Office of Chief Counsel
Internal Revenue Service

memorandum

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MJCalabrese

date: march 8, 2002

to: [redacted], International Examiner
LMSB:[redacted]

from: Associate Area Counsel, (LMSB), Chicago

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subject: **Opinion - Allocation of corporate basis and value to shareholders**

Taxpayer [redacted], Inc.

This memorandum responds to an ongoing request for assistance. We had previously consulted with Foreign Joint Ventures Industry Counsel Sergio Garcia-Pages with respect to certain matters involved in this examination, and we have provided him with a copy of this opinion. This memorandum should not be cited as precedent.

ISSUE

How should the taxpayer allocate basis and value of a deemed liquidated corporation to its shareholders?

CONCLUSION

Value of the deemed liquidated corporation should be allocated to the shareholders in proportion to their ownership interests as reflected in their holdings of shares of stock. Preferred shares may entitle the holder to a preference distribution, depending upon the rights attached to the preferred shares. Each shareholder should determine basis in accordance with the shareholder's cost of the stock plus or minus any necessary adjustments.

FACTS

In a memorandum dated December 19, 2001, we addressed an issue relating to the deemed liquidation of certain of the taxpayer's foreign subsidiaries, including [redacted], a [redacted] subsidiary, and [redacted], the taxpayer's [redacted] holding company. Prior to liquidation, the taxpayer arranged for other foreign subsidiaries to acquire interests in [redacted] and [redacted], which resulted in the other foreign

subsidiaries owning more than [redacted] of the voting stock and/or value of the liquidating corporations. Owning less than [redacted] of [redacted] and [redacted], the taxpayer was in a position to recognize losses upon the deemed liquidations.

The transactions and loss computations, required the taxpayer to determine the ownership percentages and stock basis of each shareholder of both [redacted] and [redacted] The taxpayer allocated both ownership percentages and basis to the various shareholders. You have asked whether the allocation methods were proper.

[redacted]

[redacted] was owned by [redacted] Inc. (a US subsidiary of the taxpayer), [redacted], Inc. ([redacted]) (a US subsidiary of the taxpayer), and [redacted] (a [redacted] subsidiary of the taxpayer) (hereinafter referred to as [redacted]. On [redacted], [redacted] paid $[redacted] to [redacted] and [redacted] (US). In exchange for the $[redacted], [redacted] acquired [redacted] stock from [redacted] and [redacted] that amounted to [redacted]% of the stock of [redacted]. The deemed liquidation of [redacted] occurred on [redacted] We understand that [redacted] had but one type and class of stock.

For purposes of computing gain or loss on the deemed liquidation, the taxpayer had to determine the basis and value held by each of the three [redacted] shareholders. First the taxpayer had to determine the value of [redacted] as of [redacted]. The proportionate value of [redacted] then had to be allocated to each shareholder. Each shareholder's adjusted basis had to be subtracted from its allocated amount (share of the deemed liquidation), with the difference constituting each shareholder's gain or loss on the deemed liquidation. Over the course of time, the taxpayer made a number of different gain/loss computations as a result of different valuations for [redacted].

Originally, the taxpayer valued [redacted] at $[redacted]. The taxpayer allocated [redacted]s value to its owners as follows: [redacted]% to [redacted], [redacted]% to [redacted] and [redacted]% to [redacted] The allocation was based upon the percentage of each owner's capital contribution.

In a first revised computation the taxpayer determined, based upon a valuation prepared by [redacted], that [redacted] had a value of $[redacted]. For this computation the taxpayer changed its allocation of [redacted] value as follows: [redacted]% to [redacted], [redacted]% to [redacted] and [redacted]% to [redacted]. This allocation was based upon the percentage of

each owner's stock holdings. In determining each shareholder's basis, you have advised us that the taxpayer allocated the share of tax basis to each owner in accordance with each owner's percentage of capital contributed.

A second revised computation was based upon a new $[redacted] valuation of [redacted]. We understand that the value was allocated to the owners according to the percentages in the first revised computation. This second revised computation, prepared by [redacted], states that consideration of excess liabilities would give [redacted] a [redacted] value.

[redacted]

By virtue of a check the box election, [redacted] Ltd., the taxpayer's [redacted] holding company [redacted], was also deemed to have liquidated on [redacted]. Again, to determine gain or loss for the shareholders of [redacted], the taxpayer had to determine basis and value for each shareholder.

[redacted] had authorized both common and preferred shares of stock. An agreement gives preferred shareholders preference on liquidation proceeds.

At first, the taxpayer determined that [redacted] Inc. and [redacted] Ltd., a [redacted] subsidiary of the taxpayer ([redacted] owned [redacted]% and [redacted]%, respectively, of the stock of [redacted]. In a revised computation, the taxpayer determined that the stock of [redacted] was owned [redacted]% by [redacted], [redacted]% by [redacted], and [redacted]% by [redacted].

Originally, the taxpayer estimated an $[redacted] value for [redacted]. The taxpayer allocated the value of [redacted] to [redacted]'s owners as follows: [redacted]% to [redacted] and [redacted]% to [redacted]. The taxpayer determined that [redacted]'s interest in [redacted] had a basis of $[redacted]. The taxpayer determined a deemed [redacted] liquidation loss of approximately $[redacted].[1] You state that [redacted] broke even on the liquidation, which indicates that the taxpayer determined that [redacted]'s interest in [redacted] had a basis of $[redacted].[2]

As with [redacted], the taxpayer revised its loss computation for the [redacted] liquidation. In the revised computation, the value of [redacted] was allocated based upon the percentage of voting preferred stock

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[1] ([redacted] * $[redacted]) - $[redacted].

[2] ([redacted] * $[redacted]) - $[redacted] = [redacted]

held by each owner: [redacted]% or $[redacted] to [redacted], [redacted]% or $[redacted] to [redacted], and [redacted]% or $[redacted] to [redacted]. This revision gave [redacted] a total value of $[redacted]. The taxpayer determined basis in preferred/common stock as follows: $[redacted]/$[redacted] for [redacted], $[redacted]/ $[redacted] for [redacted], and $[redacted]/$[redacted] for [redacted]. This results in [redacted] losses of $[redacted] for [redacted] and $[redacted] for [redacted], for a total loss of $[redacted].

An [redacted] reorganization agreement shows authorized shares for [redacted] as follows: [redacted] - [redacted] ordinary shares and [redacted] ordinary preferred, [redacted] - [redacted] ordinary shares and [redacted] ordinary preferred. An undated "New Articles of Association" authorizes [redacted] shares of A preferred ordinary shares at [redacted] each, [redacted] B ordinary shares at [redacted] each, and [redacted] redeemable preference shares of [redacted] each, for a total share capital of [redacted]. "A" owners are entitled to one vote per share, "B" owners have no voting rights, and redeemable preferred owners are entitled to one vote per thousand shares. Upon liquidation, surplus assets are distributed first to owners of redeemable preferred equal to the amount of the subscription price per share paid, including any premium.

ANALYSIS

1. [redacted]

a. Allocation of the value of the subsidiary to each of its shareholders

For the deemed liquidation, the taxpayer's revised computation allocated value of [redacted] to its owners based upon each owner's percentage of stock ownership. This allocation method appears reasonable and appropriate.

The taxpayer's original computation allocated [redacted]'s value to its owners based upon capital contributed. An allocation based upon capital contributed would not necessarily reflect the economics of ownership. If two shareholders each own 100 shares of a corporation, they each own the same percentage of the corporation. However, the owners may have acquired their shareholdings at different times when the corporation had different values. As a result, they would have paid different amounts to acquire their 100 share interests. Paying different amounts, the owners may have contributed different amounts of capital; however, they own the same percentage of the corporation. See Pennington v. Commonwealth Hotel Construction

Corp., 17 Del. Ch. 394, 155 A. 514 (1931) (a shareholder receives a corporate distribution in proportion to its stock's par value, even if the shareholder paid a premium therefor).

In the case of a third shareholder purchasing stock from the original shareholders, the new shareholder has a percentage interest in the corporation (evidenced by its shareholdings), yet it has contributed no capital to the corporation. Upon liquidation, each shareholder is entitled to a proportion of the liquidated assets equivalent to its percentage ownership in the corporation. Liquidation according to stock ownership percentage, rather than capital contribution, would reflect the economics of ownership interests.

On [redacted], eight days prior to the [redacted] deemed liquidation valuation date, [redacted] paid $[redacted] for [redacted] stock. The $[redacted] is approximately [redacted]% of the $[redacted] original valuation of the [redacted], approximately [redacted]% of the $[redacted] first revised valuation, and approximately [redacted]% of the $[redacted] second revised valuation of the [redacted]. If the second revised valuation is correct (and I understand the Service has not concluded that it is), [redacted] either vastly overpaid for a [redacted]% interest in the [redacted] or it acquired considerably more than a [redacted]% interest in the company.

The second revised valuation also states that [redacted] had no value when taking account of excess liabilities. If [redacted] had no value, it would make no sense for [redacted] to purchase [redacted]% of [redacted]'s stock for $[redacted].

b. Determination of basis for each shareholder

You have advised us that the taxpayer allocated basis to each [redacted] shareholder based upon the percentage of each shareholder's capital contribution. We do not have details of how the taxpayer made this allocation.

[redacted] and [redacted] were the original shareholders of [redacted]. [redacted] acquired its interest in [redacted] just 8 days prior to the deemed liquidation. It acquired this interest by paying $[redacted] to [redacted] and [redacted] for part of their holdings of [redacted] stock. The transaction resulted in [redacted] acquiring [redacted]% of the stock of [redacted].

Generally, a person's basis in property is the person's cost. I.R.C. § 1012. Cost is the cash or value of the other property given in exchange for the property. Treas. Reg. § 1.1012-1(a). Generally, the basis of the stock received in a

nonrecognition transaction is the same as the basis of the property transferred, decreased by the amount of any money received, plus any gain or minus any loss recognized. See, e.g., I.R.C. § 358.[3]

A taxpayer must make any necessary and appropriate adjustments to the cost basis for purposes of determining gain or loss upon disposition of the asset. I.R.C. § 1011. The general rule for making adjustments to basis is set forth in I.R.C. § 1016(a). In adjusting the basis of the stock of a controlled foreign corporation, subsection 18 of I.R.C. § 1016(a) and I.R.C. § 961 set forth certain rules with respect to subpart F income.

With respect to property received in liquidation, I.R.C. § 334 sets forth certain rules regarding the determination of basis. However, we understand that your basis question relates to the basis of the stock held by the shareholders, rather than the basis of the property deemed received in the deemed liquidation.

The stock basis of each [redacted] shareholder was the shareholder's cost (plus any necessary adjustments). Each shareholder computes its basis in accordance with its cost. A total or pooled basis amount is not allocated among shareholders. If any of the shareholders acquired different types or classes of stock in exchange for a contribution to the corporation, it would be necessary to allocate the cost among the types and classes of stock according to their relative values. See Treas. Reg. 1.358-2. (In this case we do not know of the existence of different types or classes of [redacted] stock.)

[redacted] paid $[redacted] to acquire [redacted]% of the [redacted] stock. Its basis in its [redacted] stock was its $[redacted] cost. We do not have details as to when [redacted] and [redacted] acquired their stock in [redacted], nor do we have details as to the property contributed by [redacted] and [redacted] to [redacted] in exchange for the stock. Generally, [redacted]'s and [redacted]'s basis in their [redacted] stock would have been the amount it cost them to acquire the stock. I.R.C. § 1012.

2. [redacted] Ltd., a [redacted] Holding Co. ([redacted])

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[3] In the case of noncash contributions to controlled foreign corporations, I.R.C. § 367 keeps the nonrecognition provisions of § 358 from applying.

The rights of a class of stockholders to assets of a corporation are fixed by contract-like rights with the corporation (as set forth in, for example, the corporate charter and articles of incorporation). See Starr Surgical Company v. Waggoner, 588 A.2d 1130 (1991); Hull v. Pfister & Vogel Leather Co., 235 Wis. 653, 667, 294 N.W. 18 (1940). Unless some special provision provides otherwise, no one class of shareholders receives a preference as to liquidation distributions. See e.g., Alley v. Miramon, 614 F.2d 1372, 1387-88 (5th Cir. 1980). A stockholder receives a distribution in proportion to the par value of its stock, even if the shareholder paid a premium therefore. Pennington v. Commonwealth Hotel Construction Corp., 17 Del. Ch. 394, 155 A. 514 (1931).

The rights of [redacted] shareholders would be governed by [redacted]s articles of incorporation, corporate charter, and applicable corporate law. As [redacted] is a [redacted] corporation, [redacted] corporate law probably applies. We have analyzed the question of [redacted] stock rights in light of general US corporate law. (b)(5)(AWP), (b)(7)a [redacted].

We have not seen [redacted]'s corporate charter or articles of incorporation. We are unsure of the nature of the liquidation preference afforded the preferred shareholders of [redacted]. The corporate provisions relating to preference need to be analyzed to determine the amounts to be received by the preferred shareholders upon liquidation.

(b)(5)(AWP), (b)(7)a [redacted].

Liquidation distribution should be made in accordance with the rights of the different shareholders. Holders of preferred shares may be entitled to receive distributions prior to holders of common shares. The extent of the preference distributions

depend upon the preference rights set forth in the articles of incorporation, corporate charter, and applicable law.

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If you have any questions on this matter, please call Michael Calabrese of this office at (414) 297-4241.

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