IRB 2023-11
March 13, 2023

ACTION ON DECISION

Subject: Complex Media, Inc. v. Commissioner,
T.C. Memo. 2021-14
Tax Court Docket No. 13368-15 & 19898-17

Issues

Issue 1

Whether the petitioner ("Taxpayer") was bound by the form of a series of transactions, as consistently provided in the agreements among the parties ("Agreements") and as implemented, which form resulted in assets received by Taxpayer having carryover basis with no step-up.

Issue 2

Whether the fair market value of a "Deferred Payment Right" (described below) for purposes of section 351(b)(1) is equal to its issue price.

Discussion

Issue 1

a. The Transactions

Taxpayer was incorporated by a partnership ("Partnership") to engage in a series of transactions in November 2009. The transactions were memorialized in the Agreements and were implemented consistently with the terms thereof. Based on the Agreements and as implemented, the transactions consisted of the following steps:

i. Partnership transferred the tangible and intangible assets of its publishing business ("Transferred Assets") to Taxpayer in exchange for Taxpayer common stock ("Exchange").

ii. A newly formed subsidiary of Taxpayer was merged ("Merger") into an unrelated corporation ("Target") the principal asset of which was cash. Target survived the Merger as a wholly owned subsidiary of Taxpayer; holders of Target preferred stock received Taxpayer convertible preferred stock in exchange for their Target stock; and the common stock of Target was cancelled for no consideration.

iii. Taxpayer redeemed from Partnership some of the common stock Taxpayer had issued in the Exchange ("Redemption"). The price Taxpayer paid for the redeemed stock ("Redemption Proceeds") was $2.7 million cash and a right to a $300,000 deferred payment ("Deferred Payment Right").

iv. Partnership distributed the Redemption Proceeds to one of its partners ("Liquidated Partner") in complete liquidation of his interest in Partnership.

v. Taxpayer made the deferred payment when due, 13 months after the redemption.

b. Federal Income Tax Treatment of the Exchange, the Merger, and the Redemption

The Service, the parties, and the court all agreed that the Exchange and the Merger should be treated, not as separate transactions, but as a single transaction in which Partnership transferred the Transferred Assets, and the holders transferred the Target preferred stock, to Taxpayer in exchange for all the stock of Taxpayer. This transaction was subject to section 351 ("Section 351 Transaction"). Thus, the transferors (Partnership and the former Target shareholders) would recognize gain only to the extent of any money or property, other than Taxpayer stock, that they received (referred to as "boot"). Under section 362(a), the basis of the transferee (Taxpayer) in the Transferred Assets was the same as Partnership's basis, increased by the amount of any gain the transferors recognized.[1]

The Service and the parties disagreed, however, as to the proper treatment of the Redemption. The Service's position was that, in accordance with the form of the transactions, the Redemption was a transaction separate from the Section 351 Exchange, and therefore Taxpayer's basis in the Transferred Assets was the same as Partnership's basis with no increase. Taxpayer's position was that Partnership received the Redemption Proceeds as boot in the Section 351 Transaction, so that Taxpayer was entitled to increase its basis in the Transferred Assets by the amount of the Redemption Proceeds. The court agreed with Taxpayer.

c. Reporting of the Transactions on 2009 Federal Income Tax Returns

i. Taxpayer

With its 2009 Form 1120, Taxpayer filed the Information Reporting Statement required by Treas. Reg. § 1.351-3 ("Taxpayer Statement"), with respect to the Section 351 Transaction. On the Taxpayer Statement, Taxpayer reported its receipt of the Transferred Assets in exchange for only Taxpayer stock, with no boot. Consistent with its reporting of the Section 351 Transaction, on its 2009 return Taxpayer reported deductions for amortization of the Transferred Assets based on carryover basis with no increase. Taxpayer did not submit any information relating to the Redemption.

[1] The Merger was also intended to qualify as a reorganization under sections 368(a)(1)(A) and 368(a)(2)(E), but Taxpayer did not file the required statement under Treas. Reg. § 1.368-3(a). Qualification of the Merger as a reorganization would have no effect on the issues in the case.

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ii. Partnership

With its 2009 Form 1065, Partnership filed a Statement ("Partnership Statement") reporting the Exchange. Like the Taxpayer Statement, the Partnership Statement reported its transfer of the Transferred Assets to Taxpayer as in exchange for only Taxpayer stock. Partnership did not submit any information relating to its receipt of the Redemption Proceeds. That is, Partnership did not report gain on a receipt of boot in the Section 351 Transaction, as would be required under section 351(b). Nor did it report gain or loss on the Redemption or file a statement required by § 1.302-2(b)(2) with respect to the Redemption.

iii. Liquidated Partner

On his 2009 Form 1040, Liquidated Partner reported long-term capital gain from the receipt of $2.7 million cash in liquidation of his interest in Partnership. On his 2011 Form 1040, Liquidated Partner reported the payment pursuant to the Deferred Payment Right as $300,000 of "other income" received from Taxpayer.

d. Taxpayer's Recast and Reporting on 2010-2013 Forms 1120

On its Forms 1120 for 2010 through 2013, Taxpayer claimed amortization deductions based on an increased basis of the Transferred Assets. In so doing, Taxpayer took a position inconsistent with its 2009 return (including the Taxpayer Statement), the Partnership Statement, and the form of the transactions as provided in the Agreements and as implemented. Neither Taxpayer nor Partnership filed an amended 2009 return or disclosed the change in position on any return or in any other manner, except Taxpayer's claimed increase in amortization deductions.

Taxpayer's post-hoc justification for the increased amortization deductions was that Partnership's transfer of the Transferred Assets to Taxpayer was in exchange for both Taxpayer stock and boot, i.e., the Redemption Proceeds, as reported by the Liquidated Partner but never by Taxpayer or Partnership. According to Taxpayer, this recast increased its basis in the Transferred Assets by $3 million (Taxpayer's understanding of the value of the purported boot) and thus increased its amortization deductions.

e. Issue

The main issue before the court was whether Taxpayer could disavow the transactional form it chose and reported and treat the transactions as resulting in increased basis for the Transferred Assets. The court held that Taxpayer could do so.

f. Service Concerns

The Service is concerned about two related aspects of the court's holding and opinion: (1) the conclusion that the parties' failure to report the transactions fully and consistently was not a major factor in determining whether Taxpayer could disavow the form of its

transactions, and (2) the overall legal standard the court applied to allow this disavowal of transactional form.

i. Parties' Failure to Report the Transactions Fully and Consistently

The Service's first concern relates to the court's conclusion that the parties' failure to report the transactions fully and consistently was not a major factor in the case.

The court found that Taxpayer did not report the transactions in a manner that was inconsistent with its claimed increase in asset basis. The court concluded that the only meaningful difference between the actual form (separate Section 351 Transaction and Redemption) and Taxpayer's recast form (Section 351 Transaction with Redemption Proceeds as boot) is the increase in the basis of the Transferred Assets. The court also found that there was no whipsaw potential to the government and no conflicting interests among the parties to the transactions.

The Service continues to believe that Taxpayer's failure to report the Redemption Proceeds at all (except as a later distribution by Partnership) should have barred the recast, or at least should have been a major factor in deciding whether a recast should be allowed. Reporting requirements exist to provide the Service with the opportunity to analyze the form and substance of transactions, and the Service necessarily relies on the reported information. Consequently, compliance with reporting requirements is an essential part of tax administration.

Here, Taxpayer and Partnership were related parties, and neither of them reported the payment and receipt of the Redemption Proceeds – neither its actual form (a separate Redemption) nor Taxpayer's recast form (boot in the Section 351 Transaction) on any return. This failure to report the Redemption put the Service in the difficult position of having to discover discrepancies by comparing amortization deductions claimed on Taxpayer's 2009 return with the larger deductions claimed on its later returns. Treas. Reg. § 1.351-3 requires the parties to a section 351 transaction to attach statements describing the transaction, including identification of any property with respect to which gain was recognized. The Taxpayer Statement and the Partnership Statement both described Taxpayer's receipt of the Transferred Assets as being in exchange only for Taxpayer stock. Neither statement identified any gain recognition property. However, Taxpayer claimed amortization deductions based on an increased basis in the Transferred Assets. This claim was inconsistent with the failure to report any boot gain in the Section 351 Transaction. Allowing taxpayers to withhold vital information from the Service but still disavow the form of their transactions and reap the resulting tax benefits, as occurred in this case, is highly detrimental to administration of the revenue laws.

ii. Standard to Allow a Taxpayer to Disavow Form of Transactions

A second concern is the legal standard the court applied to allow Taxpayer to disavow the form of its transactions and recast them for tax purposes.

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In Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974), the Supreme Court adopted what is sometimes referred to as the "non-disavowal principle":

> [W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not.

[Emphasis added.] The Service continues to believe that the facts of this case do not support an exception to the non-disavowal principle.

The court acknowledged that, in seeking to disavow the form of its transactions, a taxpayer faces a greater burden than the Service does when it challenges the form of a transaction. But the court interpreted the non-disavowal principle as applying only in limited situations:

> [R]ead in the context of the Court's entire opinion [in National Alfalfa], the familiar quotation should be interpreted to mean only that a taxpayer's ability to identify an alternative path to a given end result that provides more favorable tax consequences than the path actually taken is not enough to entitle the taxpayer to the desired tax treatment.

T.C. Memo. 2021-14 (slip op.) at 48.

The court went on to state that the case law has evolved to become more hospitable to taxpayers seeking to disavow the form of their transactions. The court described the standard it applied in this case as follows:

> The Commissioner can succeed in disregarding the form of a transaction by showing that the form in which the taxpayer cast the transaction does not reflect its economic substance. For the taxpayer to disavow the form it chose (or at least acquiesced to), it must make that showing and more. In particular, the taxpayer must establish that the form of the transaction was not chosen for the purpose of obtaining tax benefits (to either the taxpayer itself, as in Estate of Durkin [99 T.C. 561 (1992)], or to a counterparty, as in Coleman [87 T.C. 178 (1986)]) that are inconsistent with those the taxpayer seeks through disregarding that form. When the form that the taxpayer seeks to disavow was chosen for reasons other than providing tax benefits inconsistent with those the taxpayer seeks, the policy concerns articulated in Danielson [378 F.2d 771 (3d Cir. 1967)] will not be present.

T.C. Memo. 2021-14 (slip op.) at 64.

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The court found that Taxpayer's failure to adopt the recast transaction, with an increase in asset basis, resulted from an oversight – perhaps occurring to Taxpayer's accountants only when they prepared Taxpayer's 2010 return (in which Taxpayer still did not disclose a recast). Thus, under the standard described by the court, Taxpayer was allowed to recast its transactions.

This case would be appealable to the Second Circuit, which has supported strict application of the non-disavowal principle when a taxpayer changes its position on the form of its transaction. Nestlé Holdings, Inc. v. Commissioner, 152 F.3d 83 (2d Cir. 1998); Consolidated Edison of New York, Inc. v. United States, 10 F.3d 68 (2d Cir. 1993). Applying this standard here, the taxpayer would be prevented from disavowing the form of its transaction.

In the Service's view, the standard applied by the court in this case would limit the non-disavowal principle to such an extent as to produce a significant blow to tax administration. In practical terms, the Service could prevent taxpayers from disavowing the form of their transactions only if it could show purposefully conflicting tax benefits, even when, as in this case, the taxpayer withholds vital information.

g. Conclusion

The Service disagrees with the court's conclusion that the parties' failure to report the transactions fully or consistently should not be a major factor in a decision whether to allow a taxpayer to disavow the form of its transactions and also with the standard the court applied to allow Taxpayer to disavow its form in this case.

The Service will continue to challenge an assertion by a taxpayer that the form of a transaction, as chosen by that taxpayer, memorialized in relevant agreements, and implemented, does not bind the taxpayer for Federal tax purposes, especially if the taxpayer does not fully, properly, and consistently report the transaction.

Issue 2

Because the court ruled that Taxpayer could recast the transaction, Taxpayer is deemed to have received assets from Partnership in exchange for stock, $2.7 million of cash, and the Deferred Payment Right in a section 351 transaction.

Section 1001(a) provides that gain from the sale or disposition of property shall be the excess of the amount realized over the adjusted basis. Section 1001(b) provides that the "amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." Treas. Reg. § 1.1001-1(g) provides that "[i]f a debt instrument is issued in exchange for property, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1273-2 or § 1.1274-2." The regulations thus intend to treat the fair market value ("FMV") of a debt instrument as being the same as its issue price, at least in the context of a section 1001 sale or

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exchange. Furthermore, under Treas. Reg. § 1.1012-1(g), the issue price of a debt instrument issued in exchange for property is used to determine the buyer's basis in the property.

If section 351(a) would apply to an exchange but for the fact that there is received, in addition to the property permitted to be received without recognition of gain, other property or money, then under section 351(b), gain (if any) to the recipient will be recognized, but in an amount not in excess of the sum of such money and the FMV of such other property received, and no loss to the recipient will be recognized. Section 362(a) provides that the transferee corporation's basis in the property acquired in a section 351 transaction is "the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer." The amount of a transferor's realized gain on a section 351 transaction is determined under section 1001; however, the amount of gain that a transferor recognizes on a section 351 transaction is determined under section 351(b). There is no direct authority on how to determine the FMV of a debt instrument for purposes of section 351(b)(1).

Based on Taxpayer's credit risk, the court determined that the FMV of the Deferred Payment Right was $288,198 (i.e., $300,000 discounted by the Federal short-term rate plus 3 percentage points (3.71%) over 13 months). Thus, the court determined that Partnership had recognized gain of $2,988,198 on the transaction under section 351(b)(1), and Taxpayer was entitled to increase its basis in the acquired assets by $2,988,198 under section 362(a). Furthermore, the court ruled that Taxpayer would be entitled to section 197 amortization deductions to the extent that the recognized gain was allocated to section 197 intangibles. The court, however, did not address how Taxpayer should account for the $11,802 difference between the $288,198 FMV of the Deferred Payment Right (as determined by the court) and the $300,000 payment due in 13 months.

The Service's position is that the FMV of the Deferred Payment Right for purposes of section 351(b)(1) is equal to the issue price of the Deferred Payment Right. Because the Deferred Payment Right was not publicly traded and was deemed under the court's opinion to be issued in exchange for non-publicly traded property and because the Deferred Payment Right did not have adequate stated interest, the issue price of the Deferred Payment Right is $297,656 (i.e., the present value of $300,000 discounted over 13 months by the Federal short-term rate for November 2009 of 0.71%). See sections 1274(a)(2), (b), (c)(1) and (2). Had the court determined that the FMV of the Deferred Payment Right was equal to $297,656 (as argued by Taxpayer on supplemental brief with no objection by the Service), the results are clear. First, Partnership would have taken $297,656 into account in computing its recognized gain under section 351(b)(1). In addition, Taxpayer would have taken $297,656 into account when increasing its basis in the acquired assets under section 362(a). Finally, the $2,344 difference between the $300,000 due in 13 months and the $297,656 issue price is original issue discount ("OID"), which generally would be taken into account by the holder of the Deferred Payment Right as interest income and by Taxpayer as interest expense over the 13-month term of the Deferred Payment Right. See

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sections 163(e)(1), 1272(a)(1), and 1273(a)(1) and (2); Treas. Reg. §§ 1.163-7(a) and 1.1272-1. Treating the issue price of the Deferred Payment Right as its FMV for purposes of section 351(b)(1) allows the parties to properly account for the full $300,000 Deferred Payment Right (in the case of Taxpayer, either as an increase to the basis of the acquired assets or as an OID deduction).

The court's determination that the FMV of the Deferred Payment Right is $288,198, which is less than its issue price of $297,656, leaves a gap in accounting for the $9,458 difference between the FMV of the debt instrument and its issue price, the treatment of which is unclear under current law. Treating the issue price of a debt instrument as its FMV for purposes of section 351(b)(1) allows the tax treatment of the parties to the section 351 transaction to mirror a seller's amount realized and a purchaser's basis in a fully taxable exchange involving a debt instrument, each of which is determined by reference to the debt instrument's issue price. See Treas. Reg. §§ 1.1001-1(g) and 1.1012-1(g).

Accordingly, the Service will not follow Complex Media in determining the FMV of a debt instrument for purposes of section 351(b)(1).

Recommendations

Issue 1: Nonacquiescence

Issue 2: Nonacquiescence

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