DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: Area Counsel (Heavy Manufacturing, Construction, and Transportation: Edison)

FROM: Eliana Dolgoff, Assistant to the Branch Chief, CC:INTL:4

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated October 22, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Year1 = ____

Taxpayer =

US1 =

FC1 =

Country1 =

Holdings =

Country2 =

Date1 =

Date2 =

Date3 =

X =

ISSUES

1. Treating the Contributions and the Holdings Transaction as two separate and distinct transactions, was Taxpayer required to recognize gain, pursuant to § 367(a)(1), on the transfer of the 10/50 Corporations to Holdings?

2. Treating the Contributions and the Holdings Transaction as two separate and distinct transactions, what are the § 367(a) and (b) consequences of the transfer of the CFC stock to Holdings?

3. Should the step-transaction doctrine be applied to amalgamate into one transaction the Contributions and the Holdings Transaction?

4. Treating the Contributions and the Holdings Transaction as one transaction, was Taxpayer required to recognize gain realized on the transfer of the shares of the CFCs and 10/50 Corporations to Holdings pursuant to § 367(a)?

CONCLUSIONS

1. Provided that Taxpayer correctly valued the shares of the 10/50 Corporations, if the Contributions and Holdings Transaction are treated as two separate and distinct transactions, § 367(a) does not apply to the transfer of the 10/50 Corporations stock to Holdings because no gain was realized as a result of the transfer. If Taxpayer incorrectly valued the stock, and the stock actually had a built-in gain, then Taxpayer was required to enter into a 10-year gain recognition agreement ("GRA") in order to avoid gain recognition. Taxpayer filed a GRA, but it was for the wrong term of years. Also, Taxpayer failed to comply with § 6038B, as required by Temp. Treas. Reg. § 1.367(a)-3T(g). Therefore, if the 10/50 Corporation stock was appreciated, the transfer of that stock should constitute a taxable transaction. Penalties for failure to comply with § 6038B may also apply. See § 6038B, as in effect in Year1.

2. If the Contributions and the Holdings Transaction are treated as two separate and distinct transactions, § 367(a)(1) does not apply to the transfer of the CFC stock to Holdings. Taxpayer may have to recognize gain pursuant to § 367(b). See Temp. Treas. Reg. § 7.367(b)-1(b).

3. Based on the information submitted, the step-transaction doctrine should be applied to amalgamate the Contributions and the Holdings Transaction into one transaction.

4. If the Contributions and the Holdings Transaction are treated as one transaction, § 367(a) may require Taxpayer to recognize gain realized on the transfer of the CFCs and the 10/50 Corporations stock to Holdings.

FACTS

Taxpayer, a domestic corporation, was a wholly owned subsidiary of US1, a domestic corporation. US1 was the wholly owned subsidiary of FC1, a Country1 company classified as a foreign corporation for U.S. tax purposes. Taxpayer was the sole owner of Holdings, a Country2 limited liability company classified as a foreign corporation for U.S. tax purposes.

Taxpayer owned 100 percent of the stock of 32 controlled foreign corporations ("CFCs") as defined in § 957(a). Taxpayer also had ownership interests (between 10 and 50 percent) in three other foreign corporations (the "10/50 Corporations") that were not CFCs. Some of the stock in the CFCs had a built-in loss and some had a built-in gain. Taxpayer had an aggregate built-in loss in the stock of the CFCs and 10/50 Corporations.

In Date1, Taxpayer contributed all of its stock interests in the CFCs and the 10/50 Corporations to Holdings (the "Contributions"). Although Taxpayer asserts that the 10/50 Corporations stock had a built-in loss, Taxpayer filed a GRA for the contribution of the 10/50 Corporations stock. It did not file a GRA for the CFC stock. Subsequent to the Contributions, US1 merged into Taxpayer and Taxpayer survived the merger. The merger was effective as of Date2. In accordance with the Plan and Agreement of Merger, FC1 exchanged all of its US1 stock for all of the stock in Taxpayer.

On Date3, pursuant to the Agreement for Purchase of a Portion of the Shares of Taxpayer, Taxpayer transferred all of the Holdings Stock to FC1 and Taxpayer received X percent of its stock from FC1 (the "Holdings Transaction"). Taxpayer has taken the position that the Holdings Transaction qualifies as a transaction described in § 355.

LAW AND ANALYSIS

A. Consequences if the Contributions and Holdings Transaction are Separate and Distinct

1. The Contribution of the 10/50 Corporations to Holdings

Based on the information submitted, the transfer of the stock of the CFCs and the 10/50 Corporations from Taxpayer to Holdings may be treated as a transfer of property to a controlled corporation in exchange for stock in the controlled corporation without recognition of gain or loss pursuant to § 351. The Contributions would qualify as § 351 transactions because Taxpayer owned 100 percent of the stock of Holdings after the Contributions, thus satisfying the control requirement of § 368(c).

Additionally, the transfer of the stock of the CFCs would qualify as "B" reorganizations under § 368(a)(1)(B) whereby one corporation acquires the stock of another corporation in exchange for all or part of the acquiring corporation's voting stock and the acquiring corporation is in control of the other corporation after the acquisition. Holdings would be in control of each of the CFCs and could be deemed to have constructively issued its voting stock in the exchanges. Because before the transfer Taxpayer owned 100% of the voting stock of Holdings, we assume Holding's only class of stock, issuance of new voting stock would have been a meaningless gesture. See Commissioner v. Morgan, 288 F.2d 676 (3d Cir. 1961); G.D. Searle & Co. v. Commissioner, 88 T.C. 252, 356 (1987); Rev. Rul. 64-155, 1964-1 C.B. 138. See also § 367(c). The transfers of stock of the 10/50 Corporations, however, would not qualify as "B" reorganizations since Holdings (the acquiring corporation) would not control the 10/50 Corporations for purposes of § 368(c).

Section 367(a)(1) provides that if in connection with any exchange described in § 332, 351, 354, 356, or 361, a U.S. person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation. Section 367(a)(1) denies nonrecognition treatment only to transfers of items of property on which gain is realized. Temp. Treas. Reg. § 1.367(a)-1T(b)(1). If Taxpayer correctly valued the 10/50 Corporations, then § 367(a)(1) would not deny nonrecognition treatment to the contribution by Taxpayer of the 10/50 Corporations to Holdings (the "10/50 Contribution"), as Taxpayer did not have any inherent gain in the stock of the 10/50 Corporations.

If Taxpayer incorrectly valued the 10/50 Corporations and Taxpayer had inherent gain in any of the stock of the 10/50 Corporations, § 367(a) would apply to the transfer of the 10/50 Corporations stock that has built-in-gain, assuming the 10/50 Contribution is a transaction described in § 351. Because the transfer of the 10/50 Corporations stock occurred prior to July 20, 1998 (the effective date of final regulations governing the transfer of foreign stock under § 367(a)), the transfers are subject to the rules of Temp. Treas. Reg. § 1.367(a)-3T and Treas. Reg. § 1.367(a)-3(g) (incorporating the rules of Notice 87-85, 1987-2 C.B. 395). Under those rules, a U.S. transferor that transfers foreign stock in an exchange described in § 367(a) and that owns at least 5 percent of either the total voting power or the total value of the stock of the transferee foreign corporation immediately after the transfer (a 5-percent shareholder) may qualify for nonrecognition treatment by filing a GRA in accordance with Temp. Treas. Reg. § 1.367(a)-3T(g). The duration of the GRA is 5 years if all U.S. transferors, in the

aggregate, own less than 50 percent of both the total voting power and the total value of the transferee foreign corporation immediately after the transfer. In all other cases the duration is 10 years. But see Treas. Reg. § 1.367(a)-3(f). If a 5-percent shareholder fails to properly enter into a GRA, the exchange is taxable to such shareholder under § 367(a)(1). Treas. Reg. § 1.367(a)-3(g).

Applying the foregoing rules to Taxpayer, if any of the 10/50 Corporations stock had a built-in gain, Taxpayer was required to file a 10-year GRA in accordance with Temp. Treas. Reg. § 1.367(a)-3T(g) to obtain nonrecognition treatment on the transfer of the appreciated stock. Taxpayer filed a 5-year GRA with respect to the transfer of the 10/50 Corporations to Holdings. However, Taxpayer should have entered into a 10-year GRA, because Taxpayer owned 100 percent of the stock of Holdings after the Contributions. Also, the GRA should have been filed in accordance with the rules of Temp. Treas. Reg. § 1.367(a)-3T(g), which requires the transferor to comply with § 6038B. In this case, Taxpayer failed to file Form 926, and therefore, failed to comply with § 6038B. Because of these failures, if the stock was appreciated, the transfer of the stock should constitute a taxable transaction. Taxpayer may also be subject to penalties under § 6038B for failure to comply with that section. Under § 6038B as in effect in Year1, the penalty would be equal to 25 percent of the amount of gain realized on the exchange. Taxpayer may avoid the penalties if Taxpayer can show that the failure was due to reasonable cause and not to willful neglect.

2. The Contribution of the CFCs to Holdings

Section 367(b) provides that in the case of any exchange described in § 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in § 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes.

Temp. Treas. Reg. § 7.367(b)-4(b)(1) provides that if an exchange of stock in a foreign corporation (whether or not a CFC) by a U.S. person (whether or not a U. S. shareholder within the meaning of Temp. Treas. Reg. § 7.367(b)-2(b)) pursuant to a reorganization described in § 368(a)(1)(B) involving a foreign corporation transferee is described in § 351 or § 361 as well as in § 354, such exchange is not an exchange described in § 367(a)(1), and if the exchanging shareholder is a U.S. shareholder (within the meaning of Temp. Treas. Reg. § 7.367(b)-2(b)) of the corporation whose stock is exchanged, then the exchange is subject to the rules of Temp. Treas. Reg. § 7.367(b)-7, and Temp. Treas. Reg. §7.367(b)-4(b)(1)(i)(B) may require the exchanging shareholder to recognize gain. Temp. Treas. Reg. §7.367(b)-4(b)(2)(ii) provides that if the transferee corporation is a CFC after the transfer, and the exchanging shareholder is a U.S. shareholder (within the meaning of Temp. Treas. Reg. § 7.367(b)-2(b)) of the corporation whose stock is exchanged both before and after the transfer and of the transferee corporation after the transfer, then Temp. Treas. Reg. § 7.367(b)-4(b)(1)(i)(B) shall not apply.

Assuming the contribution by Taxpayer of the CFCs to Holdings (the "CFC Contribution") is a transaction described in both § 351 and § 368(a)(1)(B), § 367(a)(1) does not apply to the CFC Contribution. See § 367(a)(2) and Temp. Treas. Reg. § 1.367(a)-3T(b). Furthermore, § 367(b) applies, but does not result in any gain recognition or income inclusion to Taxpayer under Temp. Treas. Reg. § 7.367(b)-4(b)(1)(i)(B) and Temp. Treas. Reg. § 7.367(b)-7 because Holdings, the transferee corporation, is a controlled foreign corporation after the CFC Contribution, Taxpayer, the exchanging shareholder, is a U.S. shareholder of the contributed CFCs before and after the CFC Contribution, and Taxpayer is a U.S. shareholder of Holdings after the CFC Contribution.

Temp. Treas. Reg. § 7.367(b)-1(c) provides the reporting requirements for transactions described in § 367(b). Temp. Treas. Reg. § 7.367(b)-1(c)(1) generally provides that if any person referred to in § 6012 (relating to the requirement to make returns of income) realized gain or other income (whether or not recognized) on account of any exchange to which § 367(b) applies, such person must file a notice of such exchange on or before the last date for filing a Federal income tax return (taking into account any extensions of time therefor) for the person's taxable year in which gain or other income is realized. Temp. Treas. Reg. § 7.367(b)-1(c)(2) details the information that must be included in the notice.

In general, if a taxpayer fails to comply with Temp. Treas. Reg. § 7.367(b)-1 through Temp. Treas. Reg. § 7.367(b)-12, the Commissioner shall make a determination whether a foreign corporation will be considered to be a corporation based on all the facts and circumstances surrounding the failure to comply, and in making this determination the Commissioner may conclude that:

(1) A foreign corporation will be considered to be a corporation despite the failure to comply;

(2) A foreign corporation will be considered to be a corporation provided that the conditions imposed under Temp. Treas. Reg. § 7.367(b)-4 through Temp. Treas. Reg. § 7.367(b)-12 are fulfilled; or

(3) A foreign corporation will not be considered to be a corporation only for purposes of determining the extent to which gain shall be recognized on such exchange but that any gain recognized by reason of the Commissioner's determination to disregard the corporate status of a foreign corporation will be taken into account for purposes of applying the provisions of § 334, 358 or 362. See Temp. Treas. Reg. § 7.367(b)-1(b).

Temp. Treas. Reg. § 7.367(b)-1(c)(3) provides that if a person required to give notice under Temp. Treas. Reg. § 7.367(b)-1(c)(1) fails to provide, in a timely manner, information sufficient to apprise the Commissioner of the occurrence and nature of an exchange to which § 367(b) applies, the taxpayer will be considered to have failed to

comply with the provisions of Temp. Treas. Reg. § 7.367(b)-1 through Temp. Treas. Reg. § 7.367(b)-12 only if the taxpayer fails to establish reasonable cause for the failure.

Based on the information submitted, Taxpayer has not complied with the reporting requirements under Temp. Treas. Reg. § 7.367(b)-1(c) with respect to the CFC Contribution. Therefore, unless Taxpayer can establish reasonable cause for the failure, the Commissioner must determine whether the foreign corporations involved in the exchange will be considered corporations, and in making this determination the Commissioner may conclude that they will not be considered corporations for purposes of determining whether gain must be recognized on the exchange.

Although beyond the scope of this Chief Counsel Advice, we note that there is another issue presented by this case. The issue concerns the basis that Taxpayer takes in its Holdings stock upon the transfer of the CFCs and 10/50 Corporations to Holdings.

B. Application of Step-Transaction to the Contributions and Holding Transaction

If the step-transaction doctrine is applied, both of the transactions are treated as if they were part of a plan in which both transactions, or steps, are condensed as a singular transaction. The purpose in applying the step-transaction doctrine is to combine the single steps of a transaction into one that would reveal the true nature of the transaction. The step-transaction doctrine can be applied where the steps are interdependent and would not have taken place without each other, where the steps were part of a singular plan intended to reach a certain result, or where the taxpayer was under a “binding commitment” to take both steps.

Based on the information submitted, we conclude that the step-transaction doctrine should be applied in this case because it appears that the first step in the transaction (transfer of the CFCs and 10/50 Corporations stock to Holdings) would not have occurred but for the second step, the subsequent transfer of all of the stock of Holdings to FC1. Therefore, the Contributions and the Holdings Transaction were part of a singular, integrated plan to transfer the stock of the foreign corporations (the CFCs, the 10/50 Corporations, and Holdings) to the foreign parent (FC1).

Stepping the transactions, the singular transaction (the “Combined Transaction”) could be treated as including a reorganization under § 368(a)(1)(D), provided the distribution of the stock of Holdings to FC1 qualifies under § 355. A “D” reorganization occurs when a corporation transfers all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under § 354, § 355, or § 356. In the instant case, Taxpayer transferred assets to its wholly owned

subsidiary, Holdings, and then, *arguendo*, pursuant to the same plan, distributed all of the stock of Holdings to FC1 in a transaction that qualifies under § 355. If the Combined Transaction qualifies as a "D" reorganization, § 367(a)(5) may apply to the transfer of assets by Taxpayer to Holdings, which would constitute a transaction described in § 361(a). To determine whether § 367(a)(5) applies, additional factual information would be needed regarding the Combined Transaction and the entities involved the Combined Transaction.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We recommend that the field continue to work with the National Office to develop the § 367(a)(5) argument. To help develop the § 367(a)(5) argument, we recommend that the field determine [redacted]

[redacted]

[redacted]

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Please call (202) 622-3860 if you have any further questions.

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