Department of the Treasury **Internal Revenue Service**

Office of Chief Counsel

Notice

CC-2002-003

October 18, 2001

Subject: Merger Resembling Sale **Cancel Date:** October 16, 2002

PURPOSE

The purpose of this Notice is to help Chief Counsel attorneys address issues arising in certain transactions wherein corporations are nominally disposed of in a reorganization under § 368 or an exchange under § 351 but are in substance sold.

SUMMARY

Where a taxpayer disposes of a target corporation in exchange for stock in a transaction claimed to be a reorganization (here, a reverse (or sometimes, a forward) subsidiary merger), but the stock interest received largely reflects effective ownership of a pool of liquid assets of a value approximately equal to that of the target, under facts the same as or substantially similar to those below, the transaction will fail to qualify as a tax-free reorganization (here, under §§ 368(a)(1)(A) and 368(a)(2)(E) (or (a)(2)(D)) and § 368(a)(1)(B)) because the transaction is not the type of transaction Congress intended to be treated as a reorganization. Furthermore, on the facts discussed below, the transaction does not qualify for nonrecognition treatment under § 351 because (i) the acquiring corporation is an investment company within the meaning of § 351(e)(1), and (ii) the transaction is not the kind of transaction intended to be covered by § 351. In addition, § 269 denies any benefit of §§ 351 and 368 to the taxpayer, which, under facts the same as or substantially similar to those described below, acquired control of the corporation whose stock was received in the purported reorganization.

DISCUSSION

The transaction, which can take a variety of forms, generally involves the disposition by an owner (Taxpayer) of a subsidiary corporation (Target), whereby Target is acquired by a previously unrelated corporation (Acquiring) and an affiliate of Acquiring (Actual Acquirer). Actual Acquirer and/or its affiliates form Acquiring by contributing cash or other liquid assets to Acquiring. Actual Acquirer may also cause additional debt to be incurred for a loan the proceeds of which

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also go into Acquiring. The debt does not encumber Acquiring. The aggregate cash in Acquiring, which roughly equals the value of Target, is contributed to an entity, usually a newly formed limited liability company (LLC), of which Acquiring is the sole owner. No election is made to treat LLC as an entity separate from its single owner. In a series of transactions, at the heart of which is a transaction generally structured as a reverse (or forward) subsidiary merger, Target and a subsidiary of Acquiring merge. Acquiring receives stock of Target (typically voting preferred stock) representing voting control of Target but little of Target's value; Actual Acquirer receives stock of Target (typically common stock) constituting the bulk of Target's value; Actual Acquirer receives stock of Acquiring that has little value but has voting control of Acquiring, thus giving Actual Acquirer indirect voting control of Target; Taxpayer receives an interest in Acquiring that is nominally common stock; and an agreement, typically an LLC operating agreement or management agreement, gives Taxpayer managerial control of the cash in LLC. Thus, Taxpayer acquires all of the value of Acquiring except for the stock with little value that Actual Acquirer owns. In summary, Taxpayer receives control of cash roughly equal to the value of Target, and has the reasonable expectation that it will actually obtain that cash, plus or minus any investment results of that cash, in a number of years, if not sooner. Taxpayer reports the exchange as a nonrecognition transaction under either § 368 or § 351.

Section 368. Taxpayer asserts that the transaction qualifies as a tax-free reorganization under §§ 368(a)(1)(A) and 368(a)(2)(E) and under § 368(a)(1)(B). Section 368(a)(1)(A) defines a reorganization as including "a statutory merger or consolidation." Section 368(a)(2)(E) provides:

> Statutory merger using voting stock of corporation controlling merged corporation. A transaction otherwise qualifying under [§ 368(a)(1)(A)] shall not be disqualified by reason of the fact that stock of a corporation (referred to in this subparagraph as the "controlling corporation") which before the merger was in control of the merged corporation is used in the transaction, if (i) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction); and (ii) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of such corporation.

A reorganization under § 368(a)(1)(B) is defined as:

> The acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition) . . . .

The applicable control standard is that set forth in § 368(c).

Generally, § 1.368-1(b) provides that:

> The purpose of the reorganization provisions of the Code is to except from [gain or loss recognition] certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms. . . . Both the terms [of the reorganization provisions] and their underlying assumptions and principles must be satisfied in order to entitle the taxpayer to the benefit of the exception from [gain or loss recognition]. . . . [A] sale is nevertheless to be treated as a sale even though the mechanics of a reorganization have been set up.

Section 1.368-1(c) provides that “a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization.”

Section 1.368-1(e) describes the judicially-created requirement for a good reorganization under § 368(a)(1) that there be continuity of interest. Section 1.368-1(e)(1) provides, in part, “The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. . . . All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved.”

Here, Taxpayer exchanges its interest in Target for interest in Acquiring. But as part of the integrated transaction, Acquiring in effect disposes of the bulk of Target that it acquires in the reverse subsidiary merger by allowing that interest to pass to Actual Acquirer through the ownership of the common stock of Target in exchange for the cash that funded LLC.

Thus, the vast majority of the assets of Acquiring consist, immediately after completion of the transaction, of its member interest in LLC, and thus in the cash possessed by LLC. Only a small portion of Acquiring's assets, by comparison, consists of its stock interests in Target. On the other hand, Actual Acquirer has common equity interests following completion of the transaction in Target that approximate all of its value. In economic substance, therefore, Taxpayer disposes of almost all its interest in Target in return for an equivalent interest in Acquiring, which holds, through LLC, mostly cash. Taxpayer, as manager of LLC, determines how LLC’s cash is invested and is generally not liable to anyone else for the results of such management. If Taxpayer, as the manager of LLC, invests LLC’s cash wisely, Taxpayer will ultimately harvest the benefit.

By entering into the transaction, Taxpayer obtains current control over an amount of money equal to the value of Target, to use for any purpose it sees fit. Taxpayer also gets the ability ultimately to possess that money, along with any increase (or decrease) Taxpayer might produce in it as the manager of LLC.

Viewing all of the steps of the transaction, what is actually done, in substance, is the exchange by Taxpayer of the bulk of its interest in Target for interest in Acquiring, a corporation holding almost exclusively cash, disguised as a reorganization. As Judge Learned Hand said in Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), aff'd, Gregory v. Helvering, 293 U.S. 465 (1935), "[a]ll these steps were real, and their only defect was that they were not what the statute means by a ‘reorganization,’ because the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham, though all the proceedings had their usual effect."

As stated in § 1.368-1(b), quoted above:

> The purpose of the reorganization provisions of the Code is to except from [gain or loss recognition] certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms. . . . Both the terms [of the reorganization provisions] and their underlying assumptions and principles must be satisfied in order to entitle the taxpayer to the benefit of the exception from [gain or loss recognition]. . . . [A] sale is nevertheless to be treated as a sale even though the mechanics of a reorganization have been set up.

And, as stated in § 1.368-1(c), also quoted above, “a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization.”

For instance, in Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932), cert. denied, 288 U.S. 599 (1932), substantially all the properties of one corporation were acquired by another corporation in exchange for cash and short-term promissory notes. Although the transaction came within the literal language of the reorganization provisions, the court held that the term reorganization assumes “a continuance of interest on the part of the transferor in the properties transferred” and that the transaction before the court was too much like a sale to qualify. In the instant transaction, in substance, all Taxpayer gets is a basket of cash over which it has complete control. Thus, the transaction is not the type that Congress intended to be treated as a reorganization.

As further evidence that this transaction is not a reorganization, but merely a sale, Taxpayer’s continuing interest in Target is minimal at best. While a corporation may satisfy the continuity of interest requirement through ownership of preferred stock, see Rev. Rul. 71-233, 1971-1 C.B. 113, Taxpayer’s interest in Target through its ownership of the common stock of Acquiring exists in form only, that is, for the sole purpose of trying to satisfy the requirements for a tax-free reorganization. As stated in § 1.368-1(e)(1)(i), “all facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved.” In this transaction, however, the preferred stock owned by Acquiring in Target is of such little value that only in the most extreme circumstances will the value of Acquiring’s assets, and thus Taxpayer's value, be impacted whatsoever. Under these circumstances, Taxpayer does not have a true continuing interest in Target.

Section 351. Section 351(a) provides that no gain or loss shall 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 § 368(c)) of the corporation. It has been asserted that § 351 applies to the transaction. The appreciated property for which Taxpayer asserts the nonrecognition protection of § 351 is the stock of Target.

However, for the reasons discussed below, § 351 does not apply to the transaction. First, § 351(e) provides that § 351 does not apply to a transfer of property to an investment company. Section 351(e)(1) provides that the determination of whether a company is an investment company shall be made by taking into account all stock and securities of the company and by treating money as stocks and securities. Section 1.351-1(c)(1) provides, in part, that a transfer of property will be considered to be a transfer to an investment company if (i) the transfer results in the diversification of the transferors' interests, and (ii) the transferee is a corporation more than 80 percent of the value of whose assets are held for investment and are readily marketable stocks or securities.[1] Since LLC is treated as a disregarded entity for Federal income tax purposes, its assets, that is, the cash, is treated as directly held by Acquiring. Hence, Acquiring's assets being almost all cash (well over the 80% threshold of §1.351-1(c)(1)(ii)), § 351 is not available to Taxpayer for the transfers to Acquiring. (Even if LLC is not a disregarded entity for Federal income tax purposes, Acquiring's interest in LLC would be treated as stocks and securities of an entity substantially all of whose assets consist of cash, and Acquiring would still be an investment company. Section 351(e)(1)(B)(vi).)

Second, as discussed above in the reorganization context, the transaction represents in substance a sale by Taxpayer of its interest in Target, and hence is not the kind of the transaction § 351 was intended to cover. Section 351 is meant to cover mere changes in form of doing business, not what is effectively a sale of the asset transferred.

> It is the purpose of [§ 351] to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really "cashed in" on the theoretical gain, or closed out a losing venture.

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[1] Section 1.351-1(c)(1)(ii), which states that cash is excluded in determining whether more than 80 percent of a corporation's assets are held for investment and are readily marketable stocks or securities, was overridden, in relevant part, by § 351(e). See Staff of Joint Committee on Taxation, 105th Cong., 2nd Sess., General Explanation of Tax Legislation Enacted in 1997 (Comm. Print 1997).

Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940), cert. denied, 310 U.S. 650 (1940). Thus, for this reason, too, § 351 does not apply.

Section 269. Section 269(a) provides:

> If (1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or (2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the 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.

Section 1.269-1(a) provides:

> The term "allowance" refers to anything in the internal revenue laws which has the effect of diminishing tax liability. The term includes, among other things, a deduction, a credit, an adjustment, an exemption, or an exclusion.

Section 1.269-2(b) provides:

> The principle of law making an amount unavailable as a deduction, credit, or other allowance in cases in which the effect of making an amount so available would be to distort the liability of the taxpayer has been judicially recognized and applied in several cases. Included in these cases are Gregory v. Helvering . . . .

Section 269(a) disallows the benefit of a deduction, credit, or other allowance to a person or corporation if that person or corporation acquired control of another corporation with the principal purpose of evasion or avoidance of Federal income tax. Section 1.269-1(a) defines an “allowance” as anything in the Internal Revenue Code that has the effect of diminishing tax liability. The nonrecognition treatment provided by §§ 368 and 351 is therefore an allowance. Furthermore, in the transaction, Taxpayer acquires control (measured by value) of Acquiring. Thus, if the transaction is undertaken with the principal purpose of evading or avoiding Federal income tax, § 269 can apply to deny the nonrecognition treatment of §§ 368 and 351 to Taxpayer.

Taxpayer's attempted use of §§ 368 and 351 is similar to the abuse found by the Court in Gregory v. Helvering. Taxpayer acquires control of Acquiring (by acquiring stock in Acquiring representing at least 50 percent of the total value of all its outstanding stock) for the principal purpose of securing the benefit of §§ 368 and 351. The principal purpose, if not the sole purpose, for the acquisition of control of Acquiring by Taxpayer is to evade or avoid Federal income tax. There is no intention to readjust corporate structures as required under § 368 or similar readjustment as necessary under § 351, as is evidenced by the minimal continuing interest of Taxpayer in Target. The intention is merely to dispose of Target, and the complex transactions are undertaken for the principal purpose of avoiding taxation on the disposition. Taxpayer could, and if not for tax evasion or avoidance purposes would, in a much simpler transaction, simply sell its interests in Target. In summary, while Taxpayer presumably has legitimate business purposes for disposing of Target, it clearly has a tax evasion or avoidance purpose for structuring the disposition as described above. Section 269 thus disallows Taxpayer's use of §§ 368 and 351.

The Service recognizes the existence of counter authorities to the use of § 269 to prevent nonrecognition treatment. In Cherry v. U.S., 264 F. Supp. 969 (C.D. Cal. 1967), the Service attempted to use § 269 to stop the taxpayer's receiving nonrecognition treatment under §§ 336 and 453. The court noted that under § 336 no gain or loss is to be "recognized" to a corporation when it distributes property to its shareholders in liquidation, and under § 453(d)(4)(A) no gain or loss is to be "recognized" on the distributions of installment obligations in the liquidation of subsidiary corporations. The court stated that the term "recognized," like the term "realized," is a technical term used in the Internal Revenue Code; and that likewise the terms "deduction," "credit," and "allowance," as used in § 269, are technical terms, each having its precise meaning in the Internal Revenue Code. The court held that statutory provisions dealing with nonrecognition of gain, as in §§ 336 and 453(d)(4)(A), are not encompassed by the terms "deduction," "credit," or "allowance" and that § 269 does not deal with nonrecognition concepts. See also Bijou Park Properties, Inc. v. Commissioner, 47 T.C. 207 (1966). Such reasoning, if correct, might also block the Service's using § 269 to deny the use of §§ 351 and 368 to taxpayers in otherwise appropriate cases.

The Service disagrees with these authorities. Cherry, Ray K., 1969 AOD Lexis 324 (Nov. 20, 1969); Bijou Park Properties, Inc., acq. in result only, 1967 AOD Lexis 41 (Oct. 27, 1967). As stated above, § 1.269-1(a), promulgated in 1962, provides that the term "allowance" refers to anything in the Internal Revenue Code that has the effect of diminishing tax liability. Certainly, the nonrecognition of gain on a “sale” of stock has the effect of diminishing tax liability. Thus, it is the Service’s position that such nonrecognition is an allowance within the meaning of § 269 and thus § 269 can apply to deny nonrecognition treatment.

The Service may impose penalties on participants in these transactions, or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

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