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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
ASSOCIATE AREA COUNSEL

FROM: Sean P. Duffley
Assistant to the Chief
CC:CORP:B04

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated April 25, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Parent =

Sub 1 =

Sub 2 =

Newco 1 =

Newco 2 =

REIT 1 =

REIT 2 =

POSTU-157411-01

State A	=
Business B	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=
m	=
n	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=

Date 8 =

Year 1 =

Year 2 =

Year 3 =

ISSUES

(1) Whether the deduction of certain losses claimed on the Parent Group’s consolidated return can be disallowed by the application of § 269(a) to (i) the acquisition of Newco 1 by group members, or (ii) Newco 1's acquisition of property from group members.

(2) Whether the deduction of certain losses claimed on the Parent Group’s consolidated return can be disallowed because the transactions giving rise to such deductions lack economic substance, were engaged in solely for tax avoidance purposes, and lack a business purpose.

(3) Whether the payment to terminate the management agreement under the facts presented is ordinary income to the recipient.

CONCLUSIONS

(1) Section 269(a)(1) can be applied to the group members’ acquisition of Newco 1 in order to disallow the deduction of losses claimed by the Parent Group. Alternatively, § 269(a)(1) can be applied to deny the group members nonrecognition treatment on the formation of Newco 1, thereby preventing the members from recognizing losses on their dispositions of Newco 1 stock. Section 269(a)(2) may also apply to Newco 1's acquisition of property from members in the formation, but does not apply to Parent’s later contribution of property to Newco 1.

(2) The deduction of losses by the Parent Group can be disallowed because the formation of Newco 1 and related transactions giving rise to such deductions lack economic substance, were engaged in solely for tax avoidance purposes, and lack a business purpose.

(3) The termination payment received by Sub 2 was in consideration of Sub 2’s relinquishment of rights and/or obligations under the management services agreement. [redacted]

ISSUE ONE: WHETHER THE DEDUCTION OF CERTAIN LOSSES CLAIMED ON THE PARENT GROUP’S CONSOLIDATED RETURN CAN BE DISALLOWED BY THE APPLICATION OF § 269(a) TO (i) THE ACQUISITION OF NEWCO 1 BY GROUP MEMBERS, OR (ii) NEWCO 1'S ACQUISITION OF PROPERTY FROM GROUP MEMBERS

FACTS

Parent, a State A Corporation, is the common parent of a consolidated group (“the Parent Group”). Sub 1 and Sub 2 are wholly owned subsidiaries of Parent. Parent and its various subsidiaries engage principally in Business B.

Our advice has been requested with respect to two transactions engaged in by Parent and members of the Parent Group during the Year 1 and Year 3 taxable years, which are described separately below.

Transaction One

On Date 1, in a transaction purporting to qualify as a § 351 exchange, the following events occurred:

(i) Parent transferred cash to a newly incorporated subsidiary, Newco 1, in exchange for 100 percent of the Newco 1 common stock and shares of Newco 1 preferred stock;

(ii) Sub 1 transferred non-performing loans and certain assets with a tax basis in excess of their fair market value (i.e., built-in loss assets or “BIL assets”) to Newco 1 in exchange for shares of Newco 1 preferred stock and cash; and

(iii) Sub 2 transferred BIL assets to Newco 1 in exchange for shares of Newco 1 preferred stock, cash, and Newco 1’s own note (hereafter, all three steps together referred to as the “Formation”).

It is our understanding that, immediately after the Formation, Parent, Sub 1, and Sub 2 together owned stock representing 100 percent of the outstanding vote and value of Newco 1.

The taxpayer maintains that Newco 1 was formed to hold the non-performing assets of other members of the Parent Group. Newco 1 had no employees during Year 1 or Year 2 and paid no salaries or wages. In Year 3, an intercompany allocation of wages was made to Newco 1 to reflect services performed for Newco 1 by employees of other Parent Group members. In Year 3, Newco 1's only additional activity was to hold the REIT 1 interest received in the Contribution, as described below under Transaction Two.

Also on Date 1, Parent formed Newco 2 as a wholly owned subsidiary, with zero capitalization from Parent. On the same day, Newco 2 borrowed cash from Newco 1 (which constituted all of the cash remaining in Newco 1 after the Formation) in exchange for a note receivable (the "Newco 2 Note"). No payments were ever made on the Newco 2 Note. According to the taxpayer, the business purpose for forming Newco 2 was to provide an entity to invest in various unspecified business opportunities. During Years 1 through 3, Newco 2 had no employees and engaged in no additional activity.

Also on Date 1, and immediately following the above described events, Sub 1 and Sub 2 each sold all of the Newco 1 preferred stock received in the Formation to an unrelated corporation, recognizing substantial losses with respect thereto (together "Stock Disposition One"). These losses were reported on the Parent Group's Year 1 consolidated return where, after taking into account the limitations provided by § 1.1502-20, they served to offset income of the group.

In computing the amount of loss allowable under § 1.1502-20(c) with respect to Stock Disposition One, the taxpayer treated the Newco 2 Note held by Newco 1 as an intercompany security within the meaning of § 1.1502-20(c)(2)(vi)(A)(1), and consequently excluded this amount from the duplicated loss component of § 1.1502-20(c)(1)(iii). Use of the Newco 2 Note served significantly to reduce the amount of duplicated loss that would otherwise have resulted, thereby reducing the amount of loss disallowed (and consequently increasing the amount of allowable loss) on Stock Disposition One.

In Year 3, Newco 1 sold a portion of the BIL assets it had received from Sub 2 in the Formation, recognizing a loss with respect thereto ("Asset Disposition One"). This loss was reported on the Parent Group's Year 3 consolidated return.

Transaction Two

On Date 2, in a transaction purporting to qualify under § 351, Parent transferred common stock in REIT 1 (which stock had a basis substantially in excess of its fair market value) to Newco 1 in exchange for newly issued Newco 1 preferred stock and Newco 1's own note (the "Contribution"). On Date 3 (which date is within the same taxable year as the Contribution), Parent sold all of the Newco 1 preferred stock received in the Contribution to five of its managers, recognizing substantial losses with respect thereto ("Stock Disposition Two"). These losses were reported on the Parent Group's Year 3 consolidated return where, after taking into account the limitations provided by § 1.1502-20, they served to offset income of the group.

Over several months during Year 3, Newco 1 sold all of the REIT 1 common stock received in the Contribution on the open market, recognizing substantial losses with respect thereto ("Asset Disposition Two").

LAW AND ANALYSIS

Section 269(a) provides as follows:

> (a) In General. – If –
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> (1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or
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> (2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,
>
> and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means 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 shares of all classes of stock of the corporation.

I. APPLICATION OF § 269(a)(1)

There are three conditions for the application of § 269(a)(1): (1) a person or persons acquire, directly or indirectly, control of a corporation, (2) the principal purpose for the acquisition is to evade or avoid Federal income tax, (3) by securing the benefit of a deduction, credit, or other allowance that would not otherwise be enjoyed.

A. Acquisition of Control

The first requirement is that a person or persons must acquire control of a corporation. As a threshold matter, the term "person" is broadly defined to include an individual, trust, estate, partnership, association, company, or corporation. § 7701(a)(1); § 1.269-1(d). For purposes of § 269(a), control is the ownership of stock having at least 50 percent of the combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of all shares of all classes of stock. § 269(a) (flush language); § 1.269-1(c).

It is well established that the creation of a new corporation may constitute an acquisition within the meaning of § 269(a)(1). James Realty Co. v. United States, 280 F.2d 394, 399 (8th Cir. 1960); Borge v. Commissioner, 405 F.2d 673,677-78 (2d Cir. 1968). See §§ 1.269-1(c) and 1.269-3(b). The Formation of Newco 1 by Parent, Sub 1, and Sub 2 therefore satisfies the acquisition of control requirement of § 269(a)(1) because Parent, Sub 1, and Sub 2 together owned all of the outstanding stock of Newco 1 immediately after the transaction.

B. Principal Purpose to Evade or Avoid Tax

The second requirement is that the acquisition must have had as its principal purpose the evasion or avoidance of Federal income tax. To constitute the principal purpose, the purpose to evade or avoid Federal income tax must outrank, or exceed in importance, any other purpose. Canaveral Int'l Corp. v. Commissioner, 61 T.C. 520, 536; § 1.269-3(a). This is a question of fact, to be determined by considering all the facts and circumstances of the entire transaction, with the burden of proof on the taxpayer. J.T. Slocomb Co. v. Commissioner, 334 F.2d 269, 273 (2d Cir. 1964); § 1.269-3(a). Under this standard, the purpose that is relevant is the purpose which existed at the time of the acquisition, although facts occurring prior to and following the transaction may be considered to the extent that they tend to support or negate the forbidden purpose. Hawaiian Trust Co. v. United States, 291 F.2d 761, 768 (9th Cir. 1961).

The facts of this case suggest that the Formation of Newco 1 and subsequent transactions (specifically, Stock Disposition One and Asset Disposition

One) were undertaken for the principal purpose of avoiding Federal income tax.[1] Indeed, the transactions display sophisticated tax planning. The taxpayer has stated that the business purpose for the formation of Newco 1 was to house non-performing assets, which was accomplished by the asset transfers by Sub 1 and Sub 2 in the Formation. The evidence of business purpose, however, must be weighed against the significant tax savings produced by the transactions. The taxpayer has offered no business purpose for the creation and use of the Newco 2 Note. Because Newco 1 and Newco 2 were formed simultaneously, if the intent was the capitalize Newco 2, Parent could have directly contributed the cash to Newco 2. It appears that the only purpose for these arrangements was to provide Sub 1 and Sub 2 with high basis, low value Newco 1 preferred stock, the immediate disposition of which permitted the Parent Group to accelerate losses, avoid the limitations of § 1.1502-20,[2] and retain the underlying BIL assets for future disposition in Year 3 in order to produce a duplicative benefit.

In addition, we note that Newco 1 had no employees during the years at issue, and apparently engaged in no activity other than lending cash to Newco 2 (also newly organized on the same date as Newco 1) in Year 1, and briefly holding the REIT 1 interest in Year 3. In effect, Newco 1 was a mere shell. Use of a shell corporation may provide evidence that the principal purpose for an acquisition is to obtain tax benefits. See, e.g., Lewisville Investment Co. v. Commissioner, 56 T.C. 770, 780-81 (1971), acq. in part, nonacq. in part, 1976-2 C.B. 2, 3 (finding of principal purpose where shell corporation was organized to obtain benefit of surtax exemption).

C. Securing the benefit of a deduction, credit, or other allowance that would not otherwise be enjoyed

The third requirement is also met in this case. Prior to the Formation, Sub 1 and Sub 2 each held BIL assets, the disposition of which would have resulted in

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[1] The Service can apply § 269 to disallow tax benefits from transactions related to an acquisition of control of a corporation even if the transaction in which control is acquired does not create tax benefits in and of itself. See § 1.269-3(a) (providing that if the principal purpose test is met with respect to an acquisition giving rise to a tax benefit, then “it is immaterial by what method or by what conjunction of events the benefit was sought”). See, e.g., J.T. Slocomb Co., 334 F.2d at 274 (§ 269(a) applied to disallow use of Target’s net operating loss carryovers obtained through purchase of Target’s stock and its subsequent merger with two profitable corporations).

[2] In computing the amount of loss allowable under § 1.1502-20(c) with respect to Stock Disposition One, the taxpayer treated the Newco 2 Note held by Newco 1 as treated as an intercompany security within the meaning of § 1.1502-20(c)(2)(vi)(A)(1), and excluded this amount from the duplicated loss component of § 1.1502-20(c)(1)(iii). Use of the Newco 2 Note in conjunction with the transactions therefore served significantly to reduce the amount of loss disallowed (and consequently to increase the amount of allowable loss) on Stock Disposition One.

losses that the Parent Group could have reported on its consolidated return only once. To the extent that the Formation qualifies under § 351, the contribution of the BIL assets to Newco 1 was intended to allow the Parent Group to enjoy double deductions with respect to these losses: first, when Sub 1 and Sub 2 disposed of the preferred stock received in the Formation, and later when Newco 1 disposed of the BIL assets.[3]

D. Alternative Application of § 269(a)(1)

In addition, § 269 may also be applied to deny the benefits of nonrecognition treatment under § 351 to Parent, Sub 1, and Sub 2 for the Formation. When the requirements of § 269(a) are satisfied, the Service can disallow any deduction, credit, or other allowance resulting from an acquisition. Section 1.269-1(a) defines an "allowance" as anything in the Code that has the effect of diminishing tax liability. The nonrecognition treatment provided by § 351 is therefore an allowance. Because the principal purpose for the Formation appears to have been tax evasion or avoidance, § 269 can apply to prevent nonrecognition treatment, thereby making the Formation a taxable exchange under § 1001. The effect of this treatment is that Parent, Sub 1, and Sub 2 each will take a cost basis under § 1012 in the stock received from Newco 1 on the Formation, thereby eliminating any loss by Sub 1 or Sub 2 on Stock Disposition One.

We note that there are hazards with respect to such an argument. In Cherry v. United States, 264 F.Supp 969 (C.D. Cal. 1967), the Service attempted to deny nonrecognition treatment under §§ 336 and 453. The court held that the statutory provisions dealing with the nonrecognition of gain are not encompassed by the terms "deduction, credit, or other allowance" and that § 269 does not address nonrecognition concepts. See also Bijou Park Properties, Inc. v. Commissioner, 47 T.C. 207 (1966). The Service disagrees with these authorities. Cherry, Ray K., 1969 AOD Lexis 324 (Nov. 20, 1969); Bijou Park Properties, Inc., acq. in result only, 1967 AOD Lexis 41 (Oct. 27, 1967). As discussed above, § 1.269-1(a), promulgated in 1962, provides that the term "allowance" refers to anything in the Code that has the effect of diminishing tax liability. Because the nonrecognition of gain from an exchange of stock has the effect of diminishing tax liability, it is the Service's position that such nonrecognition is an allowance within the meaning of § 269 and, accordingly, § 269 can apply to deny nonrecognition treatment.

[3] The duplication occurs by operation of § 358, which generally provides that the basis of property received in an exchange to which § 351 applies is equal to that of the property exchanged.

II. SECTION § 269(a)(2)

Section 269(a)(2) applies in instances where (1) a corporation acquires property of another corporation, (2) immediately before the acquisition the transferor corporation is not controlled, directly or indirectly, by the acquiring corporation or its shareholders, (3) the acquiring corporation's basis in such property is determined by reference to the basis in the hands of the transferor, and (4) the principal purpose for the acquisition is to evade or avoid Federal income tax by securing the benefit of a deduction, credit, or other allowance that such corporation would not otherwise enjoy.

A. Application of § 269(a)(2) to the Formation

In this case, the Formation satisfies requirement (1) because Newco 1 acquired property from Sub 1 and Sub 2. If the Formation qualifies under § 351, then requirement (3) is also met because Newco 1's basis in the assets received from Sub 1 and Sub 2 would be determined by reference to the basis of such assets in the hands of Sub 1 and Sub 2. § 362.[4]

The principal purpose requirement of item (4) is identical to that discussed above. As one example of a principal purpose to evade or avoid tax, the regulations describe the acquisition by a corporation of property having a carryover basis that is materially greater than its fair market value at the time of the acquisition, which is then used to create tax-reducing losses or deductions. § 1.269-3(c)(1). In the instant case, as discussed supra, the principal purpose for the transfers of BIL assets by Sub 1 and Sub 2 to Newco 1 in the Formation appears to have been the evasion or avoidance of Federal income tax by securing the benefit of duplicative deductions with respect to a single economic loss; i.e., Stock Disposition One followed by Asset Disposition One. Thus, requirement (4) is also met.

Section 269(a)(2) also requires that the acquiring corporation and its shareholders not control the transferor corporation immediately before the transaction (the "common control exception"). In Coastal Oil Storage Co. v. United States, 242 F.2d 396, 399 (4th Circuit), the court held that § 269(a)(2) applied to deny a separate surtax exemption for a newly-formed subsidiary.[5] Under this

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[4] As discussed infra under Issue Two, the Formation may not qualify under § 351.

[5] We note that the Coastal Oil opinion does not specifically address the common control exception in connection with its holding on § 269(a)(2). As additional authority, Example (3) of § 1.269-6 indicates that § 269(a) would apply to a parent corporation's transfer of a profitable business to a recently-acquired subsidiary in a transfer in which the basis of the transferred assets in the hands of the subsidiary is determined by reference to their basis in the hands of the parent. This example implies

authority, because Newco 1 does not control Sub 1 or Sub 2 immediately before the property transfers, requirement (2) may also be satisfied. Thus, § 269(a)(2) also potentially applies to the Formation.

B. Application of § 269(a)(2) to the Contribution

The Contribution satisfies requirement (1) because Newco 1 acquired property (the common stock in REIT 1) from Parent. If the Contribution qualifies under § 351, then requirement (3) is also met because Newco 1's basis in the REIT 1 stock received from Parent would be determined by reference to the basis of such stock in the hands of Parent. § 362.

With respect to requirement (4), we are unable to conclude on the facts presented that the Contribution was made with a principal purpose to evade or avoid tax because of the time frame involved (specifically, the Contribution occurred on Date 2, Stock Disposition Two on Date 3, and Asset Disposition Two over several months during Year 3). We further note the possible application of the common control exception to this factual situation because Parent is both the transferor as well as Newco 1's shareholder immediately before the acquisition.

ISSUE TWO: WHETHER THE DEDUCTION OF CERTAIN LOSSES CLAIMED ON THE PARENT GROUP'S CONSOLIDATED RETURN CAN BE DISALLOWED BECAUSE THE TRANSACTIONS GIVING RISE TO SUCH DEDUCTIONS LACK ECONOMIC SUBSTANCE, WERE ENGAGED IN SOLELY FOR TAX AVOIDANCE PURPOSES, AND LACK A BUSINESS PURPOSE.

In addition to the reasons set forth above, the losses at issue in this case may be disallowed because the transactions lack economic substance, were engaged in solely for tax avoidance purposes, and lack a business purpose.

I. ECONOMIC SUBSTANCE DOCTRINE

Under the economic substance doctrine, sometimes referred to as the sham transaction doctrine, a transaction will not be respected if has no significant economic effects other than the creation of tax benefits. See Gregory v. Helvering, 293 U.S. 465, 469-70 (1935). Courts have developed a two-step approach to the inquiry into whether a transaction has sufficient economic substance to be respected for tax purposes. The first factor, a subjective test, focuses on whether the taxpayer was motivated by a valid business purpose other than to obtain tax

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that the common control exception is inapplicable, perhaps on the grounds that the parent is not literally controlled immediately beforehand by the subsidiary.

benefits. ACM Partnership v. Commissioner, 157 F.3d 231, 253-54 (3rd Cir. 1998), cert. denied, 526 U.S. 1017 (1999). The second factor, an objective test, looks to whether the transaction 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 248-49. United Parcel Service of America, Inc. v. Commissioner, 254 F.3d 1014, 1018 (11th Cir. 2001). While the subjective and objective aspects of the economic substance inquiry have been variously articulated by courts, they "do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis ..." ACM Partnership, 157 F.3d at 247.

On the facts of this case, it appears that the taxpayer carefully structured the transactions (including the formation of Newco 1 and Newco 2, the intercompany loan between them, followed by Stock Disposition One and then Asset Disposition One) in order to duplicate losses within the Parent Group, and then to enjoy the benefit of the deduction of such losses. This was accomplished, in part, through use of the Newco 2 Note, in an attempt to fit within the exception for intercompany securities under § 1.1502-20(c)(2)(vi)(A)(1). The taxpayer has only offered a vague statement for the formation of Newco 2 (to invest in unspecified business opportunities), and its only activity appears to have been the issuance of the Newco 2 Note. The only business purpose offered by the taxpayer to support the formation of Newco 1 was the desire to hold certain non-performing assets of the Parent Group, which was achieved by the asset transfers in the Formation. The immediate dispositions of stock by Sub 1 and Sub 2 on the same date as the Formation, however, strongly suggests that the transactions were entered into to obtain tax benefits. Similarly, there appears to be no non-tax purpose for the Contribution other than to create further double deductions, first through Stock Disposition Two and then through Asset Disposition Two.

II. LACK OF BUSINESS PURPOSE

The taxpayer maintains that the Formation qualifies under § 351. One of the requirements of a § 351 transaction is that it be motivated by a valid business purpose.[6] See Rev. Rul. 55-36, 1955-1 C.B. 340; Caruth v. United States, 688 F. Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd 865 F.2d 644 (5th Cir. 1989) (stating that the business purpose requirement under § 351 is the same as that applicable to reorganizations). As a general rule, a transaction has a business purpose if a taxpayer engages in the transaction for economic, commercial, or legal reasons and not solely or primarily for tax avoidance reasons. Wortham Machinery Co. v. United States, 375 F.Supp. 835, 838 (D. Wyo. 1974), aff'd 521 F.2d 160 (10th Cir.

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[6] We note that although courts have consistently acknowledged this requirement in the § 351 context, they have not imposed a particularly high standard in making this determination.

1975); Gregory, 293 U.S. at 469. A transaction will lack business purpose if the taxpayer engages in the transaction principally or solely to obtain tax benefits. Id.

Determining whether the formation of Newco1 has a bona fide business purpose is a test of facts and circumstances. As discussed above, although the taxpayer states that Newco 1 was formed to hold non-performing assets of the group, it appears that motivation for the formation of Newco 1 (and related transactions) was the taxpayer's effort to secure tax benefits through the duplication of losses within the Parent Group.

ISSUE THREE: WHETHER THE PAYMENT TO TERMINATE THE MANAGEMENT AGREEMENT IS ORDINARY INCOME TO THE RECIPIENT

ADDITIONAL FACTS

In Date 4, Sub 2 entered into an agreement to provide management services to REIT 1 for an initial term of c. The services included the purchase, financing, servicing and administration of d. The agreement expired in Date 5 and Sub 2 and REIT 1 executed a similar agreement for the next e years. Sub 2 also entered into concurrent submanagement agreements with Parent to perform management services for REIT 1 as Sub 2 deemed necessary.

In Date 6, Sub 2 and REIT 1 terminated the management agreement. In consideration for giving up its rights under the agreement, Sub 2 received f shares of REIT 1 stock said to be valued at approximately $g and certain other assets said to be valued at $h.

On the other hand, Sub 2 agreed to cancel a note receivable plus accrued interest from REIT 2. The note was for $i, but with accrued interest the amount cancelled equaled $j. The note arose out of a Date 6 installment sale by Parent of k residual interests in REMICs to Reit 2 for a note of between $l and $m. In Date 8, under a negotiated loan agreement for n of the residual interests, REIT 2 promised to pay $i formalized in a note. The previous note had been reduced through payments of the loan. In Date 6, Parent assigned its rights under the note to Sub 2. Sub 2, REIT 1, Parent, and REIT 2 are all related entities.

We assume for purposes of this memorandum that the payment to Sub 2 was actually to terminate the management agreement described.

LAW AND ANALYSIS

The key issue here concerns the character of the gain Sub 2 should recognize. Generally, for a transaction to result in capital gain or loss instead of ordinary gain or loss, two requirements, set out in I.R.C. § 1222, must be met: first, the transaction must be a "sale or exchange" of property; second, the property must be a "capital asset," which is defined by § 1221 to include all "property," subject to certain limited exceptions. If, in addition, the property has been held for more than one year, the resulting capital gain or loss qualifies as long-term.

Section 1222(2) excludes from the definition of “capital asset” property used in a taxpayer’s trade or business, of a character which is subject to the allowance for depreciation provided in § 167, or real property used in the trade or business. However, if such property is held for more than one year, it qualifies as "property used in the trade or business” under § 1231(b)(1) and is therefore eligible for capital gain treatment, depending on the netting rules and other provisions of § 1231.

Section 1231 provides generally that if § 1231 gains for any tax year exceed section § 1231 losses, the gains and losses shall be treated as long-term capital gains or losses; if § 1231 losses exceed § 1231 gains, the gains and losses are ordinary. Under § 1231(a)(3)(A)(i), the term "section 1231 gain" includes any recognized gain on the sale or exchange of property used in the trade or business, as that term is defined in § 1231(b)(1).

An asset that is not real property must be "of a character which is subject to the allowance for depreciation provided in § 167" in order to qualify as "property used in the trade or business" under § 1231(b)(1). "Depreciation," for this purpose, includes "amortization," a term more often used in connection with intangible assets like contracts. See § 197(f)(7). For this purpose, moreover, an asset does not lose its depreciable "character" because, in a particular instance, the asset has a zero basis and is not actually being depreciated or amortized--either because it has already been fully depreciated, or because no costs were required to be capitalized with respect to the asset.

Like § 1221, § 1231 specifically excludes certain property as ordinary assets. The first two exclusions under § 1231(b)(1), which correspond to the exclusion in § 1221(1), are: (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand of the close of the taxable year; and (B) property held by the taxpayer primarily for sale to customers in the ordinary course of the trade or business.

In the present case, the management agreement itself does not appear to be inventory in the hands of Sub 2. Nor does it appear that the management agreement was held primarily for sale to customers in the ordinary course of Sub 2’s trade or business. If so, the management agreement was not ordinary property subject to the exclusions in § 1231(b)(1)(A) or (B). Thus, the management agreement would appear to be a § 1231 asset--that is, it is depreciable property, used in the trade or business and held for more than one year, which is not itself inventory.

However, we question in the present case is whether there was a “sale or exchange of property” as required by both § 1221 and 1231. Rev. Rul. 75-527, 1975-1 C.B. 30, holds in analogous circumstances that there was no “sale or exchange.” The taxpayer there owned a building that was heated by a central hot water distribution plant, owned by a supplier who had a contract to furnish heat to the building. Because of the expense of maintaining the system, the supplier desired to terminate the contract. The taxpayer accepted the supplier's offer to reimburse the taxpayer for the cost of converting to an individual heating system, in termination of the supply contract. Rev. Rul. 75-527 holds that the amount received by the taxpayer for conversion of the system is includible in gross income as ordinary income, because there was no sale or exchange, in that the taxpayer's right to have the building heated by the central heating plant was extinguished and did not pass to the supplier. The cancellation or release of a contract right does not transfer the right to the transferee-payor and is therefore not a sale or exchange. The ruling cites Leh v. Commissioner, 260 F.2d 489 (9th Cir. 1958), and Commissioner v. Pittston, 252 F.2d 344 (2d Cir.), cert. denied, 357 U.S. 919 (1958), both of which held that gain from the cancellation of a supply contract by the other party to the contract is ordinary.

The position that the mutual relinquishment of simple contractual rights and obligations does not give rise to a capital transaction--variously termed the "extinguishment," "disappearing asset," or "vanishing asset" doctrine--has been the subject of controversy in the courts, and has been criticized as a "formalistic distinction" that ignores economic reality. See Commissioner v. Ferrer, 304 F.2d 125, 131 (2d Cir. 1962). The enactment and subsequent expansion of § 1234A, discussed below, was motivated in part by such criticisms. See S. Rep. No. 33, 105th Cong., 1st Sess. 132, 134-35 (1997). However, as discussed below, § 1234A, even as expanded, does not cover certain transactions, and in recent cases the courts have upheld the continuing validity of the "extinguishment" doctrine.

For example, in Wolff v. Commissioner, 148 F.3d 186 (2d Cir. 1998), the same court that decided Ferrer held that, in a situation not covered by § 1234A, the cancellation of a forward contract in return for a payment is not a "sale or exchange." As a result, the taxpayers' cancellation payments were ordinary losses, even though the economic result was not materially different from a sale or similar disposition of the contract, which would have resulted in capital loss. The Wolff decision followed a similar opinion in the District of Columbia Circuit, Stoller v. Commissioner, 994 F.2d 855 (D.C. Cir. 1993). In another recent case, Nahey v. Commissioner, 111 T.C. 256, 264-65 (1998), aff’d 196 F.3d 866 (7th Cir. 1999), cert. denied, 531 U.S. 812 (2000), the Tax Court held that proceeds from the settlement of a purchased legal claim are ordinary income to the recipient due to the absence of a "sale or exchange," distinguishing Ferrer, and citing, among other cases, Leh.

Further, we question whether the management agreement is "property" if it is for personal services. The term "property" has the same meaning under § 1221 as it has under § 1231. See Hollywood Baseball Assoc. v. Commissioner, 423 F.2d 494 (9th Cir.), cert. denied, 400 U.S. 848 (1970). The Supreme Court has stated it is "evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset"; rather, the term "capital asset" "is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time ... . " Commissioner v. Gillette Motor Co., 364 U.S. 130, 134 (1960) (compensation for temporary seizure of business facilities is ordinary income). Similarly, in denying capital gain treatment to the disposition of certain mineral payments carved out of established oil and gas working interests, the Court observed:

> The lump-sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income. ... In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.

Commissioner v. P.G. Lake, 356 U.S. 260, 265-67 (1958). Thus, ordinary income rather than capital gain results when the taxpayer is compensated for personal services rendered or to be rendered in the future. See Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962) (interest in films to be produced by taxpayer); Vaaler v. United States, 454 F.2d 1120 (8th Cir. 1972) (agency contract with insurance company); Foote v. Commissioner, 81 T.C. 930 (1983) (tenure rights).

On the other hand, as the courts have noted, "[s]imply because the property transferred will produce ordinary income, and such income is a major factor in determining the value of the property, does not necessarily mean that the amount received for the property is essentially a lump-sum substitute for ordinary income." In United States v. Dresser Industries, 324 F.2d 56, 59 (5th Cir. 1963), the court distinguished between proceeds from "the present sale of the future right to earn income [capital gain] and the present sale of the future right to earned income [ordinary income]." In Ferrer, the court distinguished between cases involving "an 'estate' in, or an 'encumbrance' on, or an option to acquire an interest in property which, if itself held, would be a capital asset" and "an opportunity, afforded by contract, to obtain periodic receipts of income, by dealing with another, or by rendering services, or by virtue of ownership of a larger 'estate'." 304 F.2d at 130-131 (cited cases omitted).

Cases dealing with the payment for the cancellation of a contract that have not followed the disappearing asset doctrine have allocated amounts paid to different rights under the contract. Bisbee-Baldwin Corporation v. Tomlinson, 320 F.2d 929 (5th Cir. 1963); Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962). Further, under these cases, rights under a contract are more likely to be capital if they could survive the transfer to a third party.

As indicated above, § 1234A may be applicable to the current case. Section 1234A provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer is treated as gain or loss from the sale of a capital asset.

Section 1234A was enacted, and subsequently modified, to ensure that certain cancellations and similar transactions would be treated as a "sale or exchange," thereby resulting in capital gain or loss. S. Rep. No. 33, 105th Cong., 1st Sess. 132-36 (1997).

Under the facts presented and the assumptions made above, the termination payment received by Sub 2 was in consideration for Sub 2's relinquishment of rights and/or obligations under the management services agreement. [redacted]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

We understand that to date the taxpayer has not made either of the elections available under § 1.1502-20T(i)(2) for determining the amount of allowable loss on either Stock Disposition One or Stock Disposition Two. Please contact our office for further advice on the application of § 1.1502-20T(i) and/or § 1.337(d)-2T if the taxpayer subsequently makes either of these elections.

[redacted]

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call   if you have any further questions.

Associate Chief Counsel (Corporate)

By: ____________________

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