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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR MICHAEL J. COOPER
ACTING ASSOCIATE AREA COUNSEL CC:LM:NR:DEN

FROM: Jasper L. Cummings
Associate Chief Counsel (Corporate) CC:CORP

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated April 12, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Individual	=
Holding	=
S1	=
S2	=
S3	=
Country X	=
Year 1	=
Year 2	=
Year 3	=
Date A	=
Business B	=
C	=
D	=

ISSUE

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Whether losses claimed under section 331 should be disallowed because the liquidating subsidiary avoided the application of section 332 by issuing new shares to a related party prior to the liquidation.

CONCLUSION

The loss should not be disallowed under this theory, because the issuance of the subsidiary's stock would be viewed by a court as a bona fide stock transfer reflecting a permanent realignment of ownership interests.

FACTS

For the tax years at issue (Years 2 and 3), Individual wholly owned Holding, a domestic corporation. Holding filed a consolidated return as the common parent of an affiliated group that included S1 and S2.

In Year 1, Individual, S1, and S2 collectively owned 100% of the stock of S3, a Country X corporation; S1 owned more than 80% of the S3 stock. During Year 2, S3 required capital for Business B. Individual, S1, and S2 executed an agreement pursuant to which Individual invested \$C in S3. Individual borrowed the \$C from S1, which was payable by a demand note with interest at the applicable federal rate. Individual later repaid the loan from other funds. In exchange for the \$C investment in S3, Individual received newly issued S3 shares. After the issuance of the new S3 shares, Individual owned D% (an amount greater than 20%) of the S3 stock.

On Date A of Year 2, which is sometime after the above transactions occurred, S3's shareholders voted to convert S3 from a corporation to a limited liability company under Country X law. Holding submitted with its Year 2 tax return a Form 8832 on which S3 checked the box electing to be classified as a partnership for United States federal tax purposes.

Holding treated the conversion of S3 from a corporation to a limited liability company as a deemed liquidation taxable under section 331 of the Internal Revenue Code. S1 and S2 claimed losses upon the deemed liquidation. Since the conversion, S3 has continued to operate Business B in the same manner as prior to the conversion, and Individual has maintained a D% interest in S3.

LAW AND ANALYSIS

Treas. Reg. § 301.7701-3(g)(ii) provides that if an eligible entity classified as an association elects to be treated as a partnership, the association is deemed to

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have distributed all its assets and liabilities in liquidation of the association and immediately thereafter, the shareholders are deemed to contribute all of the distributed assets and liabilities to a newly formed partnership. S3 was an eligible entity classified as an association, and elected to be treated as a partnership.

Section 331(a) provides that the amounts received by a shareholder as a distribution in complete liquidation of a corporation shall be treated as received in full payment in exchange for the shareholder's stock. Section 332(a) provides that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of a subsidiary. Section 332(b)(1) provides that for purposes of § 332, a distribution is considered to be in complete liquidation only if the distributee corporation owned subsidiary stock meeting the requirements of § 1504(a)(2) on the date of the adoption of the plan of liquidation and continues to own such stock at all times until the receipt of property in the distribution.

Treas. Reg. §1.1502-34 provides that, in determining the stock ownership of a consolidated group member in another corporation ("issuing corporation") for purposes of, inter alia, § 332(b), the issuing corporation stock owned by all other consolidated group members shall be included.

You have asked us to consider whether the transaction in which S1's ownership in S3 was reduced below 80% was "a sham and without economic substance" under the theory of Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517 (10th Cir. 1991) and thus whether § 332, rather than § 331 applies to the deemed liquidation. If § 332 applies to the deemed liquidation, then S1's loss and, pursuant to §1.1502-34, S2's loss would not be recognized.

Courts have held that a parent corporation can avoid § 332 by reducing its stock ownership below 80% in anticipation of a liquidation or after the adoption of a plan of liquidation. Generally, courts have allowed the parent corporation to avoid § 332 as long as the sale of stock that reduces the parent corporation's ownership below 80% is bona fide, notwithstanding that the sale is tax-motivated. See Granite Trust Co. v. Commissioner, 238 F.2d 670 (1st Cir. 1956); Commissioner v. Day & Zimmerman, Inc., 151 F.2d 517 (3d Cir. 1945); and Avco Mfg. Corp. v. Commissioner, 25 T.C. 975 (1956).

In Commissioner v. Day & Zimmerman, Inc., 151 F.2d 517 (3d Cir. 1945), the parent corporation ("Parent"), in anticipation of liquidating a subsidiary ("Sub"), sold a sufficient amount of the Sub stock to reduce its ownership below 80%. The purchaser, who was the Subs's treasurer, acquired the Sub stock in a public auction. Sub was then liquidated, and Parent corporation reported a loss on the transaction. The Service argued that the transaction was a nontaxable liquidation

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under § 112(b)(6) of the Internal Revenue Code of 1939 (the statutory predecessor to § 332). The Third Circuit found that the sale of the Sub stock preceding the liquidation was bona fide, and upheld Parent's claimed loss. In reaching this conclusion, the court emphasized that there was no arrangement between the purchaser and Parent for the latter to retain any interest in the transferred Sub stock.

Similarly, in Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir.1956), the parent corporation sold and gifted shares of the subsidiary immediately prior to a liquidation in order to reduce its ownership of the subsidiary stock to just below 80%. The First Circuit acknowledged that the transfers were motivated by tax considerations, but nonetheless allowed the taxpayer to recognize a loss on the liquidation. In upholding the validity of the stock transfers, the First Circuit also noted that there was no arrangement among the parties that the parent corporation would retain any interest in the transferred stock. See also Avco Mfg. Corp. v. Commissioner, 25 T.C. 975 (1956) (allowing loss recognition on liquidation where the taxpayer sold stock to avoid the application of § 112(b)(6)); Riggs v. Commissioner, 64 T.C. 474, 489 (1975) *acq.* 1976-2 C.B. 2 (stating that the § 332 legislative history and prior judicial decisions indicate that "section 332 is elective in the sense that with advance planning and properly structured transactions, a corporation should be able to render § 332 applicable or inapplicable"); H.K. Porter v. Commissioner, 87 T.C. 689, 696 (citing Granite Trust v. U.S. and Comm'r. v. Day & Zimmerman, *supra*, and stating that "§ 332 has several requirements which can easily be avoided.")

You have asked us to consider whether, notwithstanding the foregoing authorities, the claimed loss in the instant case can be disallowed under Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517 (10th Cir. 1991). In Associated Wholesale Grocers, the facts as simplified are that Parent owned 99.97% of the stock of Sub, which in turned owned various assets including the stock of Sub1. Parent structured a transaction with E, an individual interested in acquiring Sub1, that was intended to generate a substantial loss on the assets of Sub while retaining those assets in Parent's affiliated group. Thus, as part of a pre-arranged plan, E formed Newco and Sub transferred its assets to Newco in an all-cash merger, with Newco surviving and Parent receiving the cash proceeds from the merger. Immediately thereafter, Parent used some of the cash proceeds from the merger to repurchase from Newco all of the assets of Sub except for the Sub1 stock.

Parent reported the transactions as a taxable asset sale subject to § 1001 and claimed a large loss. The Tenth Circuit applied a step transaction analysis and denied the loss, agreeing with the government's position that the transactions were

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in substance a liquidation of Sub subject to § 332.

The taxpayer in Associated Wholesale Grocers argued that under Day & Zimmerman and Granite Trust, the step transaction doctrine is inapplicable in the § 332 context. The Tenth Circuit disagreed, emphasizing that in both Day and Zimmerman and Granite Trust, the courts analyzed the substance of the pre-liquidation transfers, and determined that their substance matched their form. See Associated Wholesale Grocers at 1525 (“Day and Zimmerman reaffirms the necessity of determining whether the substance of a transaction matches its form.”). The Tenth Circuit concluded that the cash merger of Sub into Newco was transitory, and should not be given effect for tax purposes.

The fact of the instant case do not support an argument under Associated Wholesale Grocers that the deemed liquidation is subject to § 332. First, no facts have been submitted indicating that Individual’s purchase of D% of the S3 shares was made in anticipation of the deemed liquidation. Second, although Individual is a related party to S3 and borrowed the \$C investment funds from S1, the facts do not suggest that the loan was a sham, particularly since Individual later repaid the loan.

Third, in contrast to the taxpayer in Associated Wholesale Grocers, S1 and S2 did not transfer their interests in S3 to Individual and then immediately reacquire them from Individual; instead, Individual made an investment in S3 that is difficult to view as transitory. Significantly, Individual has continued to hold its D% interest in S3 since the deemed liquidation occurred. The transactions described above have thus permanently realigned the parties’ interests in S3. These facts suggest that a court would treat Individual’s purchase of the S3 stock as bona fide.

Accordingly, we conclude that a § 332 argument should not be asserted in this case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Our advice assumes that the facts submitted are complete and accurate. If you are able to uncover additional facts and legal theories to disallow the loss claimed in this case, you may submit another FSA request. [REDACTED]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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Please call Marie Byrne at (202) 622-7750 if you have any further questions.

Jasper L. Cummings
Associate Chief Counsel (Corporate)

By: _____
MICHAEL J. WILDER
Senior Technician Reviewer
CC:CORP:1