

Part III - Administrative, Procedural, and Miscellaneous

Contingent Liability Tax Shelter

Notice 2001-17

The Internal Revenue Service and the Treasury Department have become aware of certain types of transactions, described below, that are being marketed to taxpayers for the purpose of accelerating and, in some cases, duplicating tax deductions. This notice is intended to alert taxpayers and their representatives that the losses generated by such transactions are not properly allowable for federal income tax purposes. This notice also alerts taxpayers and their representatives of certain responsibilities that may arise from participation in such transactions.

FACTS

These transactions take several forms but, in all cases, involve the transfer of a high basis asset (i.e., an asset with a basis that approximates its fair market value) to a corporation purportedly in exchange for stock of the transferee corporation, and the transferee corporation's assumption of a liability (such as a liability for deferred compensation or other deferred employee benefits or an obligation for environmental remediation) that the transferor has not yet taken into account for federal income tax purposes. The transferor typically remains liable on the underlying obligation. The basis and fair market value of the transferred asset, which may be a security of another

member of the same affiliated group of corporations, are generally only marginally greater than the present value of the assumed liability. Therefore, the value of the stock of the transferee received by the transferor is minimal relative to the basis and fair market value of the asset transferred to the transferee corporation.

The transaction is purported to qualify as an exchange under § 351 of the Internal Revenue Code, with the intent that the basis of the stock that the transferor receives from the transferee corporation will be equal to the basis of the transferred asset, unreduced by the liability assumed by the transferee corporation. Under § 358(a), a transferor's basis in stock received in a § 351 exchange is equal to the transferor's basis in property exchanged for such stock, subject to certain adjustments, including a reduction for any money or other property received by the transferor. Under § 358(d)(1), liabilities assumed by the transferee corporation are treated as money received by the transferor. Under certain circumstances, however, liabilities assumed by a transferee corporation in a § 351 exchange are not treated as money received by the transferor and thus do not reduce the basis of the stock received in the exchange. See § 358(d)(2); § 357(c)(3).

The transferor typically sells the stock of the transferee corporation for its fair market value within a relatively short period of time after the purported § 351 exchange and claims a tax loss in an amount approximating the present value of the liability assumed by the transferee corporation. In the case of a transaction involving members

of an affiliated group that has elected to file a consolidated return, the transaction is structured with the intention of avoiding the loss disallowance rule of § 1.1502-20 of the Income Tax Regulations. In addition to the transferor's purported loss on the sale of the stock of the transferee corporation, the transferee corporation may claim a § 162 deduction with respect to payments on the liability.

Taxpayers assert several business purposes for these transactions. However, the Service and the Treasury are not aware of any case in which a taxpayer has shown a legitimate non-tax business reason to carry out the combination of steps described above. Moreover, the Service and the Treasury believe that any business purposes taxpayers may assert for certain aspects of these transactions are far outweighed by the purpose to generate deductible losses for federal income tax purposes.

ANALYSIS

Depending on the facts of the particular case, the Service intends to disallow losses claimed by the transferor with respect to these transactions. For transfers after October 18, 1999, the Service will assert that such losses are disallowed because the transferor's basis in the stock received is reduced under § 358(h) (reducing stock basis by the amount of certain liabilities).

For transfers on or before October 18, 1999, as well as for transfers after October 18, 1999, that are not subject to § 358(h), the Service will disallow such losses for one or more reasons, including but not limited to the following: (1) that the purported

§ 351 exchange lacks sufficient business purpose to qualify as a § 351 exchange; (2) that the transfer of the asset to the transferee corporation is not, in substance, a transfer of property in exchange for stock within the meaning of § 351, but instead is either an agency arrangement for the transferor or simply a payment to the transferee for its assumption of a liability; (3) that the purported § 351 exchange constitutes an acquisition of control of the transferee corporation for the principal purpose of tax avoidance within the meaning of § 269(a) and thus the purported loss should be disallowed under § 269(a); (4) that the principal purpose of the transferee's assumption of the liability was a purpose to avoid federal income tax or was not a bona fide business purpose within the meaning of § 357(b)(1), and thus the assumption of the liability should be treated as money received by the transferor that reduces its basis in the transferee stock; (5) that the purported loss on the sale of the stock of the transferee corporation is disallowed or limited by the loss disallowance rules of § 1.1502-20, including the anti-avoidance rule in § 1.1502-20(e) and the duplicated loss rule in § 1.1502-20(c); (6) that the purported loss on the sale of the stock of the transferee corporation is not a bona fide loss actually sustained by the transferor, as required by § 1.165-1(b); and (7) that the overall transaction lacks sufficient economic substance to be respected for federal income tax purposes, see ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999).

In addition, any deduction claimed by a transferee corporation for payments on a liability assumed in a transaction similar to that described above may, depending on the facts of the particular case, be subject to disallowance on one or more of several possible grounds, including that the payments are not for ordinary and necessary business expenses of the transferee corporation. Rev. Rul. 95-74, 1995-2 C.B. 36, which addressed the treatment of certain environmental liabilities assumed by a transferee of a manufacturing business, does not apply to the deductibility by the transferee of liabilities assumed in a transaction of the type described in this notice because Rev. Rul. 95-74 dealt with liabilities assumed by a transferee corporation in connection with the transfer of substantially all the assets associated with the operation of a manufacturing business to the transferee corporation in a transaction that qualified as a § 351 exchange.

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 2001-17 (including transactions utilizing partnerships) 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 Theresa Abell, of the Office of Associate Chief Counsel (Corporate). For further information regarding this notice, contact Ms. Abell at (202) 622-7700 (not a toll-free call).