Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:NTX:DAL:TL-N-6627-00
CMWilliams

date:

to: Robert Ray
Territory Manager Group 1410
Natural Resources LMSB

from: Associate Area Counsel, LMSB, Dallas-POD

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subject: [redacted]
EIN: [redacted]

This memorandum responds to your request for assistance dated November 13, 2000. This memorandum should not be cited as precedent.

Your office requested advice on whether, based on the following facts, the provisions of I.R.C. § 269(a)(1) are applicable to [redacted].

On [redacted], [redacted] purchased from [redacted] % of the outstanding and issued capital stock of [redacted] ([redacted], being not less that [redacted] shares for $[redacted]. [redacted] also received from this purchase net operating loss (NOL) carry-overs of $[redacted] for [redacted] from the [redacted] consolidated return for [redacted]. The same taxpayers, [redacted], owned all of the stock in each company ([redacted] and [redacted]). [redacted] each owned [redacted] percent of the outstanding stock of each company. Prior to the sale, [redacted] paid a large dividend to [redacted] of $[redacted]. On [redacted], [redacted] filed for corporate dissolution or liquidation.

Based on the above-mentioned facts, in our opinion, the I.R.C. § 338(h)(10) election made by [redacted] is invalid, the transaction between [redacted] fails to qualify as a reorganization because of the lack of continuity of business enterprise and the lack of continuity of interest, the provisions of I.R.C. § 269(a)(1) apply to [redacted], and a deduction for the NOL carryover should be disallowed.

I.R.C. § 338(h)(10) Election

On its return, [redacted] made a § 338(h)(10) election. If a purchasing corporation makes an election under § 338, then, in the case of any qualified stock purchase, the target corporation shall be treated as having sold all of its assets at the close of the acquisition date at fair market value in a single transaction. I.R.C. § 338(a)(1). The target shall then be treated as a new corporation which purchased all of the assets as of the beginning of the day after the acquisition date. I.R.C. § 338(a)(2). The term "purchase" means any acquisition of stock, but only if the stock is not acquired from a person the ownership of whose stock would, under section 318(a), be attributed to the person acquiring such stock. I.R.C. § 338(h)(3)(A)(iii). I.R.C. § 318 (a)(1)(A)(i) states that "[a]n individual shall be considered as owning the stock owned, directly or indirectly, by or for--his spouse..." I.R.C. § 318(a)(3)(C) provides that "[i]f 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person." Applying the above-mentioned rules to our case, [redacted] are each deemed to own [redacted] percent of [redacted] and [redacted] by virtue of the attribution rules of § 318. Both [redacted] and [redacted] are considered as owning the stock owned by the [redacted]; as such, both corporations are deemed to own each other's stock. Therefore, there is not a purchase, as required by I.R.C. § 338(h)(3). And, [redacted]'s 338(h)(10) election is invalid.

If the § 338(h)(10) election is valid, all of the tax attributes of the old target disappear, i.e., it will be stripped of its tax history by becoming a "new corporation." B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 10.42[1][a] (6th Ed. 1998). The target can use its own net operating losses in its final return, and the limitations of § 382 do not apply to the extent of § 338 gains. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 10.42[1][a], n. 426 (6th Ed. 1998) (citing Treas. Regs. § 1.338-1T(f)(3)(iv); Prop. Regs. § 1.338-1(e)(2)(iii); I.R.C. §§ 382(c)(2)(A)(ii) and 382(h)(1)(C)). If the election were valid, [redacted]'s NOL would not be available for use by [redacted]. However, because the election is invalid, we must determine the status of the NOL under other provisions.

The Application of I.R.C. § 269

Section 269 applies to two principal types of transactions--acquisitions of control of stock of a corporation and tax-free acquisitions of one corporation's assets by a previously unrelated corporation. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 14.41[3][a] (6th Ed. 1998); I.R.C. § 269(a)(1) and (a)(2). In our case, we do not have a transfer of assets, so § 269(a)(2) is inapplicable. § 269(a)(1) provides in pertinent part:

> If any person or persons acquire...control of a 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.

The Code defines control as "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.R.C. § 269(a). Although § 269 does not explicitly adopt the attribution rules of § 318, we may be able to selectively attribute the stock owned by a spouse, minor child or other intimates if the acquisitions of stock were motivated by the forbidden tax-avoidance purpose. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 14.41[3][b] (6th Ed. 1998). In our case, [redacted] acquired control of [redacted] through the stock transfer. Incidently, both [redacted] have the requisite control of each corporation as [redacted] percent shareholders.

The regulations give three nonexclusive examples of transactions that may constitute a control acquisition under § 269(a)(1). Treas. Reg. 1.269-3(b). Only one example describes our situation: the acquisition of a corporation having current, past, or prospective tax benefits intended to bring these items into conjunction with the income of a profitable enterprise. Arguably, [redacted], a profitable enterprise, acquired [redacted], a corporation with a $[redacted] NOL, to offset its income by the amount of the NOL.

The only assets owned by [redacted] were distributed to the shareholders prior to the reorganization; therefore, the only asset [redacted] retained was the NOL. In fact, an e-mail from [redacted], Vice-President of Finance/Corporate Tax at [redacted], to [redacted], Senior Vice-President and CFO at [redacted]

[redacted], may shed light on the intent of the parties. In that e-mail, she said, "[u]se these (the NOLs) joyfully! [redacted] is not requiring any reimbursement for the tax value of these NOL's!" The facts suggest that [redacted] acquired [redacted] in order to benefit from its NOL.

Lack of Continuity of Business Enterprise and Continuity of Interest

In determining whether I.R.C. § 269 applies to [redacted], we must also determine whether the transaction qualifies as a tax-free reorganization under I.R.C. § 368. [redacted] purchased [redacted]% of the issued and outstanding stock of [redacted], [redacted] shares for $[redacted]. We are aware of no facts which indicate that the shareholders of [redacted] received [redacted] Stock in exchange for their [redacted] stock; however, because the shareholders of [redacted] and [redacted] were identical, it may have been a futile gesture for the shareholders to receive [redacted] stock.

Requisite to a reorganization under the Internal Revenue Code are a continuity of business enterprise and a continuity of interest. This requirement is found in Treas. Reg. 1.368-1. The regulation applies to transactions occurring after January 28, 1998; however, the case at hand is analyzed using the regulations because the regulations incorporate long-standing case law. The regulations generally provide a safe-harbor for taxpayers who structure their transactions under its direction after January 28, 1998. Because the taxpayers in this case fail to meet even the minimum requirements under case law, analyzing this case using the regulations will not provide benefit or harm. In this case, [redacted] meets neither the continuity of business enterprise requirement nor the continuity of interest requirement.

The continuity of business enterprise requirement is generally satisfied if [redacted] and [redacted] were in the same line of businesses. Treas. Reg. § 1.368-1(d)(2). The transferee corporation must either (1) continue the transferor's historic business or (2) continue to use a significant portion of the transferor's historic business assets in a business. Treas. Reg. 1.368-1(d). [redacted] was liquidated shortly after the reorganization. Revenue Agent Sonya Grizzle indicates that [redacted] and [redacted] were not in the same line of business; therefore, [redacted]'s historic business was not continued. Secondly, [redacted]'s business assets consisted mainly of cash that was distributed to the shareholders prior to the reorganization. Therefore, [redacted] could not have continued to use a

significant portion of [redacted]'s historic business assets in its business. The continuity of business enterprise requirement is not satisfied.

Continuity of interest requires that a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. Treas. Reg. 1.368-1(e)(1)(i). However, a proprietary interest is not preserved if the target corporation is acquired by the issuing corporation for consideration other than stock of the issuing corporation. Treas. Reg. 1.368-1(e)(1)(i). [redacted] acquired [redacted] for $[redacted] cash. Therefore, a proprietary interest in [redacted] is not preserved. The transaction between [redacted] and [redacted] more closely resembles a sale rather than a reorganization. The taxpayers in this case may argue that the requisite proprietary interest is preserved in the transaction because the shareholders were the same for each corporation. However, in Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332 (5th Cir.), cert. denied, 342 U.S. 860 (1951), the Court refused to find continuity of interest existed where the total value of the consideration paid by the transferee included less than one percent of its stock, even though substantial continuity existed prior to the transaction because of preexisting affiliation of the two corporations. In our case, [redacted] provided none of its stock as consideration for the transfer. The preexisting affiliation of [redacted] and [redacted] does not satisfy the continuity requirement.

In addition, [redacted] paid a large dividend to [redacted] of $[redacted] prior to the transfer to [redacted]. If there were not adequate earnings and profits to declare such a large dividend, this may be viewed as a redemption of the [redacted] shareholders' stock prior to the transfer to [redacted]. The large dividend prior to the transfer appears to be a distribution to the shareholders of the company's assets. Based on the facts presented, [redacted] seemed to have mainly cash as an asset. This cash was distributed to the shareholders prior to the transfer to [redacted], followed by a nominal amount of cash being paid by [redacted] for the acquisition of large net operating losses. We are aware of no other assets owned by [redacted] other than the net operating losses. If [redacted] would not benefit from the net operating losses but [redacted] would, we see no reason other than the transfer of a tax benefit for the transfer of [redacted] to [redacted].

Furthermore, the liquidation of [redacted] by [redacted] on [redacted] supports our position that this is a sale and not a valid reorganization. Shortly after the purported reorganization, the target company was liquidated. Even though

case law and the regulations do not require post-reorganization continuity, the liquidation, when analyzed with the dividend prior to sale, the nominal consideration paid, and the failure to transfer stock, provides further evidence that the parties engaged in a tax-motivated transaction that fails to qualify as a reorganization.

Bootstrap Acquisition

This case may also present the issue of whether the transaction between [redacted] and [redacted] is a bootstrap acquisition. A bootstrap acquisition consists of a sale of stock financed, in whole or in part, with the corporation's own assets. See B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders & 9.06 et. seq. (6th Ed. 1998). Any one of four forms can be used to accomplish a bootstrap acquisition: (1) a seller-redemption under section 302 (where corporate assets are used to redeem some of the stock of the seller before the remaining shares are sold to the purchaser); (2) a seller-distribution (where corporate assets are distributed to the seller in the form of a section 301 distribution); (3) a purchaser-redemption (where, in a transaction likely to be treated as a dividend under section 302(d), corporate assets are used to redeem some of that stock after the acquisition to finance part of the consideration); and (4) a purchaser-dividend (where, after the purchaser acquires the stock, corporate assets are distributed to the purchaser in the form of a section 301 distribution). See, e.g., PLR 9003003 (September 27, 1989)(purchaser-dividend form). While the economic consequences of each form are substantially the same, the tax consequences may be very different. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 9.07 (6th Ed. 1998).

(b)(7)a

[redacted]

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By:_____
CANDACE M. WILLIAMS
Attorney

Attachments