This responds to your oral request for legal advice. This memorandum should not be used or cited as precedent.

**LEGEND**

Target  = 

Sub 1  = 

Sub 2  = 

Sub 3  =
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Year 4 =

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Date 3 =

Date 4 =

Date 5 =

Date 6 =
ISSUES

(1) Whether the Step Transaction Doctrine should be applied to integrate the Date 9 sale of the Sub 3 Series B Preferred to the Acquiring group with the Date 10 merger so that Sub 3 is never deconsolidated, with the result that Sub 2’s disposition of its g shares of Sub 3 common stock and h shares of Sub 3 Series A Preferred is subject to the Full Basis Redetermination rule of Treas. Reg. §1.1502-35T(b)(1)?

(2) Assuming there was a deconsolidation of Sub 3, whether the “End of the Day Rule” of §1.1502-76(b)(1)(ii)(A)(1) treats Sub 3 as still a member of the Target group at the time of Sub 2’s disposition of its g shares of Sub 3 common stock and h shares of Sub 3 Series A Preferred, such that the Full Basis Redetermination rule of §1.1502-35T(b)(1) applies?

(3) Whether the loss claimed by the Target group with respect to the disposition of the g shares of Sub 3 common stock and h shares of Sub 3 Series A Preferred can be disallowed by the application of §269(a) of the Internal Revenue Code to (i) the acquisition of Sub 3 by members of the Target group, or (ii) Sub 3’s acquisition of property from group members?

CONCLUSIONS

(1) Under either the “end result” or “interdependence” tests of the Step Transaction Doctrine, the sale of the Sub 3 Series B Preferred to the Acquiring group should
be integrated with the merger such that the disposition of the g shares of Sub 3 common stock and h shares of Sub 3 Series A Preferred is subject to the Full Basis Redetermination rule.

(2) Under the “End of the Day” rule, as a result of the Series B Issuance, Sub 3 ceases to be a member of the Target group at the end of the day on Date 9; because Sub 3 is still a member at the time of the disposition of the g shares of Sub 3 common stock and h shares of Sub 3 Series A Preferred on Date 9, the Full Basis Redetermination rule applies.

(3) Depending upon further factual development, §269(a)(1) may be applied to the Target group members’ acquisition of Sub 3, thereby disallowing the loss deduction claimed with respect to the disposition of the g shares of Sub 3 common stock and h shares of Sub 3 Series A Preferred. Alternatively, §269(a)(1) may be applied to deny Sub 2 nonrecognition treatment on receipt of its Sub 3 stock, thereby preventing Sub 2 from recognizing a loss on the disposition of such stock. Section 269(a)(2) may not apply to Sub 3’s acquisition of property from Sub 2 in the purported §351 transfer on Date 8.

FACTS

Target is a publicly-traded State A corporation and the common parent of a consolidated group (the “Target group” or taxpayer) that filed its returns on the basis of a calendar taxable year. Target owns all the issued and outstanding stock of Sub 1.

In Year 1, Sub 1 caused its disregarded entity DRE 1 to acquire by tender offer more than 80% of the outstanding stock of Acquired, a Country B corporation engaged in Business, for approximately $a. Acquired’s assets consisted primarily of Business assets. In connection with this acquisition, an election was made pursuant to §338(g) of the Internal Revenue Code to step up the basis in most of Acquired’s foreign assets.

The following events occurred in subsequent internal restructurings during Year 1:

(i) Sub 1 transferred its interest in DRE 1 to DRE 2, a newly formed entity that elected to be treated as a disregarded entity for federal income tax purposes;

(ii) DRE 1 issued preferred interests to Target affiliates, thereby becoming a partnership for federal income tax purposes;

(iii) Acquired was converted into a Country B private limited company, DRE 3, that elected to be treated as a disregarded entity for federal income tax purposes;
(iv) Target contributed all the stock of Sub 2 to Sub 1;

(v) Sub 1 contributed its interest in DRE 2 to Sub 2.

As a result of the above, Sub 1 owned all of Sub 2, Sub 2 owned all of DRE 2, DRE 2 and affiliates owned all the interests in DRE 1, and DRE 1 owned all of DRE 3. In addition, the value of DRE 3 declined significantly from the time Acquired/DRE 3 was purchased by DRE 1.

On Date 1, Acquiring, the common parent of an unrelated consolidated group (the “Acquiring group”), commenced a takeover of Target.

On Date 2, Target formed Sub 3, a State C corporation.

On Date 3, Acquiring and Target executed an “Agreement and Plan of Merger” (the “Merger Agreement”) which provided, inter alia, that an Acquiring subsidiary would merge with and into Target with Target surviving such that Target would become a wholly-owned subsidiary of Acquiring. Section bb of the Merger Agreement required Target to pay a termination payment of $b if Target terminated the Agreement, and Acquiring to pay a termination payment of $c if Acquiring terminated the Agreement. Section cc of the Agreement granted Target the right to enter into an agreement to sell equity interests in Sub 3 to an unaffiliated party so long as such agreement was consistent with Section dd of the Disclosure Agreement. Section ee of the Disclosure Agreement permitted Target to negotiate with third parties for the sale of preferred stock or other equity interests in Sub 3.

On Date 4, DRE 1 ceased to qualify as a partnership for federal income tax purposes when two of its three partners were reorganized out of existence. DRE 1 thus became a disregarded entity for federal income tax purposes that was wholly owned by DRE 3, which was wholly owned by Sub 2.

On Date 5, in a transaction intended to qualify under §351, Sub 2 caused DRE 1 to form Sub 4, a domestic corporation, contributing the Business assets (including the interest in DRE 3) in which it had a basis of $d and certain liabilities in exchange for all the stock of Sub 4 (“Transfer One”).

On Date 6, in a transaction intended to qualify under §351, Target contributed the stock of approximately e domestic and foreign subsidiaries to Sub 3 in exchange for f shares of newly-issued Sub 3 common stock (“Transfer Two”).

On Date 7, Acquiring entered into an agreement with an unrelated party, Buyer X, pursuant to which Buyer X would acquire the Business assets from Sub 3 immediately following the merger between Target and Acquiring (the “Asset Purchase Agreement”). The Asset Purchase Agreement permitted Target to sell preferred stock
to third parties, to recapitalize Sub 3, and to issue one or more series of preferred stock to Target affiliates. Attachment 1 of the Asset Purchase Agreement states that Target could cause its affiliates (including DRE 1) to sell shares of stock to third parties. The Asset Purchase Agreement was conditioned on the closing of the merger between Target and Acquiring.

On Date 8, in a transaction intended to qualify under §351, Sub 2 caused DRE 1 to contribute all the stock of Sub 4 (in which it had a basis of $d) to Sub 3 in exchange for g shares of Sub 3 common stock, h shares of newly-issued Sub 3 Series A convertible preferred stock (the “Series A Preferred”), and the assumption of $i in indebtedness (“Transfer Three”). The Series A Preferred constituted j% of the aggregate voting power of the then outstanding Sub 3 capital stock.

On Date 9, Sub 3 sold k shares of newly-issued Series B convertible preferred stock (the “Series B Preferred”) constituting l% of the then outstanding aggregate voting power of the Sub 3 capital stock as follows (the “Series B Issuance”):

<table>
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<tr>
<th>Buyer</th>
<th># Series B preferred shares issued</th>
<th>Value</th>
<th>Voting Power</th>
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<tbody>
<tr>
<td>Acquiring Sub 1</td>
<td>m</td>
<td>$p</td>
<td>s%</td>
</tr>
<tr>
<td>Buyer Y</td>
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<td>s%</td>
</tr>
<tr>
<td>Buyer Z</td>
<td>n</td>
<td>$g</td>
<td>t%</td>
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<tr>
<td><strong>Totals</strong></td>
<td>k</td>
<td>$r</td>
<td>l%</td>
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The taxpayer treated the Series B Issuance as causing the Target group’s ownership of Sub 3 stock to fall below the 80% required for affiliation by §1504, thereby deconsolidating Sub 3 from the Target group.

Also on Date 9, Sub 2 caused DRE 1 to sell its g shares of Sub 3 common stock and its h shares of Series A Preferred stock (the “Stock Disposition”) to Buyer Z (an unrelated party that had also acquired Sub 3 stock as part of the Series B Issuance), for $u. In computing Sub 2’s gain or loss on this transaction, the taxpayer subtracted the $u amount realized from $v, its adjusted basis in the stock sold, resulting in a $w capital loss that was claimed on the Target group’s final return filed for the period ending Date 10.

The Offering Memo (dated Date 11) for the Series A Preferred states the following under the heading “Caption 1”: “DRE 1 will use the secondary sales proceeds to repay inter-company debt to Sub 2. Sub 2 will then use those funds to repay a portion of its inter-company debt.”

The “Attachment 2” included as part of the Offering Memo (dated Date 12) for the Series B Preferred states that “[t]he closing of the purchase of the Series B Preferred by
the Investors will be substantially contemporaneously with, but no later than immediately before, the sale by DRE 1 of the Series A Preferred of Sub 3 to an investor or investors (which persons may also be investors in the Series B Preferred). The Offering Memo for the Series B Preferred also states the following under the heading “Caption 1”: “Sub 3 intends to use the offering proceeds to reduce inter-company debt or for general corporate purposes.” The Offering Memo for the Series B Preferred further states the following under the heading “Caption 2”: “Acquiring expressed at the time of the announcement its intention to separate Target’s Business, either through a sale or a spin-off of the business to its shareholders, after completion of the merger.”

On Date 10, in a transaction intended to qualify under §368(a)(1)(A) by reason of §368(a)(2)(E), Acquiring acquired all the outstanding stock of Target by the merger of Acquiring Sub 2, a wholly owned Acquiring subsidiary, with and into Target with Target surviving (the “Merger”). As a result, the Target group ceased to exist, and Target and its affiliates became members of the Acquiring group. In addition, the taxpayer treated this transaction as causing Acquiring group members’ ownership in the stock of Sub 3 to increase from s% (i.e., a number less than 80%) to x% (i.e., a number more than 80%), with the result that Sub 3 also became a member of the Acquiring group.

On Date 13, Acquiring sold the Business assets held by Sub 3 to Buyer X for $y in cash, a $z face value payment-in-kind note, and a aa% interest in the new enterprise (the “Asset Disposition”), recognizing a capital loss.

Acquiring’s Year 2 annual report indicates that all of the Sub 3 Series A and Series B preferred stock were redeemed in Year 2.

On Date 14, Acquiring filed Form 1139 to carry back a portion of the capital loss arising from the Asset Disposition to the Target group’s Year 3 consolidated return.

LAW AND ANALYSIS

Issue One: Whether the Step Transaction Doctrine should be applied to integrate the Date 9 sale of the Sub 3 Series B Preferred to the Acquiring group with the Date 10 merger so that Sub 3 is never deconsolidated, with the result that Sub 2’s disposition of its g shares of Sub 3 common stock and h shares of Sub 3 Series A Preferred is subject to the Full Basis Redetermination rule of Treas. Reg. §1.1502-35T(b)(1)?

In this case, the Target group claimed a capital loss of $w on its Year 4 consolidated return as a result of the Date 9 Stock Disposition. The taxpayer has taken the position that the Series B Issuance (which constituted l% of the aggregate voting power in Sub 3) immediately prior to the Stock Disposition had the effect of deconsolidating Sub 3 from the Target group. See §§1501 and 1504(a) (affiliation requirement in order to join in the filing of a consolidated return). The taxpayer maintains that it properly applied the basis redetermination rule of §1.1502-35T(b)(2)
applicable to deconsolidations of subsidiary members, resulting in a nominal basis redetermination. The taxpayer further maintains that the loss suspension rule of §1.1502-35T(c) does not apply to the Stock Disposition because Sub 3 ceased to be a subsidiary member of the Target group as a result of the Series B Issuance. The taxpayer concludes that it is entitled to the full amount of the $w loss claimed.1

The issue in this case is whether the form of the taxpayer’s transaction (specifically, the Acquiring group’s purchase of the m shares of Series B Preferred on the eve of its acquisition of Target through the Merger) is to be respected. If the sale of the Series B Preferred to the Acquiring group were to be integrated with the Merger, Sub 3 would not have been deconsolidated, and consequently the Target group would not be entitled to the $w capital loss claimed because the Stock Disposition would have been subject to the Full Basis Redetermination rule.

I. Section 1.1502-35T

Temporary regulations under §1.1502-35T were issued by T.D. 9048 on March 14, 2003. The temporary regulations, which were generally effective March 7, 2002, state that their purpose is to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss. §1.1502-35T(a).2 The regulations carry out this objective through two major rules: the basis redetermination rule of §1.1502-35T(b) (which, as discussed below, reallocates members’ bases in subsidiary stock in prescribed situations) and the loss suspension rule of §1.1502-35T(c) (which suspends loss recognized by members on certain dispositions of subsidiary member stock).3

The basis redetermination rule attempts to mitigate the effect of the assumptions underlying the investment adjustment rules of §1.1502-32 by reversing certain investment adjustments to take into account the source of certain items of deduction and loss. The basis redetermination rule consists of two distinct rules, depending on whether the disposition at issue results in a deconsolidation of the subsidiary from the

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1 The taxpayer’s position on the application of §1.1502-35T is derived from its response to D.


3 An ordering rule provides that the basis redetermination rule applies before the rules of §1.337(d)-2T, while the loss suspension rule applies after the rules of §1.337(d)-2T are applied. See §§ 1.1502-35T(b)(6)(ii) and 1.1502-35T(c)(9). Section 1.337(d)-2T provides another set of rules that are generally applicable to loss dispositions of subsidiary stock by consolidated group members. Section 1.337(d)-2T generally disallows loss to the extent attributable to the recognition of built-in gain on the disposition of an asset.
group. For this purpose, the regulations define a deconsolidation as any event that causes a subsidiary to no longer be a group member. §1.1502-35T(d)(2).

A. Full Basis Redetermination

Section 1.1502-35T(b)(1) (the “Full Basis Redetermination” rule) provides as follows:

(1) Redetermination of basis on certain nondeconsolidating transfers of subsidiary member stock. Except as provided in paragraph (b)(3)(i) of this section, if, immediately after a transfer of stock of a subsidiary member that has a basis that exceeds its value, the subsidiary remains a member of the group, then the basis in each share of subsidiary member stock owned by each member of the group shall be redetermined in accordance with the provisions of this paragraph (b)(1) immediately before such transfer. All of the members’ bases in the shares of the subsidiary member stock immediately before such transfer shall be aggregated. Such aggregated basis shall be allocated first to the shares of the subsidiary member’s preferred stock that are owned by the members of the group immediately before such transfer, in proportion to, but not in excess of, the value of those shares at such time. After allocation of the aggregated basis to all shares of the preferred stock of the subsidiary member pursuant to the preceding sentence, any remaining basis shall be allocated among all common shares of subsidiary member stock held by members of the group immediately before the transfer, in proportion to the value of such shares at such time.

The Full Basis Redetermination rule applies if a member of a consolidated group transfers loss stock (i.e., stock with a basis in excess of value) of a subsidiary (S), and S remains a member after the transfer. Full Basis Redetermination is done by—

(1) Aggregating all members’ bases in S stock immediately before the transfer, and

(2) Allocating this aggregated basis as follows:

(i) First to S preferred stock held by members, in proportion to (but not in excess of) fair market value;

(ii) Any remaining basis is then allocated to S common held by members in proportion to value.

A significant exception provides that the basis redetermination rule does not apply to a complete disposition of all the subsidiary member’s stock to nonmembers. §1.1502-35T(b)(3).
Using the redetermined basis, the transferring member then computes its gain or loss on the transfer of subsidiary stock. The Full Basis Redetermination Rule thus generally has the effect of equalizing members’ bases in subsidiary stock.

B. **Limited Basis Redetermination**

Section 1.1502-35T(b)(2) (the “Limited Basis Redetermination” rule) provides as follows:

(2) **Redetermination of basis on certain deconsolidations of subsidiary members**—(i) **Allocation of reallocable basis amount.** Except as provided in paragraph (b)(3)(ii) of this section, if, immediately before a deconsolidation of a subsidiary member, any share of stock of such subsidiary owned by a member of the group has a basis that exceeds its value, then the basis in each share of the subsidiary member’s stock owned by each member of the group shall be redetermined in accordance with the provisions of this paragraph (b)(2) immediately before such deconsolidation. The basis in each share of the subsidiary member’s stock held by members of the group immediately before the deconsolidation that has a basis in excess of value at such time shall be reduced, but not below such share’s value, in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same; provided, however, that the aggregate amount of such reduction shall not exceed the reallocable basis amount (as computed pursuant to paragraph (b)(2)(ii) of this section). Then, to the extent of the reallocable basis amount, the basis of each share of the preferred stock of the subsidiary member that are held by members of the group immediately before the deconsolidation shall be increased, but not above such share’s value, in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same. Then, to the extent that the reallocable basis amount does not increase the basis of shares of preferred stock of the subsidiary member pursuant to the third sentence of this paragraph (b)(2)(i), such amount shall increase the basis of all common shares of the subsidiary member’s stock held by members of the group immediately before the deconsolidation in a manner that, to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same.

(ii) **Calculation of reallocable basis amount.** The reallocable basis amount shall equal the lesser of—

(A) The aggregate of all amounts by which, immediately before the deconsolidation, the basis exceeds the value of a share of subsidiary member stock owned by any member of the group at such time; and
(B) The total of the subsidiary member’s (and any predecessor’s) items of deduction and loss, and the subsidiary member’s (and any predecessor’s) allocable share of items of deduction and loss of all lower-tier subsidiary members, that were taken into account in computing the adjustment under §1.1502-32 to the bases of shares of stock of the subsidiary member (and any predecessor) held by members of the group immediately before the deconsolidation, other than shares that have bases in excess of value immediately before the deconsolidation.

The Limited Basis Redetermination rule applies in instances where, immediately before a deconsolidation of S, any member owns S loss stock. The basis amount to be reallocated (the “Reallocable Basis Amount”) is the lesser of (1) the group’s aggregate loss in S stock immediately before the deconsolidation, and (2) the total amount of S’s (and its lower-tier subsidiaries’) items of deduction and loss, to the extent taken into account to determine the group’s basis under §1.1502-32 in any non-loss stock of S held immediately before the deconsolidation.\(^5\)

The Reallocable Basis Amount is then taken into account immediately before the deconsolidation as follows:

1. The group reduces the basis of its S loss stock (but not below value) by the Reallocable Basis Amount. To the extent possible, this reduction must cause each of those shares to have the same ratio of basis to value.

2. The group next increases the basis of its non-loss S preferred stock (but not above value) by the Reallocable Basis Amount, and then allocates any remaining amount among its S common stock. To the extent possible, the increase must cause each share to have the same ratio of basis to value.

The Limited Basis Redetermination rule generally has the effect of reallocating prior negative investment adjustments under §1.1502-32 from the subsidiary’s loss shares to non-loss shares; viz, the basis in shares being sold is reduced and reallocated to shares of the subsidiary still owned by group members to the extent of the unrecognized loss.

As noted above, in this case Target takes the position that Sub 3 was deconsolidated as a result of the Series B Issuance (which included a sale to the Acquiring group of \(m\) shares of Series B Preferred constituting \(s\%\) of the voting power in Sub 3), so that the Stock Disposition was subject to the Limited Basis Redetermination

\(^5\) As noted by one commentator, the longer the subsidiary is a group member, the greater its total deduction and loss items are likely to be—and thus the more likely the Reallocable Basis Amount will be the group’s aggregate loss in the subsidiary’s loss stock. See Dubroff, *Federal Income Taxation of Corporations Filing Consolidated Returns* §73.02[3][a].
rule rather than the Full Basis Redetermination rule. If the sale of the Series B Preferred to the Acquiring group were integrated with the Merger, however, Sub 3 would not have been deconsolidated, and consequently the Target group would not be entitled to the $w\text{ capital loss claimed because the Stock Disposition would have been subject to the Full Basis Redetermination rule.}\n
II. The Step Transaction Doctrine

“The step-transaction doctrine developed as part of the broader tax concept that substance should prevail over form.” Assoc. Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1522 (10th Cir. 1991) (internal quotation omitted). Under the step transaction doctrine;

\[\text{[I]nterrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. By thus "linking together all interdependent steps with legal or business significance, rather than taking them in isolation," federal tax liability may be based "on a realistic view of the entire transaction."}\]


Courts have articulated three formulations of the step transaction doctrine: the "end result" test, the "interdependence" test, and the "binding commitment" test. Assoc. Wholesale Grocers, 927 F.2d at 1522; Brown v. United States, 868 F.2d 859, 862 (6th Cir. 1989). The "end result" and "interdependence" tests are the most frequently applied tests. Assoc. Wholesale Grocers, 927 F.2d at 1522. Only one of the tests needs to be satisfied in order for the doctrine to apply. True v. United States, 190 F.3d 1165, 1175 (10th Cir. 1999).

A. The “End Result” test

Under the "end result" test:

[\text{[P]}urportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result.”}\n
Aeroquip-Vickers, Inc. v. Commissioner, 347 F.3d 173, 182 (6th Cir. 2003) (quoting Brown v. United States, 782 F.2d 559, 564 (6th Cir. 1986) (emphasis in original). The taxpayer’s subjective intent is particularly relevant under this test, which focuses on whether the taxpayer intended to reach a particular result by structuring a series of transactions in a certain way. True v. United States, 190 F.3d 1165, 1175 (10th Cir. 1999); Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 195 (D.}
Conn. 2004) (“A prerequisite to application of the end result test is proof of an agreement or understanding between the parties to bring about the ultimate result”).

Recently, the Court of Federal Claims applied the “end result” test to a restructuring by a consolidated group. In Falconwood Corp. v. United States, 60 Fed. Cl. 485 (2004), a consolidated group engaged in a series of transactions by the group restructured into three brother-sister corporations in order to facilitate S elections. The Service argued that the consolidated group terminated under the general rule of §1.1502-75(d)(1) when the common parent (P) merged into a subsidiary (S), and therefore that a loss sustained by S after such merger could not be used to offset income of the group for prior periods. The taxpayer contended that it qualified under the “downstream exception” of §1.1502-75(d)(2)(ii) because after P’s merger into S, S briefly held stock in two subsidiaries before selling their stock to the shareholders.

The court refused to accord independent significance to S’s transitory acquisition of P’s assets (i.e., the subsidiaries’ stock), reasoning that the appropriate point to assess the transaction was at the conclusion of the restructuring. Id. at 492. In holding that both the “end result” and “interdependence” tests of the step transaction applied, the Court of Federal Claims emphasized the subjective intent of the controlling shareholder group: “Clearly, the Jarecki Family Group and its advisors always intended, for tax reasons, to terminate the existence of the Mocatta Group, and never intended to leave in place, even for a single day, a chain of corporations connected through stock ownership with a common parent.” 60 Fed. Cl. at 491.

The Sixth Circuit has applied the “end result” test in order to determine whether the separate steps of a transaction were to be respected or treated as a single unit. The issue before the court in Aeroquip-Vickers, Inc. v. Commissioner, 347 F.3d 173 (6th Cir. 2003) was whether P, the common parent of a consolidated group, was required by former §47(a)(1) to recapture investment tax credits (ITCs) on the transfer of §38 property to P’s wholly owned subsidiary S, which occurred in anticipation of the spin-off of S. Initially, X, one of P’s largest shareholders, approached P about acquiring one of its businesses. While negotiations were underway, P transferred the business to S. One day later, P and X entered into an agreement by which P would split-off S by transferring all its S stock to X in exchange for all of the P stock held by X, which exchange occurred a month later. The taxpayer cited former §1.1502-3(f)(2)(i) and an example in the regulations illustrating that the intercompany sale of §38 property, followed the next year by the sale of the buying member’s stock to a third party, would not cause ITC recapture under §47(a)(1). The Service cited Rev. Rul. 82-20, which

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6 Section 1.1502-75(d)(1) generally provides that a consolidated group remains in existence if the common parent remains as the common parent with at least one affiliated subsidiary.

7 The downstream exception generally provides that a consolidated group is treated as continuing to exist if group members acquire substantially all of the parent’s assets and there remains one or more chains of includable corporations connected with a common parent. §1.1502-75(d)(2)(ii).
explicitly rejected the exception in cases where the intercompany transfer is a step in
the planned transfer of the property outside the group.

The Sixth Circuit upheld the validity of the revenue ruling, and alternatively held
that under step transaction principles P had entered the transaction with the intent to
move §38 property out of the group without triggering the recapture of taxes. 347 F.3d
at 182-183. Because the court viewed the disposition of §38 property outside the
consolidated group as the “end result” contemplated by the taxpayer, the intercompany
sale effectively was disregarded.\(^8\)

In the instant case, the subjective intent of the parties (evidenced by their
execution of the Merger Agreement on Date 3) was for Acquiring to acquire the Target
group. Because Acquiring was not interested in retaining the Business assets held by
Sub 3, however, Acquiring entered into the Asset Purchase Agreement with Buyer X on
Date 7 for the sale of those assets following the Target-Acquiring merger.\(^9\)

In view of the impending merger and Acquiring’s lack of interest in Sub 3’s
specific assets, the Acquiring group’s purchase of the m shares of Series B Preferred
the day before the Merger served no purpose other than to create duplicative tax
benefits inuring to the Target group and the Acquiring group as its successor: First, by
(temporarily) deconsolidating Target and then disposing of the Series A Preferred, the
Target group hoped to recognize a substantial capital loss that would not be subject
to the limitations of the Full Basis Redetermination rule. Second, by reaffiliating Sub 3
through the Merger of Target into Acquiring’s subsidiary, the Acquiring group (as
successor to the Target group in a §381 transaction) hoped to enjoy a tax benefit from
the same economic loss through the Asset Disposition.

Because the “end result” sought by the parties was Acquiring’s acquisition of
Target by merger, the Acquiring group’s purchase of the m shares of Series B Preferred
on the day before the Merger should be integrated with the Merger as a single
transaction. Cf. Basic Inc. v. United States, 212 Ct. Cl. 399 (1977) (intercompany
dividend of S2 stock to S1 prior to P’s sale of both was disregarded on substance over
form grounds where no non-tax reason supported the dividend).

\(^8\) Significantly, the court upheld the application of the step transaction doctrine notwithstanding
the existence of a non-tax business purpose for engaging in the transaction. Aeroquip-Vickers, Inc. v.
States, 927 F.2d 1517 (10th Cir. 1991).

\(^9\) Acquiring’s lack of interest in an investment in Sub 3 is further evidenced by the fact that the
Series B was redeemed in Year 2. See, e.g., Long Term Capital Holdings v. United States, 330 F. Supp.
2d 122 (D. Conn. 2004) (transfer of preferred stock in exchange for partnership interest followed by sale
of partnership interest to another partner nearly one year later were stepped together as sale of preferred
stock between the partners).
B. The “Interdependence” test

The “interdependence test” looks to whether “the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.” Assoc. Wholesale Grocers, 927 F.2d at 1523 (internal quotation omitted); Falconwood Corp. v. United States, 60 Fed. Cl. 485, 491 (2004). This test focuses on the relationship between the steps, rather than on the “end result.” McDonald’s Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520, 524 (7th Cir. 1982). “Disregarding the tax effects of individual steps under this test is, therefore, ‘especially proper where … it is unlikely that any one step would have been undertaken except in contemplation of the other integrating acts …’” Assoc. Wholesale Grocers, 927 F.2d 1517, 1523 (10th Cir. 1991) (quoting Kuper v. Commissioner, 533 F.2d 152, 156 (5th Cir. 1976)). See also Greene v. United States, 13 F.3d 577, 584 (2d Cir. 1994) (in applying the test, courts must determine whether the individual steps had “independent significance or whether they had meaning only as part of the larger transaction”). In assessing interdependence, courts consider the timing of the steps. Assoc. Wholesale Grocers, 927 F.2d at 1528.

In Assoc. Wholesale Grocers, 927 F.2d 1517 (10th Cir. 1991), the taxpayer (P) sought to cash out minority shareholders and recognize a substantial loss in its subsidiary’s (S1) assets while permitting a lower-tier subsidiary (S2) to be acquired by X, an unrelated corporation. S1 first merged into X, and immediately thereafter P repurchased all of S1’s assets except the S2 stock in a taxable reorganization. The taxpayer treated the transaction as a taxable asset sale, and claimed a loss. The Service concluded that the transaction was a complete liquidation of S1 that was subject to the nonrecognition provisions of §332. The taxpayer countered that as a result of the merger, S1’s stock was cancelled, so that when P reacquired the assets of S1 it had not continuously owned 80% of S1’s stock as required by §§332(b)(1) and 1504(a)(2).

Examining the merger and reorganization agreements, the Tenth Circuit found sufficient evidence of interdependence to warrant collapsing them together. 927 F.2d at 1527. The court also considered the timing of the steps, finding it noteworthy that the reorganization agreement specified that it would occur immediately following the merger:

This provision is remarkable for at least two reasons. First, it allows virtually no time to pass between the effectiveness of the two steps which taxpayer vociferously argues are separate transactions. Second, the plan of reorganization actually sets forth the time at which the merger (supposedly a separate transaction controlled by a second agreement) will become effective. Id. at 1528.
In the instant case, the Acquiring group’s purchase of m shares of the Series B Preferred on Date 9 was not a necessary step in the acquisition of Target, which was effected on Date 10 through the Merger. Nonetheless, Target would not have caused Sub 3 to sell the Series B Preferred nor would the Acquiring group have purchased such shares without the impending Merger. As discussed above, the temporary deconsolidation of Sub 3 from the Target group followed by Sub 3’s reaffiliation (within the successor Acquiring group) with the former members of the Target group served only to produce duplicative tax benefits.

The timing of the events is also relevant in assessing their interdependence. The Offering Memo for the Series B Preferred states that “[t]he closing of the purchase of the Series B Preferred by the Investors will be substantially contemporaneously with, but no later than immediately before, the sale by DRE 1 of the Series A Preferred of Sub 3 to an investor or investors (which persons may also be investors in the Series B Preferred).” (Emphasis added.) Without the prior sale of the Series B Preferred, the loss recognized on the sale of the Series A would have been subject to the limitations of the Full Basis Redetermination rule, which would have prevented the Target group (and its successor Acquiring) from enjoying the duplicative tax benefits.

Thus, Sub 3’s purported deconsolidation should be disregarded because the Series B Issuance was tied directly to the Stock Disposition, and both events occurred in anticipation of the Merger between Acquiring and Target, which followed one day later. Cf. Falconwood v. United States, 60 Fed. Cl. 485, 492 (2004) (declining to accord independent significance to subsidiary’s transitory status as “parent” of consolidated group where this was but a step in a restructuring to facilitate S elections by former group members).

III. Impact of Step Transaction Doctrine on §1.1502-35T Analysis

If the sale of the m shares of Series B Preferred to the Acquiring group is integrated with the Merger, Sub 3 is treated as a continuing member of the Target (and its successor) group because group members never owned less than 80% of the Sub 3 stock by vote and value. See §1504(a). If Sub 3 remains a member of the group immediately after a transfer of its loss stock (i.e., the disposition of the Sub 3 Series A Preferred), the Full Basis Redetermination rule applies. Accordingly, all members’ bases in Sub 3 stock immediately before such transfer are aggregated. The aggregated basis is then allocated first to the preferred stock held by members (i.e., the h shares of Series A; the Series B is not counted because it is held only by nonmembers) up to fair market value. The remainder is then allocated to the common held by members (i.e., the f shares held by Sub 3 and the g shares held by Sub 2) in proportion to value.

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10 If the Acquiring group’s purchase of the m shares of Series B Preferred is integrated with the Merger, the m shares received by Acquiring Sub 1 would not be treated as outstanding immediately.
By allocating basis in the Series A Preferred only to the extent of value, the Full Basis Redetermination rule has the effect of eliminating any gain or loss recognized by Sub 2 on the Stock Disposition. This rule does not deny the Target group its basis, it merely reallocates such basis to the common stock still held by members.

Issue Two: Assuming there was a deconsolidation of Sub 3, whether the “End of the Day Rule” of §1.1502-76(b)(1)(ii)(A)(1) treats Sub 3 as still a member of the Target group at the time of Sub 2’s disposition of its g shares of Sub 3 common stock and h shares of Sub 3 Series A Preferred, such that the Full Basis Redetermination rule of §1.1502-35T(b)(1) applies?

Even if the pre-Merger sale of the Series B Preferred to the Acquiring group is respected, the Target group is not entitled to a loss in Year 4 as a result of the Stock Disposition. Under the applicable consolidated return regulations, the deconsolidation of Sub 3 is effective at the beginning of the day following such sale. Section 1.1502-76(b)(1)(ii)(A)(1) provides in pertinent part:

(A) End of the day rule—(1) In general. If a corporation (S) * * * becomes or ceases to be a member during a consolidated return year, it becomes or ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends for all Federal income tax purposes at the end of that day. * * *

Under the “End of the Day” rule, Sub 3’s status as a member of the Target group changes as a result of the Series B Issuance. Specifically, Sub 3 ceases to be a member at the end of the day on Date 9 when the group no longer holds 80% of the aggregate voting power in Sub 3 required for affiliation by §1504. Therefore, at the time of the Stock Disposition, which also occurred on Date 9, Sub 3 was still a member of the group.

Because Sub 3 was still a member of the group immediately after the Stock Disposition, the Target group must apply the Full Basis Redetermination rule to the Stock Disposition, rather than the Limited Basis Redetermination rule. See §1.1502-35T(b)(1) (Full Basis Redetermination rule applies if “immediately after a transfer of stock of a subsidiary member that has a basis that exceeds its value, the subsidiary remains a member of the group”).

before the transfer of the Series A loss stock, and thus would not be subject to allocation under the Full Basis Redetermination rule.

11 We note that if, after application of the Full Basis Redetermination rule, a loss still results from the Stock Disposition (e.g., due to the disposition of the g shares of Sub 3 common), such loss is subject to the loss suspension rule. §§1.1502-35T(b)(6)(ii), 1.1502-35T(c)(9). If such is the case, please contact this office for further advice.
Issue Three: Whether the loss claimed by the Target group with respect to the disposition of the g shares of Sub 3 common stock and h shares of Sub 3 Series A Preferred can be disallowed by the application of §269(a) to (i) the acquisition of Sub 3 by members of the Target group, or (ii) Sub 3’s acquisition of property from group members?

Section 269(a) provides as follows:

In General.—If-

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

I. Application of §269(a)(1)

There are three conditions for the application of §269(a)(1): (1) a person or persons acquire, directly or indirectly, control of a corporation, (2) the principal purpose for the acquisition is to evade or avoid Federal income tax, (3) by securing the benefit of a deduction, credit, or other allowance that would not otherwise be enjoyed.

A. Acquisition of Control

The first requirement is that a person or persons must acquire control of a corporation. As a threshold matter, the term “person” is broadly defined to include an individual, trust, estate, partnership, association, company, or corporation. §7701(a)(1); §1.269-1(d). For purposes of §269(a), control is the ownership of stock having at least 50% of the combined voting power of all classes of stock entitled to vote, or at least
50% of the total value of all shares of all classes of stock. §269(a) (flush language); §1.269-1(c).

In this case, Target acquired all the common stock of Sub 3 on Date 6 as part of Transfer Two, and Sub 2 acquired g shares of Sub 3 common and h shares of Sub 3 Series A Preferred as part of Transfer Three on Date 8. The Merger Agreement executed by Acquiring and Target on Date 3 specifically contemplated the issuance of preferred stock by Sub 3. Therefore, Transfers Two and Three should be viewed together as part of a single plan to capitalize Sub 3. See §1.269-1(c) (example of creeping acquisition of control). Accordingly, the acquisition of control requirement of §269(a)(1) is satisfied because members of the Target group owned all of the outstanding stock of Sub 3 after Transfers Two and Three. See §§1.269-1(c) and 1.1502-34.

B. Principal Purpose to Evade or Avoid Tax

The second requirement is that the acquisition must have had as its principal purpose the evasion or avoidance of Federal income tax. To constitute the principal purpose, the purpose to evade or avoid Federal income tax must outrank, or exceed in importance, any other purpose. Canaveral Int'l Corp. v. Commissioner, 61 T.C. 520, 536 (1974); §1.269-3(a). This is a question of fact, to be determined by considering all the facts and circumstances of the entire transaction, with the burden of proof on the taxpayer. J.T. Slocomb Co. v. Commissioner, 334 F.2d 269, 273 (2d Cir. 1964); §1.269-3(a). Under this standard, the purpose that is relevant is the purpose that existed at the time of the acquisition, although facts occurring prior to and following the transaction may be considered to the extent that they tend to support or negate the forbidden purpose. Hawaiian Trust Co. v. United States, 291 F.2d 761, 768 (9th Cir. 1961).

We do not have sufficient facts to determine conclusively whether this requirement is satisfied. Further factual development is necessary; in particular, as to the taxpayer’s non-tax business purposes for Transfers Two and Three.

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12 It is our understanding that Target was formed as a mere shell on Date 2, and not capitalized until Transfers Two and Three on Dates 6 and 8, respectively. Our conclusions with respect to the application of §269 are premised on these facts. Please contact this office for further advice if our understanding of these facts is incorrect.

13 Section 1.1502-34 provides, in pertinent part, that for purposes of §§1.1502-1 through 1.1502-80, in determining the stock ownership of a member of the group in another corporation for purposes of determining the application of §351(a) in a consolidated return year, there shall be included stock owned by all other members of the group in the issuing corporation. Under this aggregation rule, in assessing whether the control requirement of §351(a) is met all of the Sub 3 common stock received by Target in Transfer Two is considered in conjunction with the Series A Preferred received by Sub 2 in Transfer Three.
We note that Transfer Three and subsequent transactions (specifically, the Series B Issuance, the Stock Disposition, and the Asset Disposition) display sophisticated tax planning. Any evidence of business purpose offered by the taxpayer must be weighed against the significant tax savings produced by the transactions. The transactions served to capitalize Sub 3 with two series of preferred stock: the Series B (carrying 1% of the aggregate voting power in Sub 3 but relatively little of the value) and the Series A (with a high basis and low value). The Series B Issuance appears intended to deconsolidate Sub 3 temporarily prior to the Stock Disposition, while the Stock Disposition permitted the Target group to accelerate losses and avoid the limitations of the Full Basis Redetermination rule. Once the planned merger with Acquiring was consummated the next day, Target and Sub 3 became reaffiliated, thereby permitting their successor group to dispose of Sub 3’s Business assets in order to produce a duplicative benefit.  

C. Securing the benefit of a deduction, credit, or other allowance that would not otherwise be enjoyed

The third requirement is met in this case. Prior to Transfer Three, Sub 2 held all the stock of Sub 4 (which held the Business assets, and was itself newly formed on Date 5) in which it had a basis substantially in excess of value; the disposition of the Sub 4 stock would have resulted in a loss that the Target group could have reported on its consolidated return only once. To the extent that Transfer Three qualifies under §351, the contribution of the Sub 4 stock to Sub 3 was intended to allow the Target group to enjoy duplicative deductions with respect to these losses: first, when Sub 2 caused DRE 1 to dispose of its g shares of Sub 3 common stock and h shares of Series A Preferred, and later when Sub 3 disposed of the Business assets.

D. Alternative Application of §269(a)(1)

In addition, §269 may be applied to deny the benefits of nonrecognition treatment under §351 to Sub 2 on Transfer Three. When the requirements of §269(a) are satisfied, the Service can disallow any deduction, credit, or other allowance resulting from an acquisition. Section 1.269-1(a) defines an “allowance” as anything in the Code that has the effect of diminishing tax liability. The nonrecognition treatment provided by

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14 The Service can apply §269 to disallow tax benefits from transactions related to an acquisition of control of a corporation even if the transaction in which control is acquired does not create tax benefits in and of itself. See §1.269-3(a) (providing that if the principal purpose test is met with respect to an acquisition giving rise to a tax benefit, then “it is immaterial by what method or by what conjunction of events the benefit was sought”). See, e.g., J.T. Slocomb Co., 334 F.2d 269, 274 (1974) (§269(a) applied to disallow use of Target’s net operating loss carryovers obtained through purchase of Target’s stock and its subsequent merger with two profitable corporations).

15 The duplication occurs by operation of §358, which generally provides that the basis of property received in an exchange to which §351 applies is equal to that of the property exchanged.
§351 is therefore an allowance. If further development establishes that the principal purpose for Transfer Three was tax evasion or avoidance, §269 can apply to prevent nonrecognition treatment, thereby making Transfer Three a taxable exchange under §1001. The effect would be that Sub 2 will take a cost basis under §1012 in the Sub 3 Series A Preferred, thereby eliminating any loss by Sub 2 on the Stock Disposition.

We note that there are hazards with respect to such an argument. In Cherry v. United States, 264 F.Supp 969 (C.D. Cal. 1967), the Service attempted to deny nonrecognition treatment under §§336 and 453. The court held that the statutory provisions dealing with the nonrecognition of gain are not encompassed by the terms “deduction, credit, or other allowance” and that §269 does not address nonrecognition concepts. See also Bijou Park Properties, Inc. v. Commissioner, 47 T.C. 207 (1966). The Service disagrees with these authorities. Cherry, Ray K., 1969 AOD Lexis 324 (Nov. 20, 1969); Bijou Park Properties, Inc., acq. in result only, 1967 AOD Lexis 41 (Oct. 27, 1967). As discussed above, §1.269-1(a), promulgated in 1962, provides that the term “allowance” refers to anything in the Code that has the effect of diminishing tax liability. Because the nonrecognition of gain from an exchange of stock has the effect of diminishing tax liability, it is the Service’s position that such nonrecognition is an allowance within the meaning of §269 and, accordingly, §269 can apply to deny nonrecognition treatment.

II. Section 269(a)(2)

Section 269(a)(2) applies in instances where (1) a corporation acquires property of another corporation, (2) immediately before the acquisition the transferor corporation is not controlled, directly or indirectly, by the acquiring corporation or its shareholders, (3) the acquiring corporation’s basis in such property is determined by reference to the basis in the hands of the transferor, and (4) the principal purpose for the acquisition is to evade or avoid Federal income tax by securing the benefit of a deduction, credit, or other allowance that such corporation would not otherwise enjoy.

In this case, Transfer Three satisfies requirement (1) because Sub 3 acquired property (i.e., the stock of Sub 4) from Sub 2. If Transfer Three qualifies under §351, then requirement (3) is also met because Sub 3’s basis in the property received from Sub 2 would be determined by reference to the basis of such property in the hands of Sub 2. See §362.

The principal purpose requirement of item (4) is identical to that discussed above. As one example of a principal purpose to evade or avoid tax, the regulations describe the acquisition by a corporation of property having a carryover basis that is materially greater than its fair market value at the time of the acquisition, which is then used to create tax-reducing losses or deductions. §1.269-3(c)(1). In the instant case, as discussed supra, it appears that the principal purpose for the transfer of the Sub 4 stock to Sub 3 in Transfer Three may have been the evasion or avoidance of Federal
income tax by securing the benefit of duplicative deductions with respect to a single economic loss; i.e., the Stock Disposition followed by the Asset Disposition. Thus, requirement (4) also may be met.

Section 269(a)(2) also requires that the acquiring corporation and its shareholders not control the transferor corporation immediately before the acquisition (the "common control exception"). See, e.g., Coastal Oil Storage Co. v. United States, 242 F.2d 396, 399 (4th Cir.) (§269(a)(2) applied to deny a separate surtax exemption for a newly formed subsidiary). We concluded supra that Transfers Two and Three should be viewed together as an acquisition of control for purposes of §269(a)(1). Unlike §269(a)(2), however, §269(a)(1) does not contain a common control exception. If Transfer Two were to be respected as a separate transaction from Transfer Three, then the common control exception would appear to apply because Target, Sub 3's shareholder, controls Sub 2. In such a case, §269(a)(2) would not apply to Transfer Three.

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Please call ______________________ at ______________________ if you have any further questions.

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16 We note that the Coastal Oil opinion does not specifically address the common control exception in connection with its holding on §269(a)(2). As additional authority, Example (3) of §1.269-6 indicates that §269(a) would apply to a parent corporation's transfer of a profitable business to a recently-acquired subsidiary in a transfer in which the basis of the transferred assets in the hands of the subsidiary is determined by reference to their basis in the hands of the parent. This example implies that the common control exception is inapplicable, perhaps on the grounds that the parent is not literally controlled immediately beforehand by the subsidiary.