

Stock Compensation Corporate Tax Shelter

Notice 2000-60

The Internal Revenue Service and the Treasury Department have become aware of certain types of transactions, as described below, that are being marketed to taxpayers for the avoidance of federal income taxes. The IRS and Treasury are issuing this notice to alert taxpayers and their representatives that the losses generated by such transactions are not properly allowable for federal income tax purposes and also to alert them of certain responsibilities that may arise from participation in such transactions.

FACTS

These transactions generally involve three parties: a domestic corporation (P) that is the common parent of a consolidated group, a domestic subsidiary (S), and a third party (X) that either is unrelated to P or is related but is not an includible corporation within the meaning of § 1504(b) of the Internal Revenue Code. P and X transfer cash to S in exchange for S's stock. After this exchange, P owns stock representing less than 80 percent of the voting power of S's stock, thus preventing S from being a member of P's consolidated group. X owns preferred stock of S. P's and X's basis in their S stock reflects the amount of cash they contributed to S. S uses the cash to purchase stock of P from P's shareholders. From time to time, S transfers P shares to P employees in satisfaction of P's stock-based employee compensation obligations (e.g., upon the exercise by an employee of a non-statutory option to purchase P stock).

In a few years, S will sell any remaining P stock, and then S will liquidate or P will sell its S stock.

Notwithstanding that P is the majority shareholder of S, P and S take the position that S's transfers of P stock to P's employees must be treated, under § 1.83-6(d) of the Income Tax Regulations, as deemed capital contributions by S to P followed by transfers by P to the P employees. P does not reduce its basis in its S stock as a result of S's deemed transfers to P. S increases its basis in its remaining P stock by the amount of the basis of the P shares S transferred in the deemed capital contributions to P. Under § 1032, P reports no gain or loss from the deemed transfers of P stock to P's employees. P takes deductions under § 83(h) in the amount that the P employees include in income under § 83(a) from their receipt of the P stock.

When S liquidates or P sells its S stock, P claims a capital loss under § 331 or § 1001 because S has already transferred most of its P stock to the P employees, which has substantially reduced the value of S without a corresponding downward adjustment in P's basis in its S stock. Because S claims to have shifted all of its basis in the P stock to S's shares of P stock remaining after the transfers to the P employees, S also reports a capital loss on the sale of its remaining P stock immediately before S's liquidation or sale.

ANALYSIS

When a corporation makes a payment that discharges a liability of its shareholder, the discharge of the liability is treated as a distribution to the shareholder with respect to the shareholder's stock. See, e.g., Tennessee Securities Inc. v. Commissioner, 674 F.2d 570, 573 (6th Cir. 1982), citing Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929). To permit a controlled subsidiary to avoid distribution treatment for transfers made on behalf of a parent corporation merely by purchasing some shares of the parent corporation's stock would contravene the framework governing distributions under § 301. Moreover, to characterize such transfers as capital contributions made by the subsidiary in its capacity as a shareholder of the parent corporation would be inconsistent with the substance of these transactions. The characterization in § 1.83-6(d) of a shareholder's transfer of property to a corporation's employees as a deemed capital contribution only applies when the transferor is acting in its capacity as a shareholder. That characterization is inapposite when the transferee is a controlling corporate shareholder of the transferor, and the transferor subsidiary has no plausible investment motive for making such transfers.

The transfers by S to the P employees are properly characterized as distributions by S to P with respect to P's S stock, subject to the rules of §§ 301 and 311, followed by compensatory transfers by P to P's employees. Distributions to the extent of earnings and profits result in dividend treatment under § 301(c)(1). To the extent that the amount of the distributions exceeds the earnings and profits of S, the distributions reduce P's basis in its S stock under § 301(c)(2), thus reducing or eliminating P's purported loss with respect to the S stock upon S's liquidation or sale. In addition, because the transfers of P stock by S to P are distributions and not capital contributions, S is not permitted to shift basis from the transferred P stock to S's remaining P stock and, therefore, S does not have a capital loss on the sale of its remaining P stock immediately before S's liquidation or sale.

Alternatively, the IRS may disregard the described steps and treat the transaction as a redemption by P. It is a well-established principle of tax law that when transactions lack a legitimate business purpose and are undertaken solely for tax avoidance purposes, their tax consequences will be determined based on substance and not form. Gregory v. Helvering, 293 U.S. 465 (1935). The transfer of cash from P to S, the purchase by S of P stock from P shareholders, the transfers by S of P stock to P's employees, and the ultimate liquidation or sale of S, all pursuant to the same arrangement, may be disregarded for tax purposes and, instead, be treated as a redemption by P of its stock followed by compensatory transfers of treasury stock by P to its employees. No deduction is permitted for amounts paid to redeem stock. See § 162(k).

It is also well-established that, to be allowable, a loss must be bona fide and must reflect actual economic consequences in order to be sustained. An artificial loss lacking economic substance is not allowable. See § 165(a); ACM Partnership v.

Commissioner, 157 F.3d 231, 252 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999) (“Tax losses such as these . . . which do not correspond to any actual economic losses, do not constitute the type of ‘bona fide’ losses that are deductible under the Internal Revenue Code and regulations.”); Treas. Reg. § 1.165-1(b) (“Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.”). This transaction is no more than a series of contrived steps that effect an artificial loss on P’s disposition of S stock. Consequently, the arrangement described above, or any similar arrangement, does not produce an allowable loss.

The purported tax benefits from these transactions may also be subject to challenge for other reasons, including other provisions of the Code and the regulations, such as § 269.

Additionally, the Service may impose penalties on participants in these transactions, or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

Transactions that are the same as or substantially similar to those described in this Notice 2000-60 are identified as “listed transactions” for the purposes of § 1.6011-4T(b)(2) of the Temporary Income Tax Regulations and § 301.6111-2T(b)(2) of the Temporary Procedure and Administration Regulations. See also § 301.6112-1T, A-4. It should be noted that independent of their classification as “listed transactions” for purposes of §§ 1.6011-4T(b)(2) and 301.6111-2T(b)(2), such transactions may already be subject to the tax shelter registration and list maintenance requirements of §§ 6111 and 6112 under the regulations issued in February 2000 (§§ 301.6111-2T and 301.6112-1T, A-4), as well as the regulations issued in 1984 and amended in 1986 (§§ 301.6111-1T and 301.6112-1T, A-3). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under § 6707(a) and to the penalty under § 6708(a) if the requirements of § 6112 are not satisfied.

The principal author of this notice is Megan Fitzsimmons of the Office of the Associate Chief Counsel (Corporate). For further information regarding this notice, contact Ms. Fitzsimmons at 202-622-7790 (not a toll-free call).