Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Parent =

S1 =

S2 =

S3 =

Purchaser =

x =

Date A =

Date B =

Date C =

ISSUE

Does the deemed liquidation of S2 qualify as a liquidation under §332(a) of the Internal Revenue Code?

CONCLUSION

No, S1 does not receive any property with respect to its stock interest in S2. Therefore, the deemed liquidation of S2 does not qualify as a liquidation under §332(a).

FACTS

The facts as submitted indicate that Parent is the common parent of a consolidated group. Parent owns all the stock of S1. S1 owns x% (at least 80%) of the stock of S2. The public owns the remaining shares of S2. S2 owns all the stock of S3. S1 was the lender on an intercompany indebtedness with S3. Prior to the cancellation of a portion of the indebtedness, described below, S3's liabilities exceeded the fair market value of its assets and S2's liabilities exceeded the fair market value of its assets.

On Date B, S1 sold all its stock in S2 to Purchaser, an unrelated third party. As a condition to the sale, on Date A, S1 forgave a portion of the indebtedness it had with S3. Immediately after this cancellation, the net value of S3's assets exceeded its liabilities and the net value of S2's assets (including the stock of S3) exceeded S2's liabilities. On Date C, Parent and Purchaser made a joint §338(h)(10) election with respect to the sale of the stock of S2 and the deemed sale of the stock of S3.

LAW AND ANALYSIS

Section 338(a) permits certain stock purchases to be treated as asset acquisitions if: (1) the purchasing corporation makes or is treated as having made a "§338 election" or a "§338(h)(10) election" and (2) the acquisition is a "qualified stock purchase."

Section 338(h)(10) permits the purchasing and selling corporations to elect jointly to treat the target corporation as deemed to sell all of its assets and distribute the proceeds in complete liquidation. A § 338(h)(10) election may be made for target only if purchaser acquires stock meeting the requirements of § 1504(a)(2) from a selling consolidated group, a selling affiliate, or the S corporation shareholders in a qualified stock purchase. Section 1.338(h)(10)-1(c)(1) of the Income Tax Regulations.

Section 1.338-1(a)(2) provides that with respect to a §338 election, other rules of law apply to determine the tax consequences to the parties as if they had actually engaged in the transactions deemed to occur under §338 and the regulations thereunder except to the extent otherwise provided.

Section 332(a) provides that no gain or loss will be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

Section 332(b) provides, in part, that for purposes of §332, a distribution shall be considered to be in complete liquidation only if--

(1) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) meeting the requirements of §1504(a)(2); and either

(2) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year; or

(3) such distribution is one of a series of distributions by such other corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within 3 years from the close of the taxable year during which is made the first of the series of distributions under the plan.

Section 1.332-2(b) provides that §332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock that it owns in the liquidating corporation.

Rev. Rul. 59-296, 1959-2 C.B. 87, holds that where a parent corporation is a creditor of its wholly owned subsidiary in an amount greater than the fair market value of the subsidiary's assets, a distribution of the subsidiary's assets to the parent in complete liquidation of the subsidiary will not be nontaxable under §332 since no part of the transfer is attributable to the stock interest of the parent.

Rev. Rul. 68-602, 1968-2 C.B. 135, holds that the cancellation of indebtedness between a parent and its wholly owned insolvent subsidiary immediately prior to the liquidation of the subsidiary will be disregarded so that the liquidation will not qualify as a liquidation under §332(a).

Rev. Rul. 78-330, 1978-2 C.B. 147, holds that where P owns all of the stock of a two corporations, S-1 and S-2, and prior to the merger of S-1 into S-2, P gratuitously cancels the principal amount of a debt owed by S-1 to P so that the basis of S-1’s assets would exceed the total amount of its liabilities prior to the merger, the

cancellation of the debt would be given economic substance so that the liabilities of S-1 assumed by S-2 would not exceed the adjusted basis of S-1's assets transferred to S-2.

If not for S1's cancellation of a portion of the indebtedness owed to it by S3 prior to S1's sale of the S2 stock, it is clear that the deemed distribution of S2's assets pursuant to the §338(h)(10) election would not qualify as a liquidation under §332(a), because none of the distribution to S1 would be attributable to S1's stock interest in S2. Section 1.332-2(b) and Rev. Rul. 59-296. Any property received by S1 would be attributable to its creditor interest in S3.

It is also clear that even if S1 cancelled a portion of its debt from S3 prior to a liquidation of S2, that if not for the sale of the S2 stock and the §338(h)(10) election, a liquidation of S2 would not qualify under §332(a). See Rev. Rul. 68-602.

The issue in this case arises because of the insistence of Purchaser that a portion of the indebtedness between S1 and S3 be cancelled before the sale of the S2 stock. We recognize that it is reasonable for a purchaser to not want its newly purchased subsidiary to be indebted to a member of the seller's affiliated group after the purchase. Therefore, cancellation of indebtedness between a parent and its subsidiary immediately prior to the sale of the subsidiary generally has economic significance outside of the desire to derive certain tax benefits. However, the fact that cancellation of indebtedness generally has economic significance does not necessarily mean that the cancellation of the indebtedness should be taken into consideration in determining whether S1 should be deemed to have received anything in exchange for its stock interest in S2 in order to qualify under §332(a).

In making the determination of whether the liquidation of S2 qualifies under §332(a), it must be remembered that, except as otherwise provided in regulations, the tax consequences of a §338 election (including a §338(h)(10) election) should be the same as if the parties to the transaction had actually engaged in the transactions deemed to occur under §338 and the regulations thereunder. There is no provision in the regulations that treats the consequences of a deemed liquidation different than the consequences of an actual liquidation if the deemed transactions had actually occurred.

If the deemed transactions had actually occurred, the following steps would have taken place. (1) S1 cancels a portion of the indebtedness owed to it by S3. (2) S3 (Old S3) sells all its assets, subject to its remaining liabilities, to New S3. (3) Old S3 distributes the assets it receives on the sale to New S3 to S2. (4) S2 (Old S2) sells its assets, subject to its liabilities, to New S2. (5) Old S2 distributes the assets it receives on the sale to New S2 to S1.

After the assets and liabilities of S3 and S2, other than the indebtedness between S1 and S3, are sold to New S3 and New S2, respectively, the transaction becomes substantially similar to that described in Rev. Rul. 68-602, except for the fact that the indebtedness is between a parent corporation and its second tier subsidiary rather than

its direct subsidiary, that is, a cancellation of indebtedness of an insolvent subsidiary immediately before the liquidation of the insolvent corporation. Thus, as in Rev. Rul. 68-602, the cancellation of the indebtedness between S1 and S3 would be disregarded in determining the tax consequences of the liquidations of S3 and S2. And if not for the cancellation of the indebtedness between S3 and S1, neither S2 nor S1 would receive any property with respect to its stock interest. Any property received by S1 would be received in its capacity as a creditor, not as a shareholder of S2. Old S3, having no net assets, would not distribute anything to S2 with respect to S2's stock interest in S3. And S2, having received nothing from Old S3, would still be insolvent after the deemed sale of its assets to New S2. Thus, S1 would receive nothing from S2 with respect to its stock interest in S2. Accordingly, the liquidation of S2 would not qualify under §332(a). The fact that there may be economic significance in the cancellation of the indebtedness does not alter this result.[1] Rev. Rul. 78-330 is distinguishable as there is no liquidation of S1 in the revenue ruling.

Because, pursuant to §1.338-1(a)(2), the tax consequences of the deemed liquidation under §338 must be the same as the tax consequences if the deemed transactions actually took place, and, as described above, an actual liquidation would not qualify under §332(a), the deemed liquidation of S2 does not qualify under §332(a).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views. If you have any

[1] See Preamble to Notice of Proposed Rulemaking, Purchase Price Allocations in Deemed Actual Asset Acquisitions, REG-107069-97, 64 FR 43462-01, 1999-2 C.B 346, 356.

further questions please contact Mark Weiss at or Ken Cohen at

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Ken Cohen Mark J. Weiss