OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

July 30, 1999

Number: **200011001**
Release Date: 3/17/2000
CC:DOM:FS:CORP
TL-N-71-99
UILC: 351.02-00
357.01-00
357.02-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

Attn:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Gain on Section 351 Transaction

This Field Service Advice responds to your memorandum dated April 28, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer	=	
Sub	=	
CorpX	=	
Xsub1	=	
Xsub2	=	
Xsub3	=	
Buyer	=	

Bsub	=
Newco	=
Partnership	=
Pcorp1	=
Pcorp2	=
Country X	=
Date1	=
Date2	=
Date3	=
Date4	=
Date5	=
$aa	=
$bb	=
$cc	=
$dd	=
$ee	=
$ff	=
%r	=
%s	=
%t	=
%u	=

ISSUES:

1. What facts should be developed to determine whether, and to what extent, gain on a series of transactions is deferred under I.R.C. § 351, subject to any limitations of I.R.C. § 357?

2. What are the litigating hazards associated with raising the issues described above?

CONCLUSIONS:

1. Facts should be developed concerning the loans and guarantees that were executed prior to the transactions in question, as well as all of the specific transfers of property and obligations involved in those transactions.

2. The viability of any issues under I.R.C. § 357(b) or (c) depends on the facts that are ultimately developed. [redacted]

FACTS:

Taxpayer's wholly owned subsidiary, Sub, owned %r of Partnership. The other partner was Xsub1, a subsidiary of CorpX, which is not related to Taxpayer. Partnership owned Pcorp1, a domestic corporation, and several foreign corporations. Partnership also owned %s of the stock of Pcorp2, a Country X corporation. The remaining %t of the Pcorp2 stock was owned equally by Sub and Xsub3, a Country X subsidiary of CorpX.

On Date1, Taxpayer guaranteed a line of credit up to $aa established by Sub, which borrowed against the line of credit and distributed the funds to Taxpayer. Taxpayer used the funds to retire debt or for other business/financial purposes. On Date2, Taxpayer authorized Partnership to borrow up to $ff million and invest the proceeds in one or more notes rated AA or better. On Date3, Partnership borrowed $bb (with Taxpayer and Sub as guarantors) and used the proceeds to purchase a non-marketable note.

On Date4, Taxpayer approved divestiture of its interest in Partnership to Buyer. The following steps were taken to accomplish the divestiture:

> 1. Xsub1 transferred a %u interest in Partnership to Xsub2, a related corporation, resulting in three partners in the joint venture.
>
> 2. Pcorp2 elected to change its classification to that of a partnership pursuant to the check-the-box provisions of Treas. Reg. § 301.7701-3(c). Sub reported $cc in deemed dividends from this change.

3. Pursuant to an agreement dated Date5, Partnership sold Pcorp1, its foreign corporations and its %s interest in Pcorp2 to Bsub, a subsidiary of Buyer. Sub reported capital gains of $dd from these transactions.

4. Sub and Xsub3 sold their stock in Pcorp2 to Bsub. The gain on these sales had already been taxed as a result of Pcorp2's check-the-box election.

5. Taxpayer transferred its Sub stock to Newco, a subsidiary of Buyer, in exchange for nonvoting preferred stock of Newco valued at $ee. Simultaneously, Buyer transferred its stock in Bsub to Newco in exchange for Newco voting common stock. In connection with these transactions, Taxpayer was relieved of its guarantee obligations with respect to the debts of Sub and Partnership.

LAW AND ANALYSIS

I.R.C. § 351(a) provides that no gain or loss will 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 the exchange such person or persons are in control (as defined in I.R.C. § 368(c)) of the corporation. Under Treas. Reg. § 1.351-1(a)(1) and I.R.C. § 368(c), the transferors are in control of the transferee corporation if, immediately after the transfer, they own stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of share of all other classes of stock of such corporation. The ownership interests of all transferors participating in a single transaction are aggregated to determine whether the control test is met. However, a transferor's interest will not be taken into account in determining whether the control requirement is satisfied if the transferor has a binding contract to transfer the stock of the transferee corporation at the time of the exchange. *Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025, 1032-1034 (1976).

For transactions occurring after June 8, 1997, I.R.C. § 351(g)(1) provides that a transfer of property in exchange for nonqualified preferred stock is not eligible for nonrecognition under section 351(a). If the transferor receives stock other than nonqualified preferred stock in the transaction, the nonqualified preferred stock is treated as other property (i.e., boot) for purposes of applying section 351(b). Inasmuch as the transaction in this case occurred prior to June 8, 1997, there is no need to determine whether the Newco preferred stock received by Taxpayer is nonqualified preferred stock within the meaning of section 351(g).

If the transferor in a transaction subject to section 351 receives not only the transferee corporation's stock but also other property or money ("boot"), I.R.C.

§ 351(b) provides that the transferor shall recognize gain. The amount of gain recognized, however, is limited to the amount of money received plus the fair market value of other property received. Any loss to the transferor, however, is not recognized under the general rule of I.R.C. § 351(a). In contrast, if I.R.C. § 351 does not apply, the transfer of property is a taxable exchange under I.R.C. § 1001.

Section 357(a) provides that, except as provided in section 357(b) and section 357(c), where a transaction otherwise qualifies under section 351 and another party to the exchange assumes the liabilities of the transferor or acquires property subject to a liability, such assumption or acquisition does not prevent the exchange from qualifying for nonrecognition under section 351. Under section 358(d), the amount of any liability of the transferor that was assumed or to which acquired property was subject is treated as money or other property for purposes of section 358. Accordingly, under section 358(a)(1), the shareholder's basis in the stock received is equal to the shareholder’s basis in the property exchanged, with certain adjustments, including a reduction for any liabilities that the transferee assumed or acquired. This basis reduction has the effect of deferring gain until the stock is sold.

As an exception to the general rule of section 357(a), section 357(b)(1) treats the assumption or acquisition of a liability as money received by the transferor (i.e., as boot under section 351(b)) “[i]f, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer . . . was to avoid Federal income tax on the exchange, or . . . if not such purpose, was not a bona fide business purpose.” Under this provision, the entire amount of all liabilities assumed or acquired (not merely a particular liability for which a tax avoidance purpose exists) is tainted. Treas. Reg. § 1.357-1(c). In addition, under section 357(b)(2), the taxpayer must establish “by the clear preponderance of the evidence” that the assumption or acquisition of the liability was not for the principal purpose of avoiding federal income tax and that the arrangement was for a bona fide purpose.

Section 357(c)(1) provides another exception to the general rule where the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to the exchange. In such a case, the excess is treated as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be. In determining the amount of liabilities assumed or acquired in a section 351 transaction, the amount of any liability the payment of which would give rise to a deduction or would be described in section 736(a) is excluded except to the extent that the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property. I.R.C. § 357(c)(3).

In the instant case, Taxpayer transferred the stock of Sub for preferred stock of Newco, and Buyer simultaneously exchanged the stock of Bsub for the common stock of Newco. In addition, Taxpayer was relieved of its guarantee obligations with respect to the debts of Sub and Partnership. Since the available facts indicate that Taxpayer and Buyer together owned all outstanding common and preferred stock of Newco, they appear to satisfy the control requirement of section 368(c).

Based on the available information, we are unable to determine whether Newco assumed any liabilities of Taxpayer in the section 351 exchange. The facts presented indicate that Taxpayer guaranteed the indebtedness of Sub and Partnership. Under the general rule of section 357(a), if Taxpayer was the principal obligor on either of the Sub or Partnership debt, rather than a mere guarantor, and if Newco assumed Taxpayer's primary obligation, Taxpayer would not be treated as receiving money or other property in the section 351 exchange. However, if Newco were treated as assuming Taxpayer's primary obligation, section 357(b) or section 357(c) might require Taxpayer to recognize gain on the section 351 transaction.

Whether Taxpayer was the primary obligor or merely a guarantor of the indebtedness of Sub or Partnership is resolved in light of traditional debt-equity principles." *Intergraph Corp. v. Commissioner*, 106 T.C. 312, 320 (1996). In *Intergraph*, the Tax Court enumerated several factors relevant in determining whether the shareholder-guarantor or the corporation is the primary obligor:

> These principles include, among others, whether the debt obligation relating to the loan was subordinated to other debt obligations owed by the corporation, the creditworthiness of the corporation, the corporation's payment history on the loan, the extent to which the loan proceeds were used to acquire capital assets for the corporation, whether the corporation was thinly capitalized, and the intent of representatives of the corporation and of the shareholder.

106 T.C. at 320. "No single factor is controlling, and each case is to be determined on its own facts." 106 T.C. at 321, *citing Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712, 719 (5th Cir. 1972), *aff'g*, T.C. Memo. 1970-182; *Georgia-Pacific Corp. v. Commissioner*, 63 T.C. 790, 796 (1975); *Blum v. Commissioner*, 59 T.C. 436, 440 (1972).

The available information does not permit an analysis under the relevant factors of whether Taxpayer was the primary obligor on the indebtedness in question. Nor do we have the facts concerning the manner in which Taxpayer was relieved of its obligations related to that indebtedness. In order to determine whether or to what extent section 357(b) or section 357(c) may require Taxpayer to recognize gain on the section 351 transaction, the facts surrounding the loans and guarantees should be fully developed.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Issue 1. Facts to be Developed

We recommend that the revenue agents develop the following facts in order to determine whether Taxpayer should recognize any gain on the section 351 transaction:

[redacted]

[redacted]

Issue 2. Litigating Hazards

As indicated under issue 1, the release of Taxpayer from its guarantee obligations would not be treated as the assumption or acquisition of liability under section 357 unless Taxpayer was actually the primary obligor rather than a guarantor. If the facts indicate that Taxpayer was merely a guarantor, there would not be a viable issue under section 357.

Moreover, even if Taxpayer was a primary obligor and Newco assumed Taxpayer's liabilities, we note that courts are reluctant to apply the harsh result imposed by section 357(b). *See Est. of Stoll v. Commissioner*, 38 T.C. 223, 245-247 (1962) (treating only a portion of assumed liabilities as money under the predecessor of § 357(b)), *nonacq.*, 1967-2 C.B. 4. That section requires the principal purpose of the assumption or acquisition of the liability to be tax avoidance or other than a bona fide business purpose. [redacted]

Your memorandum asks whether the transfer of the Sub stock was the transfer of property subject to the liabilities of Sub or Partnership. Although Sub stock is property for purposes of section 351, Sub's obligations as the nominal primary obligor on its own indebtedness and as co-guarantor on the Partnership debt do not attach to the stock. Rather, those are obligations (i.e., liabilities) of Sub, the entity, regardless of who owns the stock. The stock represents an ownership interest in Sub and is not security for the loan to Sub. (However, the Sub stock could be security for a loan to the shareholder who owns the stock.) Assuming that there was no separate pledge of the Sub stock as security for the loan, the lenders do not look to the value of the Sub stock for repayment of Sub's loan; instead, they look to the net worth of Sub or the value of whatever assets that have been pledged for the loan. In short, there is no basis for treating Newco as acquiring the Sub stock "subject to" the loans in question.

Finally, apart from the section 357 issues, there is a remote chance that facts may be developed [redacted]

[redacted]

If you have any further questions, please call (202) 622-7930.

DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)

By: ______________________________
ARTURO ESTRADA
Acting Chief
Corporate Branch
Field Service Division

cc: Regional Counsel
Assistant Regional Counsel (LC)