Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:CIN:TL-N-6587-00
JEKagy

date:

to: Industry Director, Natural Resources (LM:NR)
Attn: Team Manager Pat Dimmitt

from: Associate Area Counsel (LMSB), Cincinnati

subject: [redacted]
Potential Section 357(b) Issue

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This memorandum responds to your November 6, 2000 e-mail inquiry regarding the matter referenced above.

ISSUES:

1. Whether the taxpayer's allocation of a portion of its group's long-term debt to a newly formed subsidiary qualifies as a bona fide business purpose as required by section 357(b).

2. Whether the future tax savings, which may potentially result from the transfer, negate the legitimacy of the business purpose offered by the taxpayer for the allocation of a portion of its group's long-term debt to a newly formed subsidiary.

3. Whether a bona fide business purpose, once established, can later be disturbed by the establishment of additional tax avoidance purposes.

CONCLUSIONS:

1. From the facts you describe, facts which are similar to those in Rev. Rul. 79-258, it appears that the allocation of a portion of its group's long-term debt to a newly formed subsidiary would qualify as a bona fide business purpose for purposes of section 357(b).

2. If it is established that, as a matter of fact, **the principal purpose** of the transaction was the satisfaction of a legitimate business purpose and NOT the avoidance of Federal income tax, then the section 357(b) exception does not apply. In other words, once it is established that **the principal purpose** of the transaction was the satisfaction of a legitimate business purpose and NOT the avoidance of Federal income tax, then the tax savings resulting from the transfer would not negate the legitimacy of the business purpose.

3. Once it is established that a bona fide business reason exists for the transaction and that the principal purpose of the transaction was not tax avoidance, the fact that later tax savings may occur in the future will not obviate the bona fide business purpose.

FACTS:

On [redacted], one of [redacted]'s subsidiaries ("Sub") entered into a term loan agreement with [redacted] unrelated banks to borrow $[redacted]. Prior to that time, Sub had operated as a section 936 company, [redacted] in [redacted] for sale to [redacted] for resale in the United States and other parts of North America. Sub had not previously incurred any term indebtedness. On [redacted], Sub loaned [redacted] $[redacted], consisting of the borrowed $[redacted] plus $[redacted] in funds already held by Sub. [redacted] used the borrowed amount to retire outstanding commercial paper obligations dating to [redacted].

Thereafter, on [redacted], in exchange for [redacted] shares of stock, Sub made a section 351 transfer of its operating assets to a newly formed, wholly owned, [redacted] subsidiary ("Second Sub")[1]. As part of the transaction, Sub transferred business assets of approximately $[redacted] and liabilities of approximately $[redacted] to Second Sub. Included in the liabilities transferred was the $[redacted] owed to the third party banks. The $[redacted] debt from [redacted], however, was not one of the assets transferred as part of the transaction. Following the section 351 transfer, Second Sub continued the business operations in [redacted] formerly carried on by Sub.

The taxpayer described the purpose for the loans and the related transactions as follows:

> The purpose of this loan, combined with the transfer of the loan proceeds to the "Parent" and the retirement by the "Parent" of commercial paper obligations, was to shift an appropriate portion of the group's external financing to the [redacted] operations. In as much as the loan was to be repaid from earnings of the [redacted] operations, the loan was assumed by "Second Sub" when the operating assets of "Sub" were later transferred in the section 351 exchange. Such a transfer, resulting in a proper allocation of the existing group's debt to a newly formed subsidiary, allows debt repayment from the assets generating income and cash flow and has long been recognized by the IRS and the courts as having a proper business purposes.

ANALYSIS:

Section 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. Section 357(a) sets forth the general rule that a corporation's assumption of a shareholder's liability in a section 351 exchange will not be treated as money or other property received by the shareholder. Section 357(b), however, provides for an exception to the general rule of section 357(a) where it appears that the principal purpose of the shareholder in having the liability

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[1] Per a third party appraisal, the [redacted] shares of Second Sub received were valued at $[redacted].

assumed was avoidance of Federal income tax on the exchange or, if not such purpose, was not a bona fide business purpose[2].

In addition, section 357(b)(2) places the burden on the taxpayer to establish by a clear preponderance of the evidence that it had a legitimate business purpose for the transaction, and its principal purpose was not the avoidance of Federal income tax.

The Courts have been asked to apply these standards to various fact patterns. Since each case turns on its own "facts and circumstances," examining the resolution of the individual cases generally provides only a snapshot of how a particular court assessed the credibility of the witnesses' testimony or how a court viewed the unique factual situation before it. For instance, in Eck v. United States, 70-2 USTC ¶ 9465 (D. N.D. 1969), a elderly man caused his sole proprietorship to borrow $50,000, pocketed the proceeds and, after causing the transfer of the assets of the sole proprietorship to a newly formed corporation, had the new corporation assume the liability for the $50,000 debt. The Court was unable to find even the slightest inference that the transaction was primarily motivated by tax avoidance, yet viewed the taxpayer's desire to begin "cashing out" of his sole proprietorship as insufficient to satisfy the establishment of a bona fide business purpose.

In Thompson v. Campbell, 353 F.2d 787 (5th Cir. 1965), the taxpayer's personal loan was assumed by a corporation controlled by the taxpayer upon the assignment to the corporation of assets encumbered by the loan. There, the Court found as a function of the burden of proof that the taxpayer had failed to establish by clear and convincing evidence that the assumption of the debt served a bona fide business purpose or that the principal purpose of the transfer was not the avoidance of Federal taxes. Similarly, see Campbell v. Wheeler, 342 F.2d 837 (5th Cir. 1965).

Generally, cases like the forgoing offer no particular assistance since their resolutions are fact specific and the opinions offer no guiding analysis and merely recite only a mechanical application of the burden of proof. However, certain other cases offer a degree of insight into the proper application of the "principal purpose" standard. One such case is Drybrough v. Commissioner, 376 F.2d 350 (6th Cir. 1967), rev'g in part and aff'g in part, 42 T.C. 1029 (1964). There, a successful businessman arranged a series of loans and corporate loan assumptions as part of his business enterprises. While a

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[2] Section 357(c) also provides an exception to the section 357(a) general rule, but such exception is not relevant here.

deficiency asserted by the Service was sustained by the Tax Court, on appeal, the Fifth Circuit reversed that part of the deficiency dealing with section 357. Noting the distinction between the reason for the encumbrance and the reason for the exchange, the Appeals Court quoted with approval the Tax Court's opinion in Simpson v. Commissioner, 43 T.C. 900, 916 (1965):

> We do not believe it (§ 357(b)) was intended to require recognition of gain on bona fide transactions designed to rearrange one's business affairs in such a manner as to minimize *taxes in the future*, consistent with existing provisions of the law.

Drybrough, 376 F.2d at 357 (emphasis original).

We feel this distinction is telling in the instant matter. As instructed by the Court, what is important is whether the purpose for the exchange itself is the avoidance of income tax, not whether, in the future, taxes potentially may be lowered. In Simpson v. Commissioner, 43 T.C. 900 (1965), in its discussion of the purpose and legislative history of section 357, the Tax Court noted that the provisions of section 357:

> are not concerned with the tax effects of activities of the transferor-stockholder prior to engaging in the transaction, nor with those of the transferee-corporation after the transaction is completed, except to the extent they might shed some light on the purpose of the taxpayer in entering into the transaction.

Simpson, 43 T.C. at 915-916.

Because of the foregoing, we believe that once a bona fide business purpose is established, and once the taxpayer establishes that the principal purpose for the transaction was not the avoidance of Federal taxes, potential future tax consequences neither obviate the bona fide business purpose nor even call into question the applicability of section 357(b).

Somewhat more recently, the Tax Court in ISC Industries, Inc. v. Commissioner, T.C. Memo. 1971-283 addressed a situation analogous to the instant fact pattern. ISC operated a consumer finance business and, in 1964, it acquired 52.8% of the stock of a bakery corporation by cash purchase, intending to merge the bakery into itself, and intending to operate the bakery either as a division or as a wholly-owned subsidiary. The cash used in the stock acquisition consisted generally of funds loaned to ISC for use in its finance business. Certain of the lenders were concerned over ISC's unfamiliarity with the bakery business and

ISC's diverting over $1,000,000 that had been loaned to ISC for use in its finance business. To insure its lenders would continue to offer it credit, ISC decided to insulate its finance business from the bakery operations and to return the funds that had been used in the stock acquisition to the finance business. ISC decided that the bakery would be operated as a wholly-owned subsidiary, and that only the operating assets of the bakery, after being encumbered, would be transferred to the subsidiary, which would assume the liabilities on the assets. Thus, ISC planned to recover a major portion of the funds diverted from its finance business to acquire the bakery stock by retaining most of the bakery's cash and liquid assets and retaining the proceeds of the encumbrance. This whole transaction took place over a two-month period.

The Service argued that the close proximity of the creation of the encumbrance to the transfer of the encumbered assets to a newly formed controlled corporation, pursuant to a plan, supported the conclusion that ISC's principal purpose in causing the newly formed corporation to assume the liabilities was to avoid tax on the exchange, under section 357(b)(1), so that gain should be recognized on the exchange under section 351(b).

Based upon the foregoing, the Tax Court held that the taxpayer's principal purpose in causing the newly formed corporation to assume the liabilities was to protect its lines of credit for its finance business, which was a bona fide business purpose. The Tax Court also held that the taxpayer had met its burden of proof by a clear preponderance of the evidence as required by section 357(b)(2). On January 6, 1972, the Service issued an AOD, acquiescing in the Tax Court's opinion.

Of final importance is Rev. Rul. 79-258, 1979-2 C.B. 143. Under the facts in the ruling, a parent corporation, for good business reasons, transferred assets of one of its businesses to a newly formed subsidiary in exchange for the stock of the new subsidiary and its assumption of certain of the parent's liabilities associated with the transferred assets. Based upon those facts, the Service concluded that: (1) it had NOT been established that the principal purpose for the transaction was the avoidance of Federal taxes and (2) the transaction was supported by valid business reasons. In that regard, the ruling acknowledged that the assumption of liabilities is frequently an integral part of a corporate reorganization and that such liabilities are invariably assumed by the corporation which continues the business following the reorganization.

The facts in the present case seem remarkably similar to those of the ruling. Although our conclusion is not free from doubt, we see no reason to believe that the results reached in Rev. Rul. 79-258 would not also be reached upon consideration of the facts in the instant matter by the National Office, Appeals or the Courts.

We hope the foregoing addresses all questions raised in your November inquiry, but if additional questions remain, please contact the undersigned at (513) 684-6152 at your convenience.

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