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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JEFFREY L. BASSIN, Special Trial Attorney (International)

FROM: ELIZABETH KARZON, Chief
Branch 1 (International) CC:INTL:BR.1

SUBJECT:

This Field Service Advice responds to your memorandum dated March 19, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Individual A =
Individual B =
Individual C =
Individual D =
Corporation A =
Corporation B =
Corporation C =
Limited Liability Company =
Limited Partnership A =
Limited Partnership B =
Foreign Corporation A =
Foreign Corporation B =

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Trust X	=	
Trust Y		=
Trust Z		=
State A	=	
Country A	=	
Country B	=	
Country C	=	
Business S	=	
Stock A	=	
Stock B	=	
Stock C	=	
Year 1	=	
Date 1		=
Date 2		=
Date 3		=
Date 4		=
Date 5		=
Date 6		=
Date 7		=
Amount A	=	

ISSUES:

1. Whether I.R.C. § 357 applies to Individual C's and Individual D's contribution of shares of Stock A, Stock B, Stock C, and other assets (including certain short sales proceeds) to Foreign Corporation A and Foreign Corporation B, respectively, subject to such corporations' agreement to assume Limited Partnership A's and Limited Partnership B's obligation to close out short sales with respect to Stock A, Stock B, Stock C, and the agreement to assume certain margin liabilities, such that Individual C and Individual D will be treated as having gain from the sale of such stock for purposes of I.R.C. § 877.
2. Whether the transfers and assumptions at issue may be disregarded for lack of business purpose, recharacterized under the substance over form doctrine, or the income therefrom reallocated under I.R.C. § 482, so that Individual C and Individual D are taxable under I.R.C. § 877 upon the closure of the short positions by the foreign corporations on Date 7.
3. Whether the distribution of shares of Stock A, Stock B, and Stock C, the short sale proceeds and the assumption of open short sale against the box positions with respect to such stock and certain margin liabilities on Date 5 by Limited Partnership A and Limited Partnership B, domestic partnerships, to their partners, Trust Y, Trust

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Z, and Limited Liability Company, and subsequent distributions of such property and assumptions on the same day by those partners to Individual C and Individual D, respectively, can be disregarded or recharacterized so as to treat the transfers and assumptions of such property by Individual C and Individual D on Date 6 to Foreign Corporation A and Foreign Corporation B as transfers by domestic partnerships to foreign corporations, resulting in the imposition of income tax under I.R.C. § 367(a) or excise tax under I.R.C. § 1491.

CONCLUSIONS:

1. I.R.C. § 357(c) will not apply to Individual C's and Individual D's contribution of shares of Stock A, Stock B, Stock C and other assets (including certain short sale proceeds) to Foreign Corporation A and Foreign Corporation B, subject to such corporations' respective agreement to assume Limited Partnership A's and Limited Partnership B's obligation to close out short sales with respect to Stock A, Stock B, Stock C, and the assumption of certain margin liabilities, providing such liabilities (the obligations to close out the short sales and the margin liabilities) do not exceed the basis of the assets transferred. In addition, I.R.C. § 357(b) will not apply if the assumption or acquisition was not for the purpose to avoid Federal income tax on the exchange and was a bona fide business purpose.
2. There are several legal doctrines that may allow the Service to recharacterize or disregard the transfers and assumptions at issue, or reallocate the income and therefore impose tax on Individual C and Individual D under I.R.C. § 877 upon the settlement of the short positions on Date 7. These doctrines include the corporate business purpose doctrine and substance over form doctrine, and I.R.C. § 482. Whether these doctrines will prevail depends on the entire facts and circumstances, as well as the weight given to the legislative history involving the need for subsequent amendments to I.R.C. § 877.
3. A substance over form analysis would have to be done to recharacterize the series of transfers and assumptions as exchanges described in I.R.C. § 367(a) or capital contributions by domestic partnerships to foreign corporations, resulting in the imposition of income tax under I.R.C. § 367(a) or excise tax under I.R.C. § 1491. The facts do not support this approach at this time.

FACTS:

Individual A and his son, Individual B, developed a manufacturing process that resulted in the formation of Corporation A and significant family wealth. Individual A died leaving the stock in Corporation A to three residual domestic trusts, Trust X, Trust Y, and Trust Z. Corporation B, of which Individual B was president, was named trustee of each trust. Individual C and Individual D,

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grandsons of Individual A and sons of Individual B, were the sole income beneficiaries of Trust Y and Trust Z, respectively.

During the 1980's, the corporate structure was reorganized. Corporation A, a domestic corporation, was restructured into brother-sister S corporations, Trust Y and Trust Z each owned 50% of the stock of each S corporation, and Individual C and Individual D each elected to have their trusts be treated as qualified subchapter S trusts (QSSTs). As a result, for the period that the trusts so qualified, the trusts were treated as grantor trusts under I.R.C. § 671, with Individual C and Individual D each treated under I.R.C. § 678 as the owner of that portion of their trusts that consisted of the stock in the S corporations.

In addition to owning stock in the various S corporations, Trust Y and Trust Z each also owned a 99% limited partnership interest in Limited Partnership A and Limited Partnership B, respectively. Limited Partnership A and Limited Partnership B were both domestic partnerships organized in State A. In Year 1, Limited Partnership A and Limited Partnership B moved their operations to Country C. Limited Liability Company, of which Trust Y and Trust Z each owned 50%, was the 1% general partner of Limited Partnership A and Limited Partnership B. Limited Liability Company was organized in State A, but operates in Country C. It is taxed as a partnership. With respect to the portion of Trust Y and Trust Z that consisted of the limited partnership interests, we have assumed that Individual C and Individual D were not treated as the owners of the trust under I.R.C. § 678. Thus, we have assumed for purposes of our analysis that Trust Y and Trust Z were nongrantor trusts with respect to income derived from their partnership interests.

On Date 1, Individual C renounced his U.S. citizenship in Country A. On Date 2, Individual D renounced his U.S. citizenship in Country B. Foreign Corporation A and Foreign Corporation B were organized and registered in Country C on Date 3, shortly after Date 1 and Date 2.

The transactions at issue involved a technique known as selling short "against the box." In a short sale, a taxpayer sells borrowed property, such as stock, and closes the transaction by returning identical property to the lender. For the taxable years at issue, no gain or loss is realized until the transaction closes. See I.R.C. § 1233 and Treas. Reg. § 1.1233-1(a)(1). In a typical short sale, a taxpayer is "betting" that the price of the stock will decline. He expects to make a profit by delivering, at the closing of the transaction, stock purchased at a lower price than the sale price of the stock sold at the transaction's inception. In a short sale against the box transaction, an additional factor is present. While a taxpayer sells borrowed property, at the same time he owns substantially identical property. A broker effectuating a short sale against the box is required to keep the taxpayer's "long" and "short" positions entirely separate. Through such transactions, a taxpayer could

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lock in gain on appreciated securities upon the opening of the transaction, but not realize the gain for tax purposes until the short position was ultimately closed out. The availability of this technique was eliminated by the enactment of I.R.C. § 1259 in the Taxpayer Relief Act of 1997, effective for short sales against the box entered into after June 8, 1997.

Over a period prior to Date 1, Limited Partnership A purchased shares of Stock A common stock in various lots at various prices per share. Shortly before and after Date 1, Limited Partnership A sold "short against the box" shares of Stock A in various lots at various prices per share. Stock A is stock of a domestic corporation.

Over a period beginning prior to Date 1 and ending prior to Date 5, Limited Partnership A purchased shares of Stock B in various lots at various prices per share. In Date 4, Limited Partnership A sold short against the box shares of Stock B in various lots at various prices per share. Stock B is stock of a domestic corporation.

Over a period prior to Date 1, Limited Partnership A purchased shares of Stock C in various lots at prices per share. After Date 1 and prior to Date 5, Limited Partnership A sold short against the box shares of Stock C in various lots at various prices. Stock C is stock of a domestic corporation.

During similar time periods, Limited Partnership B engaged in comparable transactions in Stock A, Stock B, and Stock C. Through these short sales against the box, Limited Partnership A and Limited Partnership B locked in their gains in these securities, but did not realize such gains because the short sales against the box were still open. According to the examining agent, the unrealized capital gain accumulated by Limited Partnership A through these transactions totaled Amount A, and the unrealized capital gain accumulated by Limited Partnership B was approximately the same.

On Date 5, approximately nine months after Individual C and Individual D renounced their citizenship, Limited Partnership A distributed the shares of Stock A, shares of Stock B, and shares of Stock C, as well as 99% of the cash deposited with Limited Partnership A's broker as security for the short sales described above, to Trust Y, subject to Trust Y's assumption of 99% of Limited Partnership A's obligations under these short sales, and assumption of the margin liabilities associated with the long positions in the stocks. The money distributed (including deemed distributions) did not exceed Trust Y's adjusted basis in Limited Partnership A immediately before the distribution. On the same day, Limited Partnership A distributed shares of Stock A, shares of Stock B, and shares of Stock C, as well as the remaining 1% of the cash deposited as security with Limited Partnership A's broker, to its sole general partner, Limited Liability Company,

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subject to Limited Liability Company's assumption of the remaining 1% of Limited Partnership A's obligations under these short sales. The money distributed (including deemed distributions) did not exceed the Limited Liability Company's adjusted basis in Limited Partnership A immediately before the distribution. Limited Partnership A retained its remaining assets, including certain shares of Stock B. On the same day, Limited Partnership B engaged in similar transactions. The money distributed (including deemed distributions) did not exceed Trust Z's or Limited Liability Company's adjusted basis in Limited Partnership B immediately prior to the distribution.

Also on Date 5, Limited Liability Company distributed the stock and cash it received from each of Limited Partnership A and Limited Partnership B to Trust Y and Trust Z, respectively, subject to Trust Y's and Trust Z's respective agreements to assume Limited Liability Company's obligations to cover the short sales described above and assumption of the margin liabilities associated with the long positions in the stocks. On the same day, upon receipt by Trust Y and Trust Z of the items distributed by Limited Partnership A, Limited Partnership B and Limited Liability Company, Trust Y and Trust Z distributed these items to their respective sole income beneficiaries. Trust Y distributed Stock A, Stock B and Stock C, as well as other additional assets (which include the short sale proceeds), to Individual C, subject to Individual C's agreement to cover the short sales described above, and assumption of the margin liabilities associated with the long positions in the stocks. Trust Z distributed Stock A, Stock B and Stock C it received to Individual D, subject to Individual D's agreement to cover the short sales, and assumption of the margin liabilities associated with the long positions in the stocks.

On Date 6, approximately six months after Date 5, Individual C contributed shares of Stock A, shares of Stock B and shares of Stock C to Foreign Corporation A, a Country C corporation of which Individual C was the sole owner, plus other additional assets (which include the short sale proceeds), subject to Foreign Corporation A's agreement to assume Limited Partnership A's obligation to cover the short sales and assumption of the margin liabilities associated with the long positions in the stocks. (Notwithstanding that the corporate minutes do not state that the margin liabilities were assumed, such liabilities were apparently assumed during such transaction). On the same day, Individual D engaged in comparable transactions with Foreign Corporation B, a Country C corporation of which Individual D was the sole owner.

On Date 7, approximately seven months after Date 6, Foreign Corporation A closed out the short sale obligations it assumed with the shares held on account with its broker. On the same day, Foreign Corporation B closed out the short sale obligations it assumed with the shares held on account with its broker. These transactions resulted in realization of the gains inherent in the short sale against the box transactions.

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Dates 1 through 5 all preceded the effective date of the amendments to I.R.C. § 877 by the Health Insurance Portability and Accountability Act of 1996, P.L. 104-191 (HIPAA), February 6, 1995. Date 7 preceded June 8, 1997, the effective date of I.R.C. § 1259 enacted in the Taxpayer Relief Act of 1997, P.L. 105-34, (TRA), which now prevents taxpayers from locking in the gain of appreciated property upon the opening of a short against the box transaction but not realizing the gain until the short position is closed out.

The taxpayers have represented that after the closure of the short positions, part of the proceeds were used to repay debt owed by Foreign Corporation A and B to its brokers. The remaining proceeds were loaned by Foreign Corporation A and Foreign Corporation B to a related foreign corporation owned by Individual C and used by those corporations to acquire other securities.

The taxpayers have represented that there were several reasons for the transfer of the identified shares and accompanying short positions to Foreign Corporation A. First,

Second,

Third,

Fourth,

LAW AND ANALYSIS

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ISSUE 1

Internal Revenue Code § 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for the corporation's stock and immediately after the exchange the transferors are in control of the corporation.

Internal Revenue Code § 357(a) provides a general rule that a corporation's assumption of a shareholder's liability in a I.R.C. § 351 exchange will not be treated as money or other property received by the shareholder. Internal Revenue Code § 357(b) provides an exception to the general rule of I.R.C. § 357(a) when it appears that the principal purpose of the shareholder in having the liability assumed was avoidance of Federal income tax on the exchange or, if not such purpose, was not a bona fide business purpose.

Internal Revenue Code § 357(c)(1) contains another exception to the general rule of I.R.C. § 357(a). Prior to amendment by P.L. 106-36 § 3001, I.R.C. § 357(c)(1) provided that if the sum of the liabilities the corporation assumes and takes property subject to exceeds the total of the adjusted basis of the property the shareholder transfers to the corporation pursuant to the exchange, then the excess shall be considered as gain from the sale or exchange of property.

Internal Revenue Code § 358(a)(1) provides that in a I.R.C. § 351 exchange the basis of the property permitted to be received under I.R.C. § 351 without the recognition of gain or loss shall be the same as that of the property exchanged, decreased by (i) the fair market value of any other property (except money) received by the taxpayer, (ii) the amount of any money received by the taxpayer, and (iii) the amount of loss to the taxpayer which was recognized on such exchange, and increased by (i) the amount which was treated as a dividend and (ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

Internal Revenue Code § 358(d)(1) provides that where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer, such assumption (in the amount of the liability) shall, for purposes of I.R.C. § 358, be treated as money received by the taxpayer on the exchange.

A short sale creates an obligation on the part of the seller to return the borrowed securities. *See, e.g., Deputy v. du Pont*, 308 U.S. 488, 497-98 (1940), 1940-1 C.B. 118, 122 (a short sale creates an obligation although not an indebtedness). The initial proceeds of an open short sale are not currently taxed to the short seller, but nonetheless are an asset of the short seller, increasing the aggregate adjusted basis of its total assets by the amount of the proceeds. Because the obligation on the part of the seller to return the borrowed securities

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resulted in an increase in the adjusted basis of its assets, the obligation is treated as a liability in the amount of the short sales proceeds. Rev. Rul. 95-45, 1995-1 C.B. 53; see S. REP. NO. 1263, 95th Cong., 2d Sess. 183-185 (1978), 1978-3 C.B. 481-483 (an obligation that creates basis is treated as a liability); Rev. Rul. 95-26, 1995-14 I.R.B. 6; and Rev. Rul. 88-77, 1988-2 C.B. 128. Thus, the assumption of an obligation to deliver replacement securities to close out a short sale is treated as an assumption of a liability in the amount of the short sale proceeds for purposes of I.R.C. §§ 357 and 358. *Id. Cf.* Rev. Rul. 95-26, 1995-1 C.B. 131 (short-sale obligation constitutes I.R.C. § 752 liability).

Based on this analysis, provided Limited Partnerships A and B received the initial proceeds from the short sales, and that Individual C and Individual D acquired through Trust Y and Trust Z, respectively, the proceeds (or rights therein), then on Date 6, when Individual C and Individual D respectively transferred Stock A, Stock B and Stock C to Foreign Corporation A and Foreign Corporation B in connection with exchanges described in I.R.C. § 351, Foreign Corporation A and Foreign Corporation B assumed liabilities equal to the proceeds received from the original short sales by Limited Partnership A and Limited Partnership B and the margin liabilities associated with the long positions in the stocks. Accordingly, if the amount of these liabilities with respect to Stock A, Stock B, and Stock C exceeded Individual C's and Individual D's basis in such stock plus the short sale proceeds transferred and the other assets contributed by the shareholders, then such excess will be considered gain from the sale or exchange of property. I.R.C. §§ 357(c)(1), (2). If there is a deemed sale or exchange of the stock as a result of I.R.C. § 357(c), then Individuals C and D may be liable for tax under I.R.C. § 877 by operation of former I.R.C. § 877(c)(2), which imposes tax on gains from the sale or exchange of stock in domestic corporations. However, it is our understanding that the basis of all the assets transferred by the shareholders exceeded the amount of all the liabilities assumed.

Alternatively, I.R.C. § 357(b)(1) provides that, if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption was to avoid Federal income tax on the exchange or if the purpose was not a bona fide business purpose, then the assumption (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of I.R.C. § 351 be considered as money received by the taxpayer on the exchange. Under this provision, the burden of proof shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence. I.R.C. § 357(b)(2). We recommend factual development on this point to determine whether tax consequences may arise under I.R.C. § 357(b) from the transfer of the short-sale obligation or the margin liabilities associated with the long positions in the stock. If I.R.C. § 357(b) applies, because the short sale obligation or the margin liabilities associated with the long positions in the stock

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was assumed by the foreign corporations with the principal purpose of avoiding income tax, or was incurred without a valid business purpose, then the total amount of the short sale proceeds and the margin liabilities associated with the long positions in the stocks will be treated as money received. I.R.C. § 357(b)(1). If the total amount of the proceeds and the margin liabilities associated with the long positions in the stocks are treated as money received, then this has the effect of deeming a sale or exchange of the excess of fair market value of the stock and other property transferred over its basis.

In conclusion, I.R.C. § 357(c) will not apply to Individual C's and Individual D's contribution of shares of Stock A, Stock B, Stock C and other assets (including certain short sale proceeds) to Foreign Corporation A and Foreign Corporation B, subject to such corporations' respective agreement to assume obligations to close out short sales with respect to Stock A, Stock B, Stock C, and the assumption of certain margin liabilities, providing such liabilities do not exceed the basis of the assets transferred. In addition, I.R.C. § 357(b) will not apply if the assumption or acquisition was not for the purpose to avoid Federal income tax on the exchange and was a bona fide business purpose.

ISSUE 2

The expatriation provisions were first enacted as part of the Foreign Investors Tax Act of 1966. P.L. No. 89-809, Stat. 1539 §§103(f) (income tax), 108(f) (estate tax), and 109 (gift tax). These provisions imposed an alternative scheme of income, gift and estate taxation on U.S. citizens who, with avoidance of U.S. income or transfer taxes as one of their primary purposes, renounced their U.S. citizenship. Under I.R.C. § 877 for the 10-year period following the year of expatriation, the expatriate was subject to the normal rules applicable to the income taxation of nonresident aliens, with two major differences. First, the expatriate was taxed like a U.S. citizen on U.S. source income at the income rates applicable to U.S. citizens if it resulted in a tax greater than the tax that would have been imposed on the expatriate at the rates applicable to nonresident aliens. See former I.R.C. § 877(a) and (b). Second, the class of items that was treated as U.S. source income for the purpose of I.R.C. § 877 was broader than that treated as U.S. source income for other nonresident aliens. An expatriate who was subject to former I.R.C. § 877 was required to include in gross income gains from the sale of stocks and securities issued by U.S. persons. See former I.R.C. § 877(c)(2). For these purposes, gain on the sale or exchange of property which has a basis determined in whole or in part by reference to stock issued by a domestic corporation was also treated as a sale of stock of a domestic corporation. Thus, if

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an expatriate transferred stock of a domestic corporation to a foreign corporation in a transaction described in I.R.C. § 351, and then disposed of the stock of the foreign corporation, the gain would be subject to former I.R.C. § 877, since the expatriate's basis in the stock of the foreign corporation would be determined by reference to his basis in the stock of the domestic corporation. However, a tax motivated expatriate could circumvent the imposition of tax on the disposition of stock of a domestic corporation by transferring the stock to a foreign corporation that he controlled and by causing the foreign corporation to dispose of the property.

Internal Revenue Code § 877 was substantially revised in August 1996 as part of the Health Insurance Portability and Accountability Act. Under current I.R.C. § 877(d)(2), if an expatriate exchanges property that would produce U.S. source income for property that would produce foreign source income within a 10 year period following expatriation, the expatriate is required to immediately recognize as U.S. source income any gain on such exchange, determined as if the property had been sold for its fair market value on such date, unless the expatriate enters into a gain recognition agreement pursuant to I.R.C. § 877(d)(2)(C). See H. REP. NO. 496, 104th Cong., 2d Sess. 152-53 (1996), *reprinted in* 1996 U.S.C.C.A.N., Vol. 5, pp. 1953-54 and Joint Committee on Taxation Staff, *General Explanation of Tax Legislation Enacted in the 104th Congress*, 104th Cong., 2d Sess. 382-85 ("Blue Book"). If the new provision applied to the transactions at issue, the contributions of the stock and short against the box provisions to Foreign Corporation A and Foreign Corporation B on Date 6 would be treated as exchanges of property producing U.S. source income for property producing foreign source income, *i.e.*, stock in Foreign Corporation A and Foreign Corporation B. The short against the box sales would be deemed closed as of that date, resulting in the realization of gain by Individual C and Individual D. The gain recognition agreement exception, had it applied, would only have deferred the gain to be recognized by Individual C and Individual D until Foreign Corporation A and B respectively closed its short against the box positions on Date 7.

The legislative history to the 1996 amendments to I.R.C. § 877 noted that under previous law:

Even if an individual is subject to the alternative taxing method of section 877 (because the person expatriated with a principal purpose of avoiding U.S. tax), section 877 does not impose a tax on foreign source income. Thus, such an individual could expatriate and subsequently transfer appreciated property to a foreign corporation or other entity beyond the U.S. taxing jurisdiction, without any U.S. tax being imposed on the appreciation under section 877.

H. REP. NO. 496 at 145; see also Blue Book at 375.

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The transaction described in the House Report and Blue Book is the type of transaction engaged in by Individual C and Individual D (except that the example does not include a short against the box component, whereby the gain inherent in the property transferred was locked in prior to the property being transferred to the foreign corporation.) Individual C and Individual D avoided the literal application of I.R.C. § 877 because neither one sold stock of a domestic corporation, or stock with a basis determined by reference to the stock of a domestic corporation (which would have occurred only if they had sold the stock of Foreign Corporation A or Foreign Corporation B).

CORPORATE BUSINESS PURPOSE DOCTRINE

Internal Revenue Code § 351(a) provides that gain or loss shall not 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 such exchange such person or persons are in control of the corporation. For purposes of I.R.C. § 351(a), the term “control” means the ownership of at least 80 percent of (i) the total combined voting power of all classes of voting stock, and (ii) the total number of shares of all other classes of stock of such corporation. See I.R.C. § 368(c) and Treas. Reg. §1.351-1(a)(1).

Internal Revenue Code § 351(a) generally would apply to the transfer of property and short positions by a nonresident alien to a foreign corporation if the nonresident alien received 100% of the stock of the foreign corporation in the exchange, or even if no stock were issued and the transferor already had the requisite control over the foreign corporation and the issuance of the stock would be a meaningless gesture. Under U.S. tax principles, courts have recognized that a taxpayer may benefit from nonrecognition treatment under I.R.C. § 351 only if some valid, non-tax business purpose partially motivated the transaction. See *e.g.*, *Caruth v. United States*, 688 F. Supp. 1129 (N.D. Tex. 1989), *aff'd*, 865 F.2d 644 (5th Cir. 1989); *Stewart v. Commissioner*, 714 F.2d 977, 987 (9th Cir. 1983), *aff'g* T.C. Memo 1982-209; *Estate of Kluener v. Commissioner*, 154 F.3d 630 (6th Cir. 1998), *aff'g in relevant part and rev'g in part* (on another issue) T.C. Memo 1996-519; *Smalley v. Commissioner*, T.C. Memo. 1973-85.

In determining whether a valid, non-tax business purpose partially motivated the transaction, courts examine all the facts and circumstances, with particular emphasis on the following factors: whether the transfer fulfilled its stated purpose; the extent to which the transferor, rather than the transferee, benefitted from the transfer; the extent to which the transferee needed the property; the length of time between the transfer and subsequent events; the number of such transfers; the taxpayers' expertise in tax matters; and the transaction's form. Courts also examine any indicators of a taxpayer's intent, such as documents or negotiations

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that confirm or belie the existence of a pre-arranged plan. *Estate of Kluener* at 635.

Other cases involving business purpose in the I.R.C. § 351 context also focus on whether the corporation to which property was transferred in a purported I.R.C. § 351 transaction was used solely as a mere conduit to accomplish tax benefits that could not have been accomplished directly. For example, in *West Coast Marketing v. Commissioner*, 46 T.C. 32 (1966), the taxpayer and its sole shareholder contracted to exchange appreciated land they collectively owned for stock of a publicly traded corporation. This exchange, if consummated directly by the taxpayer and its shareholder, would have been taxable. At a time when the exchange was imminent, the taxpayer's sole shareholder organized a new corporation and the taxpayer and the shareholder transferred the land to the new corporation. The new corporation then transferred the land to the publicly traded corporation in exchange for stock of that corporation. The new corporation was liquidated shortly thereafter. The taxpayer argued that the transactions described above were tax-free under I.R.C. §§ 351 and 368(a)(1)(B), respectively. The Tax Court rejected the taxpayer's arguments, holding that the exchange of land for stock is taxable to the taxpayer because the new corporation served no purpose other than as a conduit to hold title to the land pending the contemplated transfer of the land to the publicly traded corporation. *Id.* at 40. Under circumstances where a transfer of property to a corporation is undertaken to advance a tax avoidance plan and serves no other independent business purpose, courts generally disregard the transfer. *See, e.g., Estate of Kluener; Gregory v. Helvering*, 293 U.S. 465 (1935), *aff'g*, 69 F.2d 809 (2d Cir. 1934). *See also* Rev. Rul. 70-140, 1970-1 C.B. 73, (a transfer to a controlled corporation in a purported I.R.C. § 351 exchange was disregarded under circumstances demonstrating that the transfer was motivated by tax avoidance considerations), and *Hallowell v. Commissioner*, 56 T.C. 600 (1971) in which the transfer of appreciated securities by shareholder to a corporation followed by the corporation's sale of the securities was treated as a sale by the shareholder of the securities. In *Hallowell*, the taxpayers transferred greatly appreciated stock to their corporation over three years. Soon after every transfer, the corporation sold the stock and distributed most of the proceeds to the taxpayers. The Tax Court disregarded the formalities and held that the taxpayers sold the stock. The court stressed that the corporation retained very little money even though it needed capital, and that it repaid the taxpayers roughly the amount earned from each sale. While there was no evidence of a prearranged plan, the court found this irrelevant; because an open market existed for the stock, and the taxpayers could execute a plan without a formal arrangement. 56 T.C. at 607-08.

Accordingly, it may be possible to argue that the transfers to Foreign Corporation A and Foreign Corporation B in this case lacked a business purpose because they were used as mere conduits to obtain tax benefits that could not have been obtained directly. In this case there were transfers of assets other than the

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stocks, the foreign corporations continued in existence after the transfers, and the taxpayers have alleged a number of business purposes for the transfers. See *Northern Indiana Pub. Serv. Co. v. Commissioner*, 115 F.3d 506 (7th Cir. 1997). However, we have insufficient information, at this point, to determine whether the reasons articulated are, in fact, real and legitimate. Taxpayers' articulated business purposes appear to be self-serving. Accordingly, we are uncertain whether these asserted business reasons are substantial enough to satisfy the corporate business purpose doctrine without further case development. See, e.g., *Haberman Farms, Inc. v. United States*, 305 F.2d 787, 792 (8th Cir. 1962) (stating that "an analysis of these asserted reasons in light of the facts leaves us with the distinct impression that in actuality the reasons are thin and tenuous and that the only substantive one among them is the tax motivation"). In addition, most, if not all, the reasons offered address why it would be advantageous for the corporations to hold the assets. The taxpayers have not articulated a reason why they placed themselves in a situation where they distributed assets from one of their controlled entities only to be forced to contribute the assets to another controlled entity. Finally, in evaluating the business purpose of the transactions, it should be kept in mind that the gain was completely locked in under the short against the box transaction (thus the foreign corporations never bore any risk with respect to realizing that gain), the other assets transferred were debt instruments (some from related parties), and when the short against the box positions were closed, the funds (after repaying the margin liabilities) were loaned to related parties.

SUBSTANCE OVER FORM DOCTRINE

Another doctrine that could apply to disregard the transfers to Foreign Corporation A and Foreign Corporation B is the substance over form doctrine. Under this approach, the gain resulting from closing out the positions would be realized and recognized by Individual C and Individual D. It is a well settled doctrine that the incidence of a transaction depends on the substance of a transaction. 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. *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945). In *Hallowell v. Commissioner*, 56 T.C. 600, 606 (1971), the Tax Court held that a sale by one person cannot be transferred for tax purposes into a sale by another person by using the latter as a conduit to pass legal title. See also *Court Holding*, *supra*. In *Pickard v. Commissioner*, 40 B.T.A. 258 (1939), *aff'd*, 113 F.2d 488 (2d Cir. 1940), the taxpayer contracted to sell shares of stock for a price greatly in excess of its cost. The taxpayer caused a holding company to be formed, then transferred the shares of stock to the holding company in exchange for all the shares of the holding company's capital stock. The holding company borrowed money from a bank and used substantially all of the money to purchase Treasury notes. Two more corporations were formed and the holding company transferred the Treasury notes to the corporations, in exchange

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for capital stock, which was distributed to the taxpayer. The holding company issued stock to the purchaser which used the money to pay off the bank loan. Taxpayer then transferred his shares of the holding company stock to the purchaser for cash. The purchaser, now the sole stockholder of the holding company, dissolved the holding company. The taxpayer argued that he was relieved from tax because each of the steps in his elaborate plan was a nontaxable transaction. The Board of Tax Appeals specifically stated that the holding company “served merely as a conduit for transferring the ... shares.” 40 B.T.A. at 262. Both the Board of Tax Appeals and the Second Circuit collapsed the transactions and held that since the holding company was a company with no legitimate business purpose, it cannot be deemed to be a party to a tax free reorganization. *See also Bassick v. Commissioner*, 85 F.2d 8 (2d Cir.), *cert. denied*, 299 U.S. 592 (1936) (component steps of a single transaction cannot be treated separately for income tax purposes), and *Estate of Kluener, supra*.

Based on the facts presented, it could be argued that Individual C’s and Individual D’s actions were not undertaken for a valid business purpose and had a tax avoidance motive. The transferors, rather than the transferees, benefitted from the transactions by eliminating taxation on the inherent locked in gain from the stock positions. Further, the length of time between the transfers to and the assumptions of the foreign corporations and the subsequent positions was relatively short, occurring six months after the transfers to and assumptions by the corporations. It is logical to infer that Individual C and Individual D contemplated these transactions at the time of their expatriation and used the corporations as a conduit to realize the locked in gain. Even if there is no evidence of a prearranged plan, a court could still recharacterize the transaction as it did in *Hallowell*, because an open market existed for the stock, and Individual C and Individual D could execute their plans without a formal arrangement. Because the gain inherent in the positions was locked in prior to the transfers to and assumptions by the foreign corporations, neither the timing of the closure of the positions nor the expertise of Foreign Corporation A or Foreign Corporation B affected the amount of gain recognized. Substituting foreign corporations for themselves merely shielded Individual C and Individual D from the tax consequences of the transactions. Furthermore, the transactions were significant in number and amount, apparently representing a pattern of conduct that was intended to avoid tax. In fact, the transactions’ form is the type that attracted Congress’ attention to amend the relevant Code provisions.

Thus, it could be argued that the I.R.C. § 351 transactions should be disregarded under the substance over form doctrine if it can be established that: (1) the transfers lacked a business purpose; (2) the transactions were integrated parts of a prearranged plan to avoid U.S. taxes; and (3) the use of Foreign Corporation A and Foreign Corporation B indirectly accomplished tax advantages that could not have been accomplished directly. The likelihood of success of this

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argument will depend in large part on the credibility of the individuals' business reasons for forming the foreign corporations, whether the corporations performed the purposes alleged by the individuals, and the nature of the other business activities of the corporations. Alternatively, it could be argued that the partnerships used the corporations as a conduit to realize the locked in gain by first utilizing its direct and indirect owners. If the partnerships are the ones ultimately taxed on the gain, such gain would flow through to the partners Trust Y and Trust Z, I.R.C. § 702, and presumably to the beneficiaries of the trusts, Individual B and Individual C, I.R.C. § 662.

In essence, the substance over form argument is that the corporations (and possibly the individuals and the entities that own the partnerships directly or indirectly) are acting as conduits for the locked in gain from the short against the box positions, *i.e.*, the locked in gain realized from the short positions being closed with the long positions. Arguably, however, such an assertion may be viewed as contrary to the law as existing at the time of the transaction. Prior to the enactment of I.R.C. § 1259, the long and the short positions in a short against the box transaction were respected as two distinct transactions. To argue that the transactions can be stepped together and the corporations treated as conduits for the locked in gain equates to treating the two positions as one position. We would, therefore, have to establish that the transfer of the short against the box positions along with the sales proceeds and (the assumption of the) margin liabilities should be integrated for the purpose of allocating the gain in this case, *i.e.*, that the long positions were given to the conduits to satisfy the short positions. We believe that such argument may be viable as it is unlikely that a broker without requiring additional security would permit the transfer of long positions in stock while permitting the transferor to retain a short position. In fact, the law may even prohibit such transfers. 12 C.F.R. § 220.4(e)(Cash or securities may not be withdrawn if it will create a margin deficiency).

In a case such as this one, where the short positions are conveyed with the long positions, we believe that it could be argued that, in substance, the transferee is acting as a conduit for the transferor for the locked in gain. The fact that the positions were ultimately closed simultaneously further supports this analysis. However, because of inherently factual nature of this inquiry, and in light of the substantial hazard presented by the legislative history to I.R.C. § 877, we leave it to your discretion to decide whether to pursue this theory.

SECTION 482

Alternatively the Service may argue in appropriate circumstances that, even if a transfer of property to a corporation in exchange for stock does constitute a valid nonrecognition exchange under I.R.C. § 351, I.R.C. § 482 authorizes the Service to correct an income distortion resulting from the particular transfer. See Treas. Reg. § 1.482-1(d)(5); *National Securities Corp. v. Commissioner*, 137 F.2d 600 (3d Cir. 1943); *cert. denied*, 320 U.S. 794 (1943). Internal Revenue Code § 482 authorizes

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the Commissioner in the case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such allocation is necessary in order to prevent the evasion of taxes or to clearly reflect the income of the organization, trades, or businesses. An arm's length standard is utilized in determining a controlled taxpayer's true taxable income. See Treas. Reg. § 1.482-1(a), Treas. Reg. § 1.482-1(b), and *E. I. DuPont de Nemours and Co. v. United States*, 608 F.2d 445 (Ct. Cl. 1979), *cert. denied*, 445 U.S. 962 (1980). An allocation made by the Commissioner under I.R.C. § 482 is presumptively correct and must be sustained, unless the taxpayer can show that the allocation is arbitrary, unreasonable, capricious, or an abuse of discretion. *Wisconsin Big Boy Corp. v. Commissioner*, 452 F.2d 137, 140 at n.2 (7th Cir. 1971); and *Philipp Brothers Chemicals, Inc. v. Commissioner*, 435 F.2d 53, 57 (2d Cir. 1970).

Internal Revenue Code section 482 also applies to allocations between individuals and corporations. Courts have held that the two business requirement is satisfied when an individual engages in a business that is distinct from or in addition to a business in which the personal service corporation is engaged. See, e.g., *Borge v. Commissioner*, 405 F.2d 673 (2d Cir. 1968), *cert. denied*, 395 U.S. 993 (1969). There are limits placed by courts on allocations between individuals and corporations. *Fogelson v. Commissioner*, 691 F.2d 848, *rev'g* 77 T.C. 1102 (1981), involved a individual who worked exclusively for a corporation that was controlled by that individual. The Seventh Circuit held that if an individual has no trade or business other than working for the corporation, the individual is not engaged in a trade or business separate from the corporation, and therefore, the "two or more organizations trade or businesses" requirement is not met. Thus, for an allocation under I.R.C. § 482 to occur, it should be established that Individual C and Individual D were engaged in a trade or business other than working for that trade or business. But see Rev. Rul. 88-38, 1981 C.B. 246.

The Regulations contemplate that I.R.C. § 482 may be used in circumstances involving nontaxable transactions. Treas. Reg. § 1.482-1(f)(1)(iii) provides that

[s]ection 482 may, when necessary to prevent the avoidance of taxes or to clearly reflect income, be applied in circumstances described in sections of the Code (such as section 351) providing for non-recognition of gain or loss. See, for example *National Securities Corp. v. Commissioner*, 137 F.2d 600 (3d Cir. 1943), *cert. denied* 320 U.S. 794 (1943).

In *National Securities Corp.*, a parent corporation bought shares of stock in an unrelated corporation. Subsequently, when the stock had a built in loss, the parent contributed the stock to a subsidiary. The court held that I.R.C. §351 regulates the time when gain or loss is recognized but I.R.C. § 482 regulates the

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allocation of the income to clearly reflect income. The court thus did not allow the subsidiary to take the loss built in at the time of the transfer when it sold the stock.

In *Southern Bancorporation v. Commissioner*, 67 T.C. 1022 (1977), the petitioner's subsidiary, Birmingham Trust, distributed dividends to petitioner in the form of appreciated U.S. Treasury bonds and notes which petitioner sold shortly after the transfers. The petitioner was in a tax favored position. The Commissioner, under the authority of I.R.C. § 482, allocated to the subsidiary the gain realized by petitioner on the sale of the securities; the commissioner did not attempt to override the dividend distribution but rather attacked the subsequent income distortion. In sustaining the allocation, the court observed, at page 1027, that

[i]t was ... [Birmingham Trust's] money that was invested and produced the income The corresponding income or gain was sought to be diverted to the petitioner prior to the sale of the obligations by the distribution of a dividend in kind. This clearly resulted in the distortion of the income of Birmingham Trust. *Foster v. Commissioner*, 756 F.2d 1439 (9th Cir. 1985), *discussed below*, is distinguishable because in that the case the court found that the taxpayer's contentions as to business purpose were not credible.

In *Foster v. Commissioner*, 756 F.2d 1439 (9th Cir. 1985), a partnership consisting of Mr. Foster and his three sons transferred real estate to four corporations each of which was wholly owned by one of the partners. The transfers were treated as tax free exchanges under I.R.C. § 351. The Service under authority of I.R.C. § 482 reallocated the income from the sale of lots from the corporations to the partnership. Both the Tax Court and the Ninth Circuit upheld the reallocation of income attributable to pre- and post-transfer appreciation. The courts' conclusions were based upon their findings that the transfers were motivated by tax avoidance and that the taxpayers' contentions as to business purposes for the transfers were not credible. The Ninth Circuit observed

that the Commissioner may employ § 482 to reallocate income derived from the disposition of property previously acquired in a nonrecognition transaction. *Rooney v. United States*, 305 F.2d 681, 686 (9th Cir. 1962). (Section 482 will control when it conflicts with § 351 as long as the discretion of the Commissioner in reallocating is not abused.); Treas. Reg. §1.482-1(d)(5) (1984); *see also Stewart v. Commissioner*, 714 F.2d 977 989 (9th Cir. 1983).

756 F.2d at 1433.

Based on *National Securities Corp.*, *Southern Bancorporation* and *Foster*, the Service could reallocate the gain realized by Foreign Corporation A and Foreign Corporation B to Individual C and Individual D respectively to clearly reflect income. In this case, but for the transfers to Foreign Corporation A and Foreign Corporation

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B, the gains inherent in the positions would have been taxable to Individual C's and Individual D's under I.R.C. §§ 482 and 877. Similar to *Southern Bancorporation*, it was Individual C and Individual D's income that was invested and produced the income. The gain was diverted to Foreign Corporation A and Foreign Corporation B, under I.R.C. § 351, resulting in the distortion of income of Individual C and Individual D. As approved by the Ninth Circuit in *Foster*, the Commissioner would be able to employ I.R.C. § 482 to reallocate income of Foreign Corporation A and Foreign Corporation B derived from the disposition of the positions that were previously acquired through the I.R.C. § 351 nonrecognition transaction. This transaction similarly can be challenged as motivated by tax avoidance. Individual C and Individual D transferred passive assets not used in a trade or business outside U.S. tax jurisdiction, and such assets were disposed of approximately six months after the transfer. In fact, with respect to these positions, the foreign corporations were not subject to any downside risk because the gain was locked in. Had Individual C and Individual D been U.S. citizens transferring the same assets to Foreign Corporation A or Foreign Corporation B, such transfers would have been taxable at the time of the transfer under I.R.C. § 367(a)(1) and would not have qualified for any exception from taxation under I.R.C. § 367(a)(2) (for certain stock transfers) or I.R.C. § 367(a)(3) (for assets used in the active conduct of a trade or business) or the regulations thereunder.

However, the authority of the Service to override nonrecognition treatment under I.R.C. § 482 is not plenary. For example, in *Eli Lilly & Co. v. Commissioner*, 856 F.2d 885 (7th Cir. 1988), *aff'g in part and rev'g in part* 84 T.C. 996 (1985), the appellate court held that the Service could not entirely disregard nonrecognition of the transfer of intangibles in exchange for stock by a mainland corporation to its Puerto Rican affiliate, even though the transaction did not appear to be at arm's length. The appellate court appears to have rejected the view represented in *Ruddick Corp v. United States*, 643 F.2d 747 (Ct. Cl. 1981) that the Service's power to override nonrecognition treatment depends upon the extent to which the nonrecognition transaction served business aims other than the reduction of taxes, based on the perceived Congressional mandate of incentives to perform such a transfer. 856 F.2d at 862. The appeals court instead adopted the view, based on *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252, 363-67 (1987), and *Bank of America v. United States*, 79-1 USTC ¶ 9170 (N.D. Cal. 1979), that nonrecognition provisions can at least limit the scope of I.R.C. § 482 even where tax considerations formed part of the motivation for the transaction in question. 856 F.2d at 861-64.

In conclusion, the Service would have to make a very strong showing that Individual C or Individual D should be treated as realizing the gain rather than the corporations by disregarding or recharacterizing the transfers of appreciated stock, either under the corporate business purpose doctrine and the substance over form doctrine, or I.R.C. § 482. This is especially true because under I.R.C. § 7491, added by the IRS Restructuring and Reform Act of 1998, the burden of proof is shifted in a court proceeding with respect to a factual issue that is relevant to

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determine an individual taxpayer's tax liability if the taxpayer presents credible evidence with respect to that issue, as long as the taxpayer complies with substantiation and record keeping requirements, and the taxpayer cooperates with reasonable requests by the Service for witnesses, information, documents, meetings and interviews. Since the audit was not opened before the effective date of the Act, July 22, 1998, and Individual C and Individual D has responded to all discovery and IDRs, giving a number of non-tax reasons for the transactions, the burden may shift to the Service in a Tax Court proceeding. In addition to proving the facts the Service will need to be able to show that one of the principal purposes of Individual C's and Individual D's expatriation was the avoidance of U.S. income, estate or gift taxes, based on the transactions described above. Compare *Kronenburg v. Commissioner*, 64 T.C. 428 (1975) and *Furstenberg v. Commissioner*, 83 T.C. 755 (1984). Whether the doctrines discussed above will prevail depends on the entire facts and circumstances, as well as the weight given to the legislative history involving the need for subsequent amendments to I.R.C. § 877. Although the ultimate decision should be made by the Field, we believe that the litigating hazards caused by the I.R.C. § 877 legislative history, in conjunction with the shift in the burden of proof and the inherent difficulties in pursuing a corporate business purpose or substance over form case militates against pursuing this issue in litigation.

ISSUE 3

SECTION 367(a)(1)

Under I.R.C. § 367(a)(1), transfers of certain appreciated property by a U.S. person to a foreign corporation in transactions that would otherwise qualify as nonrecognition transfers are nevertheless taxable unless an exception applies. There is no exception to I.R.C. § 367(a)(1) in the case of a transfer of stock or securities in a domestic corporation to a foreign corporation where the U.S. transferor owns more than fifty percent of either the total voting power or the total value of the stock of the transferee corporation immediately after the transfer. Thus, if it were possible to identify a U.S. person as the transferor of the domestic stock and short against the box positions and a foreign corporate transferee, and the transfer is an exchange described in I.R.C. § 367(a)(1), then the transfers would be taxable.

To apply I.R.C. § 367(a)(1) to the transactions at issue, there are three requirements: (1) that the transferor be a U.S. person; (2) that the transferee be a foreign corporation; and (3) that the transfer be in connection with an exchange described in I.R.C. §§ 332, 351, 354, 356, or 361. Applying these rules to the form of the transaction leads to the conclusion that I.R.C. § 367(a) is inapplicable. The transferors in this case might initially be considered Limited Partnership A and Limited Partnership B. Limited Partnership A and Limited Partnership B are 1 percent owned by Limited Liability Company and 99% owned by Trust Y and Trust Z, respectively. Ordinarily Treas. Reg. § 1.367(a)-1T(c)(3) provides that if a

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partnership transfers property to a foreign corporation in an exchange subject to I.R.C. § 367(a)(1), then any U.S. person that is a partner in the partnership is treated as having transferred a proportionate share of the property in an indirect exchange under I.R.C. § 367(a). In this case, however, the partnerships are transferring their assets to their partners in the form of distributions described in I.R.C. § 731. Since the 99 percent partners are domestic nongrantor trusts, and partnership distributions are not exchanges described in one of the aforementioned nonrecognition provisions, I.R.C. § 367(a) cannot apply at this juncture.

The trusts, Trust Y and Trust Z, then distributed the assets to Individual C and Individual D on Date 5. Since these trusts are not grantor trusts within the meaning of I.R.C. §§ 671-679, the trusts would be considered the transferors themselves for purposes of I.R.C. § 367(a). Treas. Reg. § 1.367-1T(c)(4)(i). However, once again, this type of distribution is not described in the list of exchanges in I.R.C. § 367(a)(1). Nor can the distributions be subject to the excise tax imposed by I.R.C. § 1491, which applies only to transfers of property by domestic trusts if made to certain foreign corporations, partnerships, trusts or estates, but not to nonresident alien individuals, such as C and D. The subsequent transfers of the assets by Individual C and Individual D to Foreign Corporation A and Foreign Corporation B, arguably in connection with valid I.R.C. § 351 exchanges, are transfers described in I.R.C. § 367(a)(1). However, the transferors at this point are not U.S. persons. Thus, none of the individual steps in the series of transfers is described in either I.R.C. §§ 367(a) or 1491.

The step transaction doctrine is a rule of substance over form. The step transaction doctrine treats a series of formally separate steps as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result. Courts have held that "where an interrelated series of steps are taken pursuant to a plan to achieve an intended result, the tax consequences are to be determined not by viewing each step in isolation, but by considering all of them as an integrated whole." *Packard v. Commissioner*, 85 T.C. 397, 420 (1985).

There are generally three alternatives tests applied by courts in determining whether to invoke the step transaction doctrine. These tests are the "binding commitment" test, the "interdependence" test and the "end result" test. *Id.*

The "binding commitment" test is the most stringent of the three tests. Under this test, a series of transactions would be collapsed if, when the first step is undertaken, there was a binding commitment to undertake the later step. *Commissioner v. Gordon*, 391 U.S. 83, 96 (1968). The second test is the "interdependence" test. Under the "interdependence" test, the test is whether the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." *Redding v. Commissioner*, 630 F.2d 1169, 1177 (7th Cir. 1980), *cert. denied*, 450 U.S. 913

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(1981), citing PAUL & ZIMET, STEP TRANSACTION, in PAUL, SELECTED STUDIES IN FEDERAL TAXATION 200, 254 (2nd series 1938) .

The third test is the "end result" test. Under the "end" result test, which may prove to be the easiest to apply in this case, "the step transaction doctrine will be invoked if it appears that a series of formally separate steps are really prearranged parts of a single transaction intended from the outset to reach the ultimate result." *Gaw v. Commissioner*, T.C. Memo. 1995-531 citing *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969). In *King Enterprises*, the court stated:

The essence of the step transaction doctrine is that an 'integrated transaction must not be broken into independent steps or, conversely, that the steps must be taken together in attaching tax consequences.'

Id. at 516, citing BITTKER AND EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, p. 18 (1966).

In addressing the "interdependence" test and the "end result" test, the *King Enterprises* court stated that "despite the real differences between the tests, each is faithful to the central purpose of the step transaction doctrine; that is, to assure that tax consequences turn on the substance of a transaction rather than on its form." *Id.* at 517. The *King Enterprises* court stated that the step transaction doctrine derives vitality "from its application where the form of a transaction does not require a particular further step to be taken; but, once taken, the substance of the transaction reveals that the ultimate result was intended from the outset." *Id.*

However, taxpayer may argue that the steps should not be reordered under the rationale of *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988), *aff'd without published opinion*, 886 F.2d 1318 (7th Cir. 1989). In *Esmark*, the Tax Court held that where there are no meaningless or unnecessary steps that should be ignored and when a taxpayer has different routes to achieve its objective and chooses the route that it expects to result in the least amount of tax the court will not recast the transaction under the step transaction doctrine. See also *Grove v. Commissioner*, 490 F.2d 241 (2d Cir. 1973), *aff'g* T.C. Memo. 1972-88 and Rev. Rul. 84-111, 1984-2 C.B. 88 (holding that partnership assets can be incorporated in different ways with each yielding different basis and holding periods in the assets and stock).

To prevail, the Service must apply a step transaction doctrine to prove that the Limited Partnerships A and B, and indirectly their 99 percent domestic partners, Trust Y and Trust Z, in substance transferred the assets to Foreign Corporations A and B in connection with an I.R.C. § 351 exchange, notwithstanding the fact that the assets remained in the hands of Individual C and Individual D for more than 6 months, between Dates 4 and 5, after the trusts distributed the assets to them. In addition, the Service would have to prove that the domestic partnerships maintained control (as defined in I.R.C. § 368(c)) over the foreign corporations in

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order to prove a deemed I.R.C. § 351 exchange occurred, even though they did not receive or own directly any stock in Foreign Corporation A or B. Assuming the articulated business purposes existed for the transactions, the application of substance over form would appear to be difficult for the reasons specified above. In addition, a court may decide that the taxpayers merely chose a route that they expected to result in the least amount of tax and refuse to recast the transaction under the step transaction doctrine. *See Esmark*. Because of inherently factual nature of this inquiry, and in light of the substantial hazard presented by the legislative history to I.R.C. § 877, we leave it to your discretion to decide whether to pursue this theory.

SECTION 1491

Internal Revenue Code § 1491 generally provided, in relevant part, that an excise tax equal to 35 percent of any unrecognized gain will be imposed on the transfer of property by a citizen or resident of the United States, or by a domestic corporation or a partnership to a foreign corporation as paid in surplus or as a contribution to capital. The excise tax was imposed on the excess of the fair market value of the property transferred over the sum of the adjusted basis (for determining gain) plus the amount of gain recognized to the transferor at the time of the transfer. Under former I.R.C. § 1494 and Treas. Reg. § 1.1494-1(a), the excise tax was due and payable by the transferor at the time of the transfer without assessment or notice and demand. Internal Revenue Code § 1492(2)(A) provides that the tax imposed by I.R.C. § 1491 will not apply to a transfer described in I.R.C. § 367. Internal Revenue Code §§1491 through 1494 was repealed on a prospective basis by the Taxpayer Relief Act of 1997 (enacted on August 5, 1997).

Under I.R.C. § 1491, in order to find a contribution of capital by a domestic partnership to a foreign corporation, the Service would have to make the same argument as in the I.R.C. § 367(a) argument above, the difference being that the Service would not have to prove that the partnerships controlled the foreign corporations immediately after the transfer of stock on Date 6 for purposes of I.R.C. § 351, only that they made contributions to the capital of the foreign corporations on Date 6. This may not represent, however, much of a substantive difference. If the Service could somehow establish such capital contributions, the excise tax could be imposed on the domestic limited partnerships, and thus their partners, in that year. As under the I.R.C. § 367(a)(1) approach, the Service must disregard the form of the transactions, under which the transfers to Foreign Corporation A and Foreign Corporation B were made by Individual C and Individual D, respectively. As before, we would utilize the "substance over form/step transaction doctrine, discussed in detail above.

We have coordinated this memorandum with Branch 4, (International); Branch 5, (International); Branch 6, Chief Counsel (International); Corporate Branch, (Field Service); Branch 3 (Corporate), Passthroughs and Special Industries Branch, (Field Service); Branch 1, (Passthroughs and Special Industries); Financial

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Instruments and Products Branch, (Field Service); Branch 2, (Financial Instruments and Products); and Income Tax and Accounting, (Field Service).

If you have any further questions, please contact Michael Hara at (202) 622-3134.

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