Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **20124601F**
Release Date: 11/16/2012

CC:LB&I:HMT:DET:MTHammoud
POSTF-122604-12

UILC: 351.00-00, 954.00-00

date: October 02, 2012

to: , International Examiner
( )

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subject: Transitory Corporations and I.R.C. section 351

This memorandum is in response to your recent request for our advice regarding the above-subject matter. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Buyer =
CFC =
NewCo 1 =
NewCo 2 =
Sub 1 =
Owner =
Buyer 2 =
Country A =
Country B =
Country C =
Country D =
Property A =
Date A =
Date B =
Date C =
Date D =
Date E =

Amount A	=
Amount B	=
Amount C	=
Amount D	=
Amount E	=
Amount F	=
X	=
Amount G	=
Amount H	=
Amount I	=
Amount J	=
Amount K	=
Amount L	=
Amount M	=
Amount N	=
Amount O	=
Y	=
Amount P	=
Amount Q	=
Z	=
Amount R	=
Property	=
City	=
**	=
Date F	=

ISSUE

Whether the provisions of I.R.C. section 351 apply to the taxpayer's transfer of its Country B business segment under the circumstances described below.

CONCLUSION

The entities formed by the taxpayer were mere conduits to accomplishing the sale of the Country B business segment and are ignored for tax purposes. Accordingly, I.R.C. section 351 does not apply.

FACTS

The facts, as set forth in your memorandum dated May 23, 2012 ("Memo"), are briefly summarized as follows:

On Date F, Taxpayer, a Country A Corporation, and Buyer, an unrelated Country D corporation, entered into a purchase agreement (the "Agreement") for the sale of most of Taxpayer's Property (the "Transaction"). The Transaction included operations in several countries, including Country A and Country B. Due to Taxpayer's desire to receive the proceeds from the sale of the Country B business outside of Country B and Buyer's desire to hold the Country B business through a Country C subsidiary for investment treaty purposes, the Agreement required that the Property A business (assets and liabilities) be restructured prior to the closing of the Transaction. As outlined in Attachment A to the Memo, the restructuring involved the following steps:

Step 1- Formation of New Companies:

On Date A, CFC, a controlled foreign corporation owned by Taxpayer, incorporated NewCo 1 with Amount A of Country B currency divided into Amount B shares each with par value of Amount C of Country B currency.

On Date B, Owner, acting on behalf of Taxpayer, incorporated NewCo 2, a City, Country C registered corporation with Amount D shares of Amount E of Country C currency par value stock.

Step 2 – Inter-Company Note Restructuring:

Sub 1, a Country A subsidiary of Taxpayer, and CFC agreed to restructure an existing US$Amount F intercompany loan receivable between the two parties ("IC Loan") into two IC Notes: 1) a note with a face value of US$X and 2) a note with a face value of US$Amount G.

Step 3 – Capitalization of New Companies:

On Date C, CFC contributed all of the assets and liabilities of Property A to NewCo 1 in exchange for Amount H newly issued shares each with a par value of Amount C of Country B currency and premium associated with those shares equal to Amount I of Country B currency for a total contributed book value of Amount J of Country B currency (US$Amount K at the official exchange rate of Amount L of Country B currency to US$1). The net E&P value of the Property A business as of Date C was US$Amount M.

On Date D, Owner transferred his Amount D share of NewCo 2, representing all of the issued and outstanding stock of NewCo 2, to Sub 1 for Amount E of Country C currency.

On Date D, Sub 1 subscribed to **, Amount E of Country C currency par value newly issued shares of NewCo 2, in exchange for the US$X inter-company note receivable ("Demand Note") from CFC.

Step 4 – Transfer of Country B New Company:

On Date D, CFC transferred to NewCo 2, all the issued and outstanding stock of NewCo 1, amounting to Amount N shares Bs. Amount C of Country B currency par value, in exchange for the Demand Note.

Step 5 – Sale Closing:

On Date E, Sub 1 sold its Amount O shares of NewCo 2 to Buyer 2 for US$Y million. The fair market value of the Property A business net assets was US$Y.

<u>Taxpayer's Position and Treatment on 2010 Tax Return (Form 1120)</u>:

According to the Taxpayer, the face value and fair market value of the Demand Note issued by CFC to Sub 1 were US$X and US$Y, respectively.[1]

For the year at issue, Taxpayer recorded an additional pre-tax gain on the sale of the Property A business of US$Amount P relating to the write-off of the DTL under the business sale accounting rules. The US GAAP net book value of the Property A business as of Date C, was US$X. This amount included US$Amount Q of fresh start accounting fair value step-up (taxpayer was previously in bankruptcy), net of accumulated depreciation. The net E&P value of the Property A business as of Date C was US$Amount M (US$X - Amount Q).

The Transaction resulted in the following tax treatment:

> 1. Sub 1 recognized a US$Z ordinary loss on the deemed sale of the US$X Demand Note (from CFC) to NewCo 2;[2]
>
> 2. CFC recognized a US $Amount R E&P gain ($Y (gross purchase price) less [$X (US GAAP net book value of the Property A business) - $Amount Q (fresh start accounting step-up related to the Property A business, net of all depreciation)] on the deemed sale of the Property A business to Newco 1; and
>
> 3. CFC recognized a US$Z E&P gain on the acquisition of its US$X Demand Note from NewCo 2 which at the time had a fair market value of US$Y million (the FMV of the Property A business).[3]

The Taxpayer argues it applied Rev. Rul. 70-140 and the Step Transaction Doctrine to the Transaction, treating both NewCo 2, and Newco 1 as transitory corporations that are ignored for tax purposes.[4] Under this analysis, the Taxpayer argues the following is deemed to have occurred:

> 1. Buyer is deemed to have incorporated NewCo 2, as a wholly-owned subsidiary and Newco 1 as a second tier subsidiary wholly-owned by NewCo 2, and Buyer capitalized NewCo 2 with US$Y in cash (the purchase price of Property A);

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[1] Presumably, this is because the Taxpayer exchanged the note for assets worth $ million.
[2] The note appears to be a capital asset in Sub 1's hands (under I.R.C. § 1221), so that if Taxpayer's treatment were ultimately respected, the loss would appear to be capital.
[3] It is our understanding that this represents cancellation of indebtedness income since CFC is no longer liable on the note.
[4] Taxpayer's principal place of business is in a jurisdiction that has adopted the Danielson rule, under which a Taxpayer is viewed to be bound by the form it chooses. <u>See</u> <u>Commissioner v. Danielson</u>, 378 F.2d 771 (3d. Cir. 1967). Accordingly, Taxpayer's ability to ignore the steps it took may be limited.

2. SUB 1 is deemed to have sold the US$X Demand Note due from CFC to NewCo 2 for US$Y cash, realizing a loss on the sale of US$Z;

3. NewCo 2 is deemed to have contributed the Demand Note to Newco1 as a capital contribution; and

4. Newco 1 is deemed to have purchased Property A from CFC in exchange for the Demand Note. CFC realized an E&P gain of US$Amount R on the sale of Property A, and cancellation of indebtedness income of US$Z.

In the Memo, you take the following position:

1. Both NewCo 2 and Newco 1are not transitory and should therefore be respected for tax purposes.

2. The Taxpayer should be held to the form of the transaction it has chosen.

3. Rev. Rul. 70-140 is inapplicable because the facts are distinguishable.

4. I.R.C. sections 351 and 367 apply to Step 3 above, resulting in CFC having an outside basis in Newco 1 of US$Amount M; Sub 1 taking a Amount E of Country C currency carryover basis in the stock of NewCo 2; and Sub 1 taking a carryover outside basis in NewCo 2 of US$X.

5. I.R.C. sections 304(a)(1) and (b)(2) apply to Step 4 above, resulting in CFC having to recognize a capital gain of US$Amount Q as Subpart F income (to the extent of CFC's earnings and profits).

6. Sub 1 shall recognize the US$Z loss as a capital loss since the property that was sold, i.e., the assets of NewCo 2 are capital assets.

The focus of the inquiry is whether Taxpayer's treatment can be sustained, and, if not, how should the transactions be treated.

<u>LAW AND ANALYSIS</u>

Internal Revenue Code § 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the corporation.

Pursuant to I.R.C. § 368(c), "control" is defined as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Treasury Regulation § 1.351-1(a)(1) provides that the phrase "immediately after the exchange" does not necessarily require simultaneous exchange by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.

The Service generally disregards a transitory corporation that is formed solely for the purpose of acquiring the stock of a target corporation. See Rev. Rul. 73-427, 1973-2 C.B. 301; Rev. Rul. 78-250, 1978-1 C.B. 83; Rev. Rul. 79-273, 1979-2 C.B. 125; and Rev. Rul. 90-95, 1990-2 C.B. 67. Courts have also long recognized that transitory ownership, as part of a prearranged plan, is of no substance for tax purposes. Helvering v. Bashford, 302 U.S. 454 (1937); Commissioner v. Ashland Oil & Refining Co., 99 F.2d 588 (6th Cir. 1938); and Overland Corporation v. Commissioner, 42 T.C. 26 (1964).

The step transaction doctrine is founded on the principle that substance prevails over form, and combines a series of individual steps into a single transaction if such steps are "in substance integrated, interdependent and focused toward a particular result." Penrod v. Commissioner, 88 T.C. 1415; see also Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

In Rev. Rul. 70-140, 1970-1 C.B. 73, A, an individual, owned all of the stock of corporation X and operated a business in the form of a sole proprietorship that is similar to that of X. Pursuant to an agreement between A and Y, an unrelated corporation, A transferred all of the assets of the sole proprietorship to X in exchange for additional shares of X stock. A then transferred all his X stock to Y solely in exchange for the widely held voting common stock of Y. The ruling states that the two steps of the transaction are part of a prearranged integrated plan and may not be considered independently of each other for federal income tax purposes. The ruling concludes that A's receipt of the X stock in exchange for the sole proprietorship assets is transitory and without substance for tax purposes because it is apparent that the assets of the sole proprietorship are transferred to X to enable Y to acquire those assets without the recognition of gain to A. Accordingly, the ruling treats A as transferring its sole proprietorship assets directly to Y in a transfer to which section 351 does not apply, and Y as transferring these assets to X, independently of A's transfer of the X stock to Y in exchange for Y voting stock.

The facts in this case are comparable to the facts in Rev. Rul. 70-140. NewCo 2 and NewCo 1 were used as conduits through which the Demand Note passed. However, their ownership of the Demand Note was transitory and should thus be ignored for tax purposes, just as X corporation's transitory ownership of A's sole proprietorship assets in Rev. Rul. 70-140 was disregarded. Because CFC held the assets being sold, it is treated as selling them to Buyer. See Rev. Rul. 70-140; Commissioner v. Court Holding Company, 324 U.S. 331 (1945) ("A sale by one person can not be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.”). In substance, the Transaction was merely a sale of assets for cash between CFC and Buyer, and the Demand Note owed by the CFC was satisfied with the cash received from the sale.

Accordingly, section 351 is not applicable. NewCo 2 and NewCo 1 are ignored for tax purposes, and there are no implications under sections 304 or 367. Moreover, no capital gain is to be recognized as Subpart F income.

With respect to the transactions as recast, there will be no gain or loss recognized for federal tax purposes. Although CFC recognized a US$Amount R of E&P gain on the sale of assets to Buyer, this income does not appear to be subpart F income or US-sourced based on the facts.

The Demand Note was transferred by Sub 1 to CFC for less than the amount owed on the obligation. Under Treas. Reg. § 1.61-12(a), a shareholder’s gratuitous forgiveness of debt owed by a corporation is treated as a capital contribution to the extent of the principal of the debt. Section 108(e)(6) explains that if a debtor corporation acquires its own debt from a shareholder as a contribution to capital, the corporation is treated as having satisfied the debt with an amount of money equal to the shareholder’s adjusted basis in the debt. Therefore, Taxpayer cannot deduct a US$Z loss on the sale of the Demand Note (which is not considered to have happened), and CFC does not have cancellation of indebtedness income of US$Z because the cash previously received as a loan is now treated as a capital contribution. Under § 108(e)(6), Sub 1’s basis in CFC will be increased by US$Z, the adjusted basis in the debt that was forgiven. (The remaining portion of the debt was satisfied with the US$Y deemed to have been transferred by CFC to Sub 1).[5]

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS</u>

[redacted].[6] [redacted].[7]

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[5] If the forgiveness of the Demand Note is for some reason not treated as a capital contribution, any cancellation of indebtedness would result in ordinary income to CFC, but probably give Sub 1 a capital loss under § 1271. Further consideration would be appropriate if it becomes necessary to determine the implications of a cancellation of indebtedness. In addition, Section 267(f) would likely defer Taxpayer’s recognition of Sub 1’s loss until Taxpayer’s recognizes CFC’s corresponding gain.

[6] You may wish to consider whether § 482 may apply.

[7] If the CFC’s cancellation of indebtedness income was not included in gross income on Taxpayer’s Form 1120, you may wish to consult with INTL as to whether this income is subpart F income or US-sourced. If our treatment (as set forth above) is not upheld, the write-down of the debt is suspect, since the CFC is reportedly solvent.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (313) 628-3136 if you have any further questions.

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