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

MEMORANDUM FOR BRADFORD A. JOHNSON
ASSOCIATE AREA COUNSEL, AREA 1 LM:FSH:HAR

Attn: Carmino Santaniello

FROM: Jasper L. Cummings
Associate Chief Counsel CC:CORP

SUBJECT:

This Field Service Advice responds to your memorandum dated October 23, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Corporation A	=	
Corporation B	=	
Shareholder C	=	
Shareholder D	=	
Shareholder E	=	
Shareholder F	=	
Shareholder G	=	
Year 1	=	
Year 2	=	
Year 3	=	
Date 1	=	
Date 2	=	
Date 3	=	
Date 4	=	
Date 5	=	
Date 6	=	
Date 7	=	
T	=	
U	=	
V	=	
W	=	
X	=	
Business	=	

Property 1	=
Property 2	=
Agency	=
State M	=
a	=
b	=
c	=

ISSUES

(1) Whether a series of transactions involving Corporation A, Corporation B, and their common shareholders may be characterized as a reorganization under section 368(a)(1)(D) of the Internal Revenue Code ("Code").

(2) Alternatively, whether the transactions may be characterized as a reorganization under section 368(a)(1)(F) of the Code.

CONCLUSIONS

(1) The Service may characterize the series of transactions involving Corporation A, Corporation B, and their common shareholders as a reorganization under section 368(a)(1)(D).

(2) The Service may not characterize the transactions as a reorganization under section 368(a)(1)(F).

FACTS

The facts as we understand them are as follows:

Corporation A, an S corporation formed in Year 1, was engaged in Business until its dissolution in Year 3. Prior to Date 1, Shareholder C owned all the stock of Corporation A. On Date 1, Shareholder C transferred by gift a% of the Corporation A stock to his children, Shareholder D, Shareholder E, Shareholder F, and Shareholder G (collectively, the "Children"). After Date 1, each of the Children held c% of the Corporation A stock. On Date 4, Shareholder C sold his entire remaining interest in Corporation A to the Children for $T (the "Stock Purchase").[1]

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[1]The stock certificates for Shareholder C's stock indicate that the Stock Purchase occurred on Date 5.

Shareholder C recognized capital gain as a result of the Stock Purchase. After the Stock Purchase, the Children held equal shares of Corporation A.

Corporation B, an S corporation formed in Year 1, is also engaged in Business. Prior to Date 2, Shareholder C owned all the stock of Corporation B. On Date 2, Shareholder C transferred by gift a% of the Corporation B stock to the Children. After Date 2, Shareholder C held b% of the Corporation B stock, and each of the Children held c% of the Corporation B stock.

In Year 2, Corporation A sold its largest asset to an unrelated third party for $U. Part of the consideration was cash paid at the time of closing, and the remainder was an installment note for $V ("Installment Note"). The purchaser satisfied the note on Date 6 by paying $W, which included the note balance plus a prepayment penalty. The Children's Schedule K-1s for Year 3 reflect each shareholder's allocable share of the capital gain realized on the Installment Note.

During Year 3, Corporation A's primary operating assets consisted of Property 1 and Property 2. On Date 3, Corporation A requested Agency's permission to assign to Corporation B the licenses for Property 1 and Property 2. Agency granted permission for the assignment, and Corporation A assigned the assets to Corporation B for no consideration on Date 4.

On Date 5, Corporation A transferred its remaining operating assets to Corporation B for no consideration. After the transfer of its operating assets, Corporation A's assets consisted solely of nonoperating assets, including the Installment Note and two other receivables.

At a special meeting of Corporation A's shareholders on Date 4, the shareholders voted to dissolve Corporation A, effective on Date 7, and to distribute the remaining assets (the Installment Note and receivables) of Corporation A to the shareholders. Corporation A notified the State M Secretary of State of its intent to dissolve. Upon Corporation A's dissolution, each of the Children received payments of $X, which the taxpayers reported on the Schedule K-1s as liquidating distributions. Corporation A treated the values of neither the Property 1 and Property 2 licenses nor the assets transferred to Corporation B in the mass asset disposition as part of the liquidating distributions.

Corporation A and its shareholders treated the transactions described above as a complete liquidation of Corporation A. As a result of the Stock Purchase, each of the Children had a basis in his Corporation A stock that exceeded the amount of the liquidating distribution. Each of the Children reported losses on the liquidation of Corporation A.

LAW AND ANALYSIS

(1) The series of transactions involving Corporation A, Corporation B, and their common shareholders may be characterized as a reorganization under section 368(a)(1)(D).

Several courts have characterized as reorganizations transactions that taxpayers have treated as liquidations. See, e.g., Rose v. United States, 640 F.2d 1030 (9th Cir. 1981); Atlas Tool Co. v. Commissioner, 614 F.2d 860 (3d Cir. 1980), cert. denied sub nom Shaffan v. Commissioner, 449 U.S. 836 (1980); Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967); Moffatt v. Commissioner, 363 F.2d 262 (9th Cir. 1966).

Section 368(a)(1)(D) defines a reorganization under that section as

> a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor, or one of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

For nondivisive reorganizations under section 368(a)(1)(D), “control” means 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. The attribution rules of section 318 apply to the control determination. Sections 304(c), 318, 368(a)(2)(H). Here, Corporation A and Corporation B have identical ownership before and after the transactions by virtue of the section 318 attribution rules. Shareholder C and the Children collectively own all the stock of both Corporation A and Corporation B, thus satisfying the control requirement of section 368(a)(2)(H).

Section 354(a) provides that a shareholder recognizes no gain or loss on the exchange, in pursuance of the plan of reorganization, of his stock or securities in a corporation that is party to a reorganization solely for stock or securities in such corporation or in another corporation party to the reorganization. Section 354(b)(1) provides that section 354(a) will not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D) unless the corporation to which the assets are transferred acquires substantially all the assets of the transferor corporation, and the stock, securities, and other properties received by the transferor are distributed in pursuance of the plan of reorganization.

Although the taxpayers in the present case characterized the transaction as a liquidation, their label is not determinative. Courts have not required a formal written plan of reorganization if other evidence establishes the existence of a plan of reorganization. See Atlas Tool, 614 F.2d at 866 ("If what resulted was a reorganization, the chosen label is not dispositive."). Here the proximity of time between the shareholders' agreement to dissolve Corporation A and the asset transfers for no consideration to commonly controlled Corporation B establish the plan. Corporation A's transfer of all of its operating assets to Corporation B, followed by Corporation A's dissolution, indicates a mere readjustment of continuing interests in property, the hallmark of a reorganization.

Courts generally have interpreted the "substantially all the assets" requirement for D reorganizations to mean operating assets, rather than total assets. See, e.g., Smothers v. United States, 642 F.2d 894 (5th Cir. 1981); American Mfg. Co. v. Commissioner, 55 T.C. 204 (1970); James Armour Inc. v. Commissioner, 43 T.C. 295 (1065).. Here, Corporation A satisfied the substantially all requirement by transferring all of its operating assets to Corporation B for no consideration.

Although section 368(a)(1)(D) requires a distribution of stock or securities, courts generally have not interpreted this provision literally. Courts and the Service have held that a distribution of stock or securities is not necessary where there is common ownership of the transferor and transferee corporation. See Rose, 640 F.2d at 1034; Atlas Tool, 614 F.2d at 865; Davant, 366 F.2d at 886-887. See also Rev. Rul 70-240, 1970-1 C.B. 81.

In addition to meeting the statutory requirements, a transaction must satisfy certain nonstatutory requirements to qualify as a reorganization under section 368(a)(1)(D), including the continuity of business enterprise requirement. The continuity of business enterprise requirement is satisfied in this case. Following Corporation A's transfer of its historic business assets to Corporation B, Corporation B conducted the historic business with those assets in substantially the same manner in which it had been conducted prior to the transfer. See § 1.368-1(d).

We believe it is appropriate to recharacterize the series of transactions involving Corporation A, Corporation B, and their common as a reorganization under section 368(a)(1)(D).

(2) The transactions may not be characterized as a reorganization under section 368(a)(1)(F).

A section 368(a)(1)(F) reorganization is a “mere change in identity, form, or place of organization of one corporation, however effected.” The statutory provision indicates that only a single corporation can engage in a reorganization under section 368 (a)(1)(F).

The legislative history of section 368(a)(1)(F) suggests that Congress intended to permit a reorganization by multiple entities under this subsection only if the purported reorganization involves a single operating company. See Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 225(a), 96 Stat. 324, 490. In the present case, both Corporation A and Corporation B were operating companies prior to the transaction. Accordingly, the transactions cannot be characterized as a reorganization under section 368(a)(1)(F).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Your memorandum indicates that if the transaction were treated as a reorganization, the cash distributions to the Corporation A shareholders would be treated as ordinary income under the boot provisions of section 356, rather than as capital gain under section 331. We note that because Corporation A and Corporation B are S corporations, section 1368 provides that the shareholders treat the cash distributions as returns of capital or as capital gain income, rather than as ordinary income.

The principal tax difference between the taxpayer’s position and our recommended characterization appears to be a timing difference. The taxpayer’s position permits the Children to claim a loss immediately on the disposition of their Corporation A stock. Classification of the transactions as a reorganization, however, results in deferral of any loss until the shareholders genuinely diminish their investment in the business. The amount the Children claimed as losses instead would increase their bases in their Corporation B stock, thus reducing any future gain (or increasing future loss) on the ultimate disposition of their Corporation B stock.

In addition, there is some risk involving the transaction’s satisfaction of the section 356(b)(1) requirements that 1) substantially all the assets of the transferor be transferred, and 2) that transferee stock be distributed in the transaction. With respect to the “substantially all” requirement, we noted above that courts generally have found the requirement satisfied where the transferor transferred all of its operating assets to the transferee corporation. This interpretation conflicts with our ruling position, which contains a much higher threshold. Rev. Proc. 77-37, 1977-2 C.B. 568 (70% of gross assets, 90% of net assets must be transferred). We do not feel this disparity poses a compelling risk, as numerous courts in the liquidation-reincorporation context have held that the "substantially all" test is met where the operating assets are transferred. In Smothers, for example a transfer of 15% of the transferor assets satisfied the "substantially all" test because they represented all the transferor's operating assets. See also American Mfg. Co., 55 T.C. 204 (1970) ("substantially all" test satisfied where only 20% of the total assets were transferred, but all of the operating assets).

We noted above that courts generally disregard the requirement that the transferee corporation distribute stock in liquidation-reincorporation transactions like this one. In one case, however, the Tax Court refused to ignore the lack of an actual stock exchange where the ownership of the transferor and transferee corporations was not identical. See Warsaw Photographic Assocs., 84 T.C. 21 (1985). In this case, the ownership of Corporation A and Corporation B is identical because of the application of the attribution rules. Where ownership is identical only because of the attribution rules, the answer is not certain. In at least one letter ruling, the Service has held that an actual stock transfer in a D reorganization is unnecessary where ownership via the attribution rules of the transferee and transferor corporations is identical. See PLR 9111055 (Dec. 19, 1990)(citing S. Prt. No. 169, 98th Cong., 2d Sess., vol. 1, at 209-209 (Apr. 2, 1984); Staff of the Joint Committee of Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 193-194 (December 31, 1984) for the proposition that the 1984 enhancement of section 368(a)(1)(D) control requirement intended to coordinated related person asset sale treatment with section 304 related person stock sale treatment).

As with all liquidation-reincorporation cases, treatment of the series of transaction here as a reorganization under section 368(a)(1)(D) involves reliance on the step transaction doctrine. The step transaction doctrine requires that all integrated steps in a single transaction be amalgamated in determining the true nature of a transaction. While separate from the "plan of reorganization" requirement, the step transaction doctrine and the plan requirement are mutually reinforcing concepts in the reorganization context. Above we note that the timing and lack of consideration in this transaction appear to establish a plan of reorganization. These factors help to establish the shareholders' plan to continue their existing business in a reorganized corporate form, but additional evidence of a plan would be helpful. [redacted]

You did not ask us to address whether the Stock Purchase should be respected as a meaningful transaction. We note that the Stock Purchase occurred nearly simultaneously with the transfer of Corporation A assets to Corporation B and the Corporation A shareholders' adoption of a plan of liquidation. If the transaction constituted a reorganization represented by a true value for value exchange, the Children would have received additional Corporation B stock in the exchange. Instead, Shareholder C receives b% of the value of the operating assets transferred to Corporation B because of his b% interest in Corporation B. It appears that the reorganization undoes the transfer of assets to the Children in the Stock Purchase, because Shareholder C in substance reacquires his interest in the Corporation A assets in the reorganization. Accordingly, we question whether the Stock Purchase should be respected. The timing and details of the Stock Purchase suggest that it was an integrated step in the taxpayers' plan to reorganize their interests in Corporation A. It seems more consistent with substance over form principles to view the Stock Purchase as one part of the whole reorganization transaction, than to treat it as a separate event. Disregarding the Stock Purchase also eliminates the hazard related to the distribution requirement, noted above, insofar as the ownership of Corporation A and Corporation B would be identical before and after the reorganization. If the Stock Purchase is disregarded as a meaningless step, the tax result of recharacterizing the transaction will vary significantly.

Please call Marie Byrne at (202) 622-6831 if you have any further questions.

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By:________________________
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