



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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (LMSB) – ATLANTA
(RETAILERS, FOOD, PHARMACEUTICALS, AND
HEALTHCARE)

Attn: Carolyn L. Rountree
Special Litigation Assistant, LM:RFPH

FROM: Acting Associate Chief Counsel (CORP), CC:CORP

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated February 26, 2002. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Seller =

SellerSub =

Purchaser =

PurchaserSub =

State A =

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State B =

State C =

State D =

Investment Banker =

Corporate Officer =

State B Agency =

Year 1 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

Date 11 =

q =

r =

s =

t =

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v =w =x =y =z =ISSUES

1. Should the distributions totaling \$z by SellerSub to Seller during Year 1 constitute dividends or a portion of the consideration paid to purchase Seller's stock in SellerSub?
2. Is Seller entitled to a dividends received deduction for Year 1 for the distribution of \$z from SellerSub under § 243 of the Code?

CONCLUSIONS

1. The distributions may constitute a portion of the consideration paid to purchase Seller's stock in SellerSub.
2. If the distribution is characterized as consideration paid for the SellerSub stock, Seller is not entitled to a dividends received deduction.

FACTS

Seller, a State A corporation, is a publicly traded holding company and the parent of a group of wholly owned subsidiary corporations involved in several lines of business, including the insurance business. Seller and its subsidiaries are accrual method taxpayers who file returns on a calendar year basis. Among Seller's subsidiaries is SellerSub, a State B corporation that is a domestic life and disability insurer. Seller acquired its stock in SellerSub on Date 1. Purchaser, a State C corporation, is a holding company that owns or manages assets and operates several insurance companies. Among the subsidiaries of Purchaser is PurchaserSub, a State D corporation.

During Date 2, representatives of Seller met with individuals at Investment Banker to discuss the possibility of selling SellerSub to Purchaser in an all cash

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transaction for \$q. Corporate Officer of Seller stated at that meeting that he would accept no price lower than \$q. The Seller representatives met with Purchaser representatives soon thereafter and the Seller representatives proposed the sale of SellerSub to Purchaser for \$q. The Purchaser representatives agreed to the purchase. On Date 3, the parties entered into an exclusivity agreement that gave Purchaser 30 days to conduct due diligence.

In a meeting on Date 4, Seller's Board of Directors reviewed the proposed agreement. At that meeting, the Board unanimously authorized Seller to enter into an agreement with Purchaser and PurchaserSub in which Seller would sell its stock in SellerSub to Purchaser and PurchaserSub. In a stock purchase agreement, dated Date 5, Seller agreed to sell its stock (all r issued and outstanding capital shares) in SellerSub to Purchaser and PurchaserSub for \$q in cash subject to several conditions including approval of the State B Agency. The agreement required SellerSub to sell or transfer to Seller its interest in certain investment assets ("unwanted assets") and hold an amount of cash (or equivalents) equal to the fair market value of the unwanted assets. The parties jointly issued a press release on that date describing the sale for \$q and Seller filed papers with the Securities and Exchange Commission outlining the same terms of the sale.

On Date 6, Seller and SellerSub's Boards of Directors formally decided that SellerSub would recapitalize and pay dividends to Seller by Date 10. SellerSub declared an \$s dividend to Seller payable on Date 8, that consisted of certain investment assets. SellerSub also declared a \$t dividend to Seller payable on Date 10. The SellerSub Board also authorized the issuance of an additional v shares of common capital stock and the sale of w shares to Purchaser in exchange for \$x. The shares sold to Purchaser represented an over 20 percent ownership interest in SellerSub. Seller retained a call option on those shares whereby Seller could force PurchaserSub to sell the newly issued stock back to Seller.

Further purchase agreements were executed on Date 7 that modified the earlier agreements. The new purchase agreements reduced the price PurchaserSub was to pay Seller for the remaining SellerSub stock from \$q to \$y. The revised agreements also stated that Seller would cause SellerSub to distribute the unwanted assets to Seller as a dividend having a fair market value up to \$z. If the State B Agency did not approve of the dividend or if, for any other reason, SellerSub failed to make the full distribution, PurchaserSub would reimburse Seller to whatever extent \$z exceeds the amount distributed.

The State B Agency approved the \$t dividend on Date 9, subject to approval for SellerSub's sale of the w shares of stock to Purchaser for \$x and contingent on such sale. The State B Agency approved the sale of SellerSub to PurchaserSub on Date 11.

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LAW AND ANALYSIS

Characterization of the Distribution

Whether the distribution in question should be characterized as a dividend or part of the consideration paid for the SellerSub stock depends on the legal characterization of the factual circumstances surrounding the transaction. There are many cases that address the question before us but that reach opposite conclusions based on the facts of each case. The two leading cases are Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970), and TSN Liquidating Corp., Inc. v. United States, 624 F.2d 1328 (5th Cir. 1980).

In Waterman, the Court of Appeals ruled that the form of a transaction and intent of the parties is less important than the true substance and effect of the parties' agreement when judging whether a dividend is part of the sale price. The parties reached agreement on a sale price of \$3.5 million for the stock of two corporations. In hopes of receiving tax favorable treatment from the government, the seller declared a dividend of \$2.8 million in the form of a promissory note and then sold the stock of the corporations to purchaser for \$700,000 in cash. However, as part of the agreement, the purchaser loaned the corporations \$2.8 million after the sale was completed in order to pay the note issued in lieu of the cash dividend.

The court concluded that the dividend was in fact part of a pre-arranged plan to sell the stock and that the distribution was "a mere conduit for the payment of the purchase price." Waterman at 1192. There were several critical facts that led the court to this determination. First, the purchaser originally offered \$3.5 million for the stock of the corporations and the seller intended to sell the stock for that price, but with \$2.8 million disguised as a dividend. The distribution was financed by money supplied by the stock purchaser and not by the seller. In other words, the purchaser ultimately paid the entire purchase price, not just \$700,000. The fact that the distribution was made pre-sale and in the form of a promissory note rather than in cash conflicts with the nature of a dividend being a distribution of earnings and profits in the context of a corporation-shareholder relationship. Finally, the court was convinced that the dividend would never had been paid but for the impending sale of the corporation stock.

TSN dealt with similar factual circumstances but reached an opposite conclusion. In TSN, the purchaser of the corporation's stock reached an agreement with the seller that the purchase price would be reduced automatically when certain assets, consisting primarily of capital stock in small, public companies trading infrequently and in small quantities in the over-the-counter market, were removed from the corporation's ownership by the closing date of the sale. Pursuant to the agreement, the seller declared a dividend worth about \$1.8 million primarily

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in the form of capital stock in the small, public companies prior to the closing date. The purchaser then purchased the stock of the corporation for approximately \$800,000. After the purchase, the purchaser contributed to the capital of the corporation \$1.1 million in bonds (assets significantly different in nature than those distributed) and purchased \$800,000 of additional capital stock in the corporation. Prior to the sale and dividend, the corporation was worth approximately \$2 million, and afterwards was worth \$2.4 million.

The Court of Appeals found that the facts of TSN distinguishable from those of Waterman. The purchaser in TSN made it clear that they did not want the distributed assets in the corporation after closing, had valid business purposes for not wanting them, and would not pay for them. Once the assets were distributed, they remained in the hands of the selling shareholders. Unlike Waterman, the assets that the purchaser contributed to the corporation after the sale were not later transferred to the selling shareholders. The mere fact that the dividend was part of the purchase agreement does not make the dividend a conduit for the transfer of consideration.

Waterman and TSN discuss many factors that are considered in determining whether a purported dividend should be respected as such or should be treated as part of the purchase price. Although the case before us contains elements of Waterman and TSN and falls somewhere between them, we believe that the Field's position that it is more similar to Waterman than TSN is supported by the facts and could be further supported by facts further developed as outlined below.

It is our view of the cases in this area that the most important factor in deciding whether the "dividend" should be characterized as such or as part of the consideration paid for the stock is whether the purchaser truly did not want the distributed assets. In TSN, it was clear that for valid business reasons the purchaser did not want the infrequently traded stock of the small companies. Similarly, in Coffey v. Commissioner, 14 T.C. 1410 (1950), another case which respected the form of a distribution as a dividend, it was clear that the purchaser did not want to acquire certain assets of the acquired corporation, most specifically a contingent payment owed to the corporation.

As was the case in TSN, SellerSub is distributing assets to Seller that were "unwanted" by PurchaserSub and Purchaser. It is unclear whether Seller has retained the distributed assets. However, unlike in TSN, Coffey, and other similar cases, it is by no means clear whether the Purchaser truly didn't want the "unwanted assets" or whether Seller merely concocted this plan to distribute the "unwanted assets" after the sale was already agreed to in order to derive significant tax benefits. Unlike the assets in TSN and Coffey, the "unwanted assets" distributed were by no means unique, and in fact, appear to be investment assets of a very similar nature and quality to other assets of SellerSub which were not

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distributed. We have no evidence from Purchaser that it did not want to acquire these assets. In fact, the stock purchase agreement provides evidence to the contrary. Section 5.17(d) of the stock purchase agreement states:

If the State B Agency does not approve, or if [SellerSub] does not make, a distribution to Seller (as dividends) of Unwanted Assets having a Fair Market Value of \$z, or if [SellerSub] for any other reason does not make aggregate Permitted Dividends to Seller of \$z, then Purchaser will reimburse Seller at the Closing for the [undistributed amount] (emphasis added).

This quoted passage appears to be strong evidence of the willingness of Purchaser to buy such assets, and that it was merely Seller's desire that prevented Purchaser from buying such assets. Similarly, Seller's initial agreement to sell such assets shows that the Seller had no real desire to keep those assets either.

The State B Agency approved the dividend contingent upon Purchaser, in effect, replacing the assets distributed by SellerSub, Seller did not necessarily want to keep the unwanted assets, and Purchaser was not opposed to acquiring such assets. Therefore, it appears that the only reason that the transaction was structured as done, rather than as a straightforward sale of the SellerSub stock, was as a tax planning device.

Seller and Purchaser agreed on a price of \$g and publicly stated that the sale of the SellerSub stock was for that amount. It is clear that the dividend would not have occurred but for the contemplated sale. It also appears that PurchaserSub supplied the funds through the first purchase of SellerSub stock that eventually became the source for the bulk of the \$z dividend. This inference is buttressed by the fact that PurchaserSub promised to reimburse Seller to whatever extent \$z exceeded the actual amount distributed. However, contrary to the facts in Waterman, SellerSub distributed assets, not cash, to Seller, which undermines the supposition that PurchaserSub (the purchaser) supplied the funds to support the dividend. We do note, however, that the distributed assets appear to be readily marketable (and in fact may have been disposed of by Seller), thus this difference from Waterman may not be very significant. What is clear is that, in the end, PurchaserSub expended \$g to acquire all the stock of SellerSub in two separate steps.

We suggest that the facts of this case be further developed in order to determine whether the distributions should be properly classified as a dividend or as consideration paid for the SellerSub stock.

It would be particularly helpful to determine:

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- 1) the veracity of the business purpose alleged by Purchaser and/or PurchaserSub regarding the unwanted assets, i.e., whether Purchaser truly did not want the unwanted assets;
- 2) the nature of the assets distributed by SellerSub as compared to the nature of the assets contributed by PurchaserSub to SellerSub and/or acquired with the assets contributed;
- 3) whether Seller has retained the assets distributed to it by SellerSub; and
- 4) SellerSub's continued status as an insurance company for both state and Federal tax law purposes after the sale.

Dividends Received Deduction

If the distribution is characterized as part of the consideration paid for the SellerSub stock, Seller is not entitled to a dividends received deduction since no dividend occurred.

If, upon further analysis, it is determined that the distribution should be characterized as a dividend, please contact the Office of Associate Chief Counsel (Financial Institutions and Products) for guidance.

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Please call (202) 622-7790 if you have any further questions.

By: _____
Senior Technician Reviewer, Branch 3