases refer to legislative regulations, and the regulations at issue here, §1.83-6(d), are interpretative regulations. See Joseph v. U.S. Civil Serv. Commissioner, 554 F.2d 1140, 1154 n.26 (D.C. Cir. 1977) ("Legislative rules have the full force of law and are binding on a court subject only to review under an arbitrary and capricious standard. Interpretative rules do not have the force of law and even though courts often defer to an agency's interpretative rule they are always free to choose otherwise."); see also Batterton v. Francis, 432 U.S. 416, 424-26 and n.9 (1977) (same). Thus, interpretative regulations have no authority to create rules contrary to the law, and the law characterizes these transactions as dividends. Interpretative regulations are intended to be reasonable interpretations of the statute, to be read in context and not applied outside of the Code's statutory framework.

As noted above, the transfers nevertheless do fit within more than one Code section; therefore, there is a strong possibility that we could convince a court to consider all the facts and circumstances involved in this case in determining the appropriate tax treatment of the transaction. In addition, there have been recent cases where a court has looked beyond the literal application of certain regulations to the intent of the writers as well as the intent of the taxpayers. See Textron, Inc. v. Commissioner, 115 T.C. No. 6 (2000). Here, on the basis of such authority to consider all the facts and circumstances, the Service could prevail because there is no real business purpose for the transaction that compares to the extraordinary and duplicative tax savings the taxpayer is trying to achieve.

However, more information does need to be gathered on the alleged business purpose. Information submitted by Representative thus far does not conclusively show the necessity for the use of Sub. Representative states that, just prior to these transactions, Parent assumed significant debt that resulted in a credit rating downgrade and made Parent sensitive to its debt-to-equity position. Parent therefore apparently entered into the agreement to repurchase its shares through Sub so that the shares would remain outstanding, and Parent's debt-to-equity position (and therefore its credit rating) would not be affected. However, Representative has not established the effect on Parent's credit rating that would have resulted if Parent had repurchased the stock itself. Nor has Representative established the necessity for the use of outstanding, as opposed to newly issued or treasury, shares of Parent stock to fulfill the stock based compensation obligations. Finally, Representative has not provided any evidence that the value of maintaining Parent's credit rating approaches the value of the tax savings achieved through these transactions.

The business purpose for Sub's purchase and transfer of the Parent shares will affect almost any argument the Service proposes against Taxpayer's characterization of the transaction, especially the economic substance and step transaction arguments, the §269 argument (see below), and the boot in a §351 argument (see below). Therefore, as much information as possible should be obtained and verified about Parent's credit rating and the relative importance of such credit ratings to Parent's business.

Another argument might be made that the liquidation of Sub should be treated not as a taxable §331 liquidation but as tax free under §332. More information should be obtained as to the economics of the participation of X: X's ownership of voting stock prevents Parent from having the control necessary for the liquidation to fall within the language of §332. However, if the facts support that X had truly minimal involvement in the transaction, we could argue that X should be disregarded for purposes of applying §332. However, If X did have involvement, economically or otherwise in the transaction, the §332 argument would be difficult to pursue (as is the step transaction argument for similar reasons). The other litigating hazard here, of course, is that the transaction was structured to take place over more than 3 years, the time requirement within which a liquidation under §332(b)(3) must be accomplished.

Care should also be given to development of facts that diminish the likelihood of the contingencies that Taxpayer has already cited. Taxpayer claims, for example that both the vagaries of the stock market and of Parent's shareholders' inclinations to exercise their options, suggest a lack of prearrangement. [redacted]

[redacted]

Another theory that requires more information regarding the involvement of X is the characterization of the transfers of Parent stock by Sub to Parent employees as boot in the original §351 transaction. [redacted] In some respects, it could be argued that the transfers do seem more like boot than dividends (particularly since they are not contingent on the future earnings of Sub). In Davis v. U.S., 255 F.2d 48 (6th Cir. 1958), the court found a payment made by the corporation to its shareholder four years after the §351 exchange that formed the corporation was boot in the §351 exchange, rather than a dividend. In that case, the parties who formed the corporation were unsure of the value of the property that they were transferring to the corporation and agreed that if a future audit reflected a higher value than that assumed at the transfer, the corporation would pay the transferors any excess. Id. The audit did reflect a higher value, and the Sixth Circuit held that the resulting cash payment to the transferors was boot as an agreed-upon payment as part of the original §351 exchange. Id.

Alternatively, there is a line of cases which hold that continuing payments to shareholders are dividends rather than boot from an original § 351 exchange, based on anticipated earnings of the subsidiary. See Dunn v. U.S., 259 F. Supp. 828 (W.D. Okla. 1966), aff'd 400 F.2d 679 (10th Cir. 1968); Crabtree v. Commissioner, 22 T.C. 61 (1954), aff'd per curiam, 221 F.2d 807 (2d Cir. 1955). However, the facts of Davis seem similar to the facts in this case because the payments of Parent stock from the Sub were agreed upon from the initial §351 transfer, seem more like consideration, and were certainly not made in any anticipation of future earnings of the Sub.

Relying on the argument that these transfers are boot from the original §351 exchange does require distinguishing these payments from the characterization of the payments as dividends. But this is a strong alternative argument because, if the payments of Parent stock are boot, upon each transfer, Parent would reduce its basis in the Sub stock by the fair market value of the Parent stock transferred, pursuant to §358(a)(1)(A). The result would be that Parent would not have a loss to recognize upon the liquidation of Sub because Parent's basis in the Sub stock would have been reduced to the equivalent of the value of the Parent stock that Sub had not transferred.

Section 269(a) states that if control of a corporation is acquired for the principal purpose of securing the benefit of a deduction, credit, or other allowance, then the Secretary may disallow such deduction, credit, or other allowance. Accordingly, §269(a) is not applicable unless the tax evasion or avoidance motive is the principal purpose for the acquisition. In the context of §269, "principal purpose" means that the evasion or avoidance purpose must outrank, or exceed in importance, any other purpose. Capri Inc. v. Commissioner, 65 T.C. 162, 178 (1975). Section 269(a) thus requires the presence of three elements, as follows: (1) an acquisition of control of a corporation, (2) the principal purpose of avoiding Federal income tax, and (3) securing the benefit of a deduction, credit or other allowance which would not otherwise be enjoyed. See Cromwell Corp., et. al. v. Commissioner, 43 T.C. 313, 318 (1964).

Control for the first element is the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of the shares of all classes of stock of the corporation. Acquisition of control can be the formation of a controlled corporation. James Realty Co. v. U.S., 280 F.2d 394 (8th Cir. 1960). Sub was not newly created; Parent's direct control of Sub was achieved by a transfer of all the issued and outstanding stock of Sub to Parent by another subsidiary of Parent. Representative relies on Challenger Inc. v. Commissioner, T.C. Memo 1964-338, to argue that §269(a) does not apply to the use of existing subsidiaries. In Challenger, the subsidiary was created with a business purpose, then had fallen dormant because the majority of its business operations (slot machines) were outlawed. The court concludes that the use of these corporations does not fall within the definition of an acquisition of control for application of §269. Id.

However, the facts in Challenger can be distinguished from the facts in this case. The mere fact that a subsidiary used for tax avoidance reasons was in existence at the time the transaction took place to evade tax should not be allowed to circumvent §269. Here, Sub had no earnings and profits and had not engaged in any business until Parent acquired direct control and made the initial transfer of cash to it. Sub therefore had no value until it engaged in this scheme. The relative value of the acquired tax benefit of the eventual liquidation that duplicates the §83 deductions is enormous when compared to the economic profit of Sub, which is literally nothing. The Senate Report for §129, the predecessor section to §269, states that the aim of §129 is to prevent "perverting deductions ... so that they no longer bear a reasonable business relationship to the interest or enterprises which produced them and for the benefit of which they were provided." S. Rep. No. 627, 78th Cong., 1st Sess. 58 (1943). The original investment into Sub by Parent is made with the end goal of duplicating a loss, which may satisfy both the first and second prongs of the §269 test.

In addition, the second prong, that the principal purpose of the transaction is the avoidance of federal income tax, is clearly satisfied here. Although Representative argues that the transaction was engaged in for legitimate business purposes, as discussed above, Representative has not provided sufficient evidence to establish such a business purpose. In addition, the resultant magnitude of evasion or avoidance of federal income taxes in this transaction exceeds any purported business purpose.

The third prong, that the deduction would not have otherwise been enjoyed, presents another argument. Parent is entitled to one deduction for the expenditure that it incurred in the compensation of its employees through its stock option plans. Parent duplicated that deduction through the use and liquidation of Sub. The duplicated deduction would not have been enjoyed without the use of the Sub. The here is that §269 has generally been used for the disallowance of deductions for losses that occurred before the acquisition of the loss corporation. See, e.g., Collins v. U.S., 303 F.2d 142 (1st Cir. 1962) (where a parent corporation acquired a corporation with significant operating losses was denied deductions for those losses under §269 because the parent was found to have acquired control of the loss corporation with tax avoidance motives). However, although §269 has been applied to pre-acquisition losses, there is nothing in the literal language of the statute which precludes the application of §269 to post-acquisition losses. In fact, in §1.269-3(b)(1), in illustrating transactions indicative of a tax avoidance purpose, there is an example where a corporation acquires control of another with “current, past, or *prospective* credits, deductions, net operating losses or other allowances (emphasis added).” Thus, the idea that the losses to be deducted which otherwise would not have been enjoyed would be incurred after the acquisition of control has been considered and approved, at least in regulations. The added advantage of making an argument under §269 is the focus on the principal purpose of tax avoidance, and, if it prevails, the remedy is a simple denial of the loss on the liquidation of the Sub.

If these transfers are treated as capital contributions under §1.83-6(d), Representative asserts that there are no immediate tax consequences and Sub is entitled to increase the basis of its shares of Parent stock by the amount of its basis in the property transferred to the corporation. Commissioner v. Fink, 483 U.S. 89, 94 (1987). Therefore, if §1.83-6(d) supports treating the transfers of Parent stock by Sub to Parent as capital contributions, Sub should not have any gain or loss on such transfers and should be able to add its basis in the transferred stock to the basis of its remaining Parent stock.

Although we cannot disagree with Representative’s assertions that, if these transfers are treated as capital contributions, the basis in transferred shares shifts to Sub’s remaining Parent stock, Representative’s foundation for this conclusion and treatment, the Fink case, first requires the demonstration of an investment motive to reach the capital contribution conclusion.

In Fink, a husband and wife, who were the dominant shareholders in a closely held corporation, voluntarily surrendered some of their shares to the corporation in an effort to increase the attractiveness of the corporation to outside investors. The Supreme Court found that the Finks had exhibited an investment motive through their intention to bolster the financial condition of the corporation and to enhance the value of their remaining shares. The Court thus held that the Finks had made a contribution to the capital of the corporation and opined that the holding also drew support from two other sections of the Code, one of which was §83. The Court recognized that, although Congress was concerned in §83 with transfers of restricted stock to employees as compensation rather than surrenders of stock to improve a corporation's financial condition, both cases require that "the shareholder's underlying purpose be to increase the value of his investment." Commissioner v. Fink, 483 U.S. 89, n. 14.

Representative has argued that, before the enactment of §83, it was unclear whether transfers by a shareholder would be capital contributions or would be entitled to ordinary loss treatment. See Downer v. Commissioner, 48 T.C. 86 (1967). Taxpayers took the position that they were entitled to an ordinary loss, and the Service took the position that the surrenders of stock were capital contributions. Id. Representative argues that since the enactment of §83, however, it is clear that no other characterization of non-pro rata surrenders of stock is appropriate, nor should any of the considerations that were taken into account prior to §83 be of any importance. However, the language of the Supreme Court in Fink directly contradicts such a proposition. The Court, interpreting Congressional intent, considered the shareholders' underlying purpose in making the transfers to their corporation and concluded that the purpose was to increase the value of the shareholders' investment. In a footnote, the Court also queried Congressional intent with respect to §83 transfers.

In this case, Sub has no investment motive in transferring the Parent stock to Parent employees; Sub simply is making a distribution of appreciated property in satisfaction of its shareholder's obligation to compensate its employees. The most realistic explanation for Sub's transfers of Parent stock is that the transfers are being made at the direction of Sub's controlling shareholder, Parent. As discussed above, such transfers are thus properly treated as distributions with respect to the Sub stock and are subject to the rules of §§301, 311, and 316. See Sparks Nugget, Inc. v. Commissioner, supra.

Also to be considered, the Supreme Court recently decided a tax case using an extremely narrow, textual reading of the Code. Gitlitz v. Commissioner, 2001 U.S. LEXIS 638. In that case, an S corporation's shareholders had increased the bases in their stock in the amount of discharge of indebtedness income, even though §108 would exclude the discharged amount under an exclusion for insolvent taxpayers. The Commissioner argued, among other things, that the exclusion under §108 changes the character of the income such that it is not an item of income for purposes of §1366, which would therefore not increase in the shareholders' bases. The Commissioner further argued, and the dissent agreed, that other provisions of §108 are inconsistent with the shareholders' treatment (specifically, that §108(d)(7)(A) mandates that the discharged debt amount be determined and applied to reduce tax attributes "at the corporate level," rather than at the shareholder level). Despite this apparent ambiguity in Code language and the policy reasons against protecting this loophole, the Court held that excluded discharge of debt is an item of income that passes through to shareholders, increasing their stock bases, and that the increase occurs before they are required to reduce the S corporation's tax attributes. Id. Thus, in light of Gitlitz, however strong the policy arguments are against allowing the duplicated deductions to Parent here, there also needs to be strong textual support for the Service's position. The fact that the transfers from Sub to the Parent employees are distributions with respect to stock under §301 and the long line of cases that support treating the true substance of the transaction without respect to the form should provide such textual support.

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